Dear Mrs Healy

Invitation to Comment – Enhancing Audit Quality in the Public Interest – A focus on Professional Skepticism, Quality Control and Group Audits (ITC)

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the ITC. We commend the IAASB for the comprehensive and thoughtful discussion put forth in the ITC. We largely support the IAASB’s proposed actions set out in the ITC and believe, subject to our recommendations, that they have the potential to significantly enhance audit quality and the value of audit. We have provided a summary of our key recommendations below in relation to the three topics, and explain these recommendations in more detail in our response to the specific questions posed by the IAASB that we have set out in Appendix 1.

Professional Scepticism (Section 2 of Appendix 1)

We agree with the IAASB that the interpretation and application of professional scepticism is a critical aspect of audit, and audit quality. Given the fact that concerns continue to be raised that auditors do not appropriately apply professional scepticism in the audit, it is in the public interest that the IAASB explore these issues further. In response to concerns similar to those raised in the ITC regarding the need to strengthen the application of professional scepticism in audits, in 2012, following a public consultation, the FRC published Professional Scepticism: Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality which sets out our views on the nature of auditor scepticism and its role in the audit1 (‘Briefing Paper’).

A sceptical attitude is absolutely fundamental in delivering a rigorous and high quality audit. We believe that it should frame each of the judgments made by the auditor at every stage of the audit from risk assessment to forming the audit conclusion and reporting. These judgments define all the actions that the auditor takes in performing the audit and ultimately how effective those actions are in delivering a rigorous and high quality audit. Such an audit should obtain a high level of assurance (subject to the inherent limitations of an audit), and engender user2 confidence and trust, that

2 A ‘user’ for the purpose of this response letter is an abbreviation of ‘intended users’ of the auditor’s report (and the audited financial statements) which is described in the international auditing standards (ISA 200.3). As explained in paragraph 2 of ISA 320 ‘Materiality’, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. ISA 320 also explains that investors are providers of risk capital to the enterprise, and the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

18 May 2016

Mrs Kathleen Healy
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
6th Floor
New York
NY 10017
USA
misstatements in the financial statements have been detected and either corrected or identified in the auditor’s report.

The definition of professional scepticism\(^3\) (set out in ISA 200\(^4\)) incorporates three examples of how a sceptical attitude should be expressed in the audit (a questioning mind; alertness to possible misstatement; and critical appraisal of evidence). These are important ingredients of its expression but we believe they need to be further developed to ensure that auditors understand and deliver more consistently what is expected of them in applying professional scepticism in the audit.

Our experience as an audit regulator is that when auditors fail to apply professional scepticism appropriately it is because they fail to act appropriately on their understanding of which matters they should challenge, the extent of their challenge in relation to those matters, and what evidence they should obtain to satisfy those challenges. As set out in our Briefing Paper, and summarised on page 3, we believe that embedding a user perspective would assist auditors to apply the appropriate level of professional scepticism. The user perspective is critical if the auditor is to win user confidence and trust and deliver on the intended purpose of an audit, to enhance the credibility of the financial statements for users. In our experience, users are increasingly using the financial statements and other information to inform their stewardship of the entities in which they invest.

We would therefore encourage the IAASB to focus its work primarily on the more practical aspects of professional scepticism. In particular, we believe the IAASB should:

A. **Enhance the description of what the expression of professional scepticism is expected to look like**

As explained above, the three examples in the definition may not be inappropriate in themselves but they are not sufficient and we believe they should be expanded to include:

- not only a questioning mind but one that robustly evaluates management’s assertions;
- not only being alert to the potential for misstatement but remaining open minded, probing and proactive about the potential for misstatement, notwithstanding past experience and the absence of manifest indicators of that potential having been realised;
- not only a critical appraisal of the evidence that management presents but also subjecting it to robust challenge through comparison with other relevant available sources of evidence whether those contradict or corroborate management’s position; and
- the need to reflect the perspective of the user in applying professional scepticism.

B. **Review and improve language used in the standards to reflect the enhancements referred to in A above, to support changes in auditor behaviour**

We believe that making such changes needs to be co-ordinated with other actions to change behaviour (see C and D below) but we do not believe that simply inserting in the standards further reminders that the auditor should apply professional scepticism would be enough to support behavioural change.

C. **Require auditors to identify risks to the appropriate application of professional scepticism and to respond by identifying and implementing appropriate actions to mitigate those risks**

This should be a part of developing the quality control standards. Factors that may give rise to such risks and that we believe should be addressed in the quality control standards include:

\(^3\) Professional Scepticism – 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 (ISA 200.13)

\(^4\) ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
in sufficient competence in understanding and responding to factors that may incentivise or
dis-incentivise the application of professional scepticism by auditors – for example,
deadlines or budget constraints and the behaviour of: those who direct, supervise and
review the audit work; or management; or those charged with governance;
the impact of audit firm culture and governance and how this can support or undermine the
application of professional scepticism;
in sufficient competence in understanding the entity and its business and the environment
in which it operates – to enable informed and independent challenge of management’s
assertions; and
insufficient competence in the identification of risks of material misstatement and in
understanding their root causes (including the implications of change, uncertainty,
ambiguity and complexity, whether in the financial reporting framework or in the entity and
its business and the environment in which it operates or the system of internal control, and
the conditioned and motivated behaviour of relevant individuals within the entity or its
environment).

D. Work pro-actively with the IAESB to develop a better understanding of the behavioural
competence that auditors need and how they can acquire and maintain that competence

We recently recommended that the IAESB should consider behaviour as a separate
competence area and should seek to understand behavioural influences over matters such as
the appropriate application of professional scepticism and more generally how an individual’s
professional skills can be developed to better enable them to self-regulate their own behaviour
and to understand and influence others’ behaviours.

Core principles to guide standard setting activity (Section 1 of Appendix 1)

We support the approach of the IAASB to identify specific public interest issues in relation to the
three projects set out in Table 1 of the ITC. We believe that the IAASB could consider taking this
approach a step further and develop a set of core principles that would guide its future standard
setting activity in serving the public interest. For example, we believe that ‘Transparency for Users’
could be established as a core principle. In meeting such a principle, the IAASB would aim to
ensure that the outcome of its standard setting activity will result in investors and other stakeholders
(such as those charged with governance) having greater insight into the audit process and audit
firm governance. Related to ‘Transparency for Users’, we have also proposed another core
principle ‘Embedding a User Perspective’, described further below.

Embedding a user perspective throughout the audit

We believe that the IAASB should also consider how to embed the perspective of users more widely
in the entire audit process. To be effective, embedding a user perspective should include not only
considering how to require that perspective to be taken into account, but also how the auditor
obtains and maintains their understanding of user expectations. It should therefore involve
consideration of mechanisms for communications between users and audit firms and auditors,
including requirements for Transparency Reporting by audit firms and additional auditor reporting
about matters relevant to audit quality (such as the auditor’s materiality judgments and their
approach to the audit, in the context not only of risks of material misstatement but also of risks to
audit quality). For example, under the ISAs (UK and Ireland) we require auditors of public interest
entities to report on matters relating to materiality and audit scope.

In respect of professional scepticism, embedding a user perspective would include considering
how to require auditors to be able to demonstrate that they have adequately taken into account
what users would expect them to ask, what matters users would expect them to challenge, how far
users would expect them to go in challenging those matters, and ultimately what evidence users would expect them to obtain to satisfy those challenges. We also highlight in our response ways in which a user perspective might be embedded in the quality control standards and in relation to group audits.

Quality Control (Section 3 of Appendix 1)

Outcome of a high quality audit

We believe that an important starting point for any discussion of quality control is to agree what the outcome of a high quality audit looks like. We therefore believe it is important for the IAASB to set out the expected outcome of a high quality audit and then to demonstrate how the various factors identified in the audit quality framework\(^5\) are addressed in the quality control standards in the context of that outcome. In this regard, we propose two key outcomes of a high quality audit:

1. The audit has obtained a high level of assurance (subject to the inherent limitations of an audit) that misstatements (if any) in the financial statements would have been detected, and either corrected or identified in the auditor’s report; and

2. This has been achieved in a manner that serves the intended purpose of an audit to enhance the degree of confidence and trust of intended users in the financial statements through meeting their expectations.\(^6\)

Quality Management Approach

We fully support the IAASB’s plan to revise ISQC 1 and ISA 220 to respond to the issues and challenges in quality control. We agree with the IAASB that these standards are no longer sufficient to support audit firms in today’s complex and challenging business environment.

We strongly support the introduction of the Quality Management Approach (QMA) in ISQC 1. It responds well to the diverse challenges being raised, including those relating to the proportional application of ISQC 1 and its future-proofing, as it is a more proactive, scalable and robust response to managing risks to quality at the firm level.

Whereas the audit model in the ISAs has reflected a risk-based approach for risks of material misstatement for some time, it continues to reflect a more passive approach to addressing risks to audit quality, with required responses to those risks ‘hard-wired’ into the quality control standards. The proposed QMA would introduce a risk-based approach for risks to audit quality at the firm level. Key benefits of doing so include: focusing the firm’s resources on the areas of greatest risk to audit quality; making application of the standard more scalable, given the extent and nature of an individual firm’s audit activities and of its exposure to risks to audit quality; and making application of the standard more responsive to emerging risks to audit quality in a changing environment.

Overseeing such an approach would provide a potentially direct role for (and enhanced communications with) the audit firm’s governance function, particularly where this includes independent representation. Indirectly, such an approach may also provide a basis for enhanced Transparency Reporting by audit firms and related engagement with audit stakeholders.

Risk-based approach to risks to audit quality at the engagement level

\(^{5}\) IAASB Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality (audit quality framework)
\(^{6}\) ISA 200.3 describes the purpose of an audit, which is to ‘enhance the degree of confidence of intended users in the financial statements’.
We also strongly encourage the IAASB to pursue a similarly risk-based approach to risks to audit quality at the engagement level by building into ISA 220 (and ISA 600) a more proactive, scalable and robust approach to the identification of such risks and development of specific responses to address these risks. This would extend the benefits referred to above in relation to the proposed QMA, to each audit engagement (QMA-EL). By directly assessing risks to quality at the engagement level, the engagement partner would be in a more informed position to appropriately tailor the direction, supervision and review procedures to control and mitigate those risks. We believe this will be the most meaningful way for the IAASB to address the challenges identified in relation to quality control at the engagement level, and will result in more effective audits.

This approach, taken together with our proposal to embed a user perspective more widely in the audit process would, for example, provide a basis for addressing a common theme running through the ITC that in today’s environment engagement partners are finding it increasingly challenging to meet their overall responsibility set out in ISA 220 for the performance of audits – including demonstrating appropriate direction, supervision and review throughout the audit. For example, the ITC identifies issues in demonstrating sufficient involvement in the work of the audit engagement team and component auditors and in the work of specialists, experts or other auditors.

It could also bring additional benefits in providing an enhanced basis for communications with audit committees in their oversight of the audit relationship. It could also provide an enhanced basis for user transparency about the audit through extended auditor reporting about such matters.

**Role and responsibility of the engagement partner**

We believe that a fundamental principle in the ISAs is that the engagement partner has overall responsibility for the engagement. Accordingly we do not support the proposal in the ITC for the IAASB to explore the ability to use another auditor’s report as audit evidence in certain circumstances. In the case of a group audit, the conclusion is premised upon each of the judgments made by the group auditor throughout the audit. The principle in the ISAs today is that the group auditor must be sufficiently involved in the work of any other auditor to effectively direct, supervise and review that work and therefore be in a position to stand behind the key judgments made.

It would appear that the IAASB’s proposals are seeking to address access issues for the group auditor. However, the ISAs already address access issues as an acceptance and/or qualification matter. We believe that this is the right approach and in the public interest because it will appropriately signal to investors that such a situation exists and that the auditor was not able to protect investors’ interest by providing an independent view on the component’s financial information.

The IAASB also proposes to clarify the performance requirements for other parties involved in the audit. We are supportive of greater transparency about the nature and extent of involvement of other parties in the audit, for example, by providing such information in extended auditor reporting about how the scope of the audit addressed certain risks to audit quality. However, we would not support reporting about such matters in the auditor’s report in a manner that would undermine the core principle in the ISAs that the engagement partner assumes overall responsibility for the audit. Doing so in such a manner could send an inappropriate signal about the reliability of the financial statements and could undermine investor confidence.

**Reliance on other network firms**

We strongly support the IAASB’s proposals to re-address the quality aspects of ‘network firms’ in response to issues that have been raised in relation to undue reliance by firms and engagement teams on the network’s system of quality control. The ISAs should provide a robust basis for the use of the work of any other firm of auditors, whether or not a network firm, in the performance of
an audit. This should reflect the fundamental principle that the principal auditor takes responsibility for all of the other auditor’s work and the conclusions drawn from that work. Quality control over the work of any other firm whose work is used in the audit should, in our view, involve a ‘risk based’ approach. Where the principal auditor believes it is appropriate to place some reliance on the network level controls over risks to audit quality relating to the use of the work of another firm, the ISAs should clearly set out the principal auditor’s responsibilities. We believe that the principles in ISA 315 and ISA 330 in relation to reliance on entity controls over risks of material misstatement are a reasonable source of analogous material to guide the IAASB in doing so. We believe that a similar approach should be taken in relation to Audit Delivery Models.

Other matters

Amongst the other matters relating to quality control, we believe that there are a number of areas of particular significance including Audit Firm Governance, Engagement Quality Control Reviews, Monitoring and Remediation, including root cause analysis, and Transparency Reporting.

Particularly in connection with Audit Firm Governance we will in the next few months be issuing an updated UK Audit Firm Governance Code clarifying the objective of governance over audit quality and risks thereto. Our experience in promoting high quality corporate governance is that clarity of purpose and independent yet diverse input are key. Many of these lessons to our mind “read across” to the promotion of high quality audit.

Group Audits (Section 4 of Appendix 1)

We fully support the IAASB’s plan to revise ISA 600 to respond to the issues and challenges in performing group audits. We agree with the IAASB that ISA 600 is no longer sufficient to support engagement teams in addressing the audit challenges that arise in audits of groups in today’s evolving global business environment.

We believe that the theme mentioned above as running through the ITC (that engagement partners are finding it increasingly challenging to meet their overall responsibility set out in ISA 220 for the performance of audits) is particularly observable in the group audits section of the ITC. In that regard, we support the proposal for the IAASB to strengthen the links to the principles and requirements in ISQC 1 and ISA 220, and in particular we further encourage the introduction of a quality risk based approach (to group audits) through a QMA-EL.

We also support the proposals of the IAASB to strengthen the links in ISA 600 to the principles, requirements and related application material of ISA 315, and other relevant ISAs such as ISA 330, so as to better support engagement teams’ application of those ISAs in the context of a group audit engagement.

This includes our support for re-examining the validity of the mechanisms for scoping a group audit in ISA 600 i.e. focusing the determination of the necessary work effort on the basis of whether components are considered significant or non-significant, and on risk assessment of, primarily, significant components. We believe that these mechanisms are more consistent with a ‘bottom-up’ approach to the audit rather than a ‘top down’ approach. A ‘top down’ approach results in the assessment of risks at the level of the group and drives responses to those risks down to the component level through stronger two-way communication with the component auditors. We consider that pro-active two-way communication should be encouraged.
Development of future work plans (Section 1 of Appendix 1)

In the development of future work plans we believe that there are key topics that should be taken into account and prioritised in the IAASB Work Plan 2017-18 including: ISA 620\textsuperscript{7}; ISA 320\textsuperscript{8} and ISA 330\textsuperscript{9}.

Yours sincerely

Melanie McLaren
Executive Director, Audit

---

\textsuperscript{7} ISA 620 Using the Work of an Auditor’s Expert
\textsuperscript{8} ISA 320 Materiality in Planning and Performing an Audit
\textsuperscript{9} ISA 330 The Auditor’s Responses to Assessed Risks
1. General Questions

<table>
<thead>
<tr>
<th>General Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>G1.</strong> 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:</td>
</tr>
<tr>
<td>(a) Are these public interest issues relevant to our work on these topics?</td>
</tr>
<tr>
<td>(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.</td>
</tr>
<tr>
<td>(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.</td>
</tr>
</tbody>
</table>

### Public Interest Issues

The IAASB develops international audit and assurance standards (IAASB pronouncements) that are used widely around the world, and thus the standard setting activity of the IAASB is correctly motivated by the public interest. The IAASB has emphasised in its Strategy for 2015–2019: *Fulfilling Our Public Interest Mandate in an Evolving World*[^10] that the IAASB’s mandate is to set (i.e. develop), independently and under its own authority, high-quality international standards to serve the public interest, but what is not clear is how the IAASB’s consideration of the public interest is executed when developing individual requirements (and guidance). We therefore support the approach of the IAASB to identify specific public interest issues in relation to the three projects that can be taken into consideration, and we support those set out in Table 1.

**Core principles to guide standard setting activity**

In addition, we believe that the IAASB could consider taking this a step further to develop a set of core principles that would guide its future standard setting activity in serving the public interest. Indeed, some of the issues raised in Table 1 of the ITC could be considered such core principles. For example:

- **Transparency for Users**

  Table 1 notes that “Exploring Transparency and its role in audit quality” is a relevant public interest issue related to professional scepticism, quality control and group audits. We believe that ‘Transparency for Users’ could be established as a core public interest principle, as it is of general relevance in relation to audit. It is an issue commonly raised in our outreach activity with investors i.e. that greater transparency regarding the audit process and audit firm governance would be welcomed. In meeting a “Transparency” principle, the IAASB would aim to ensure that the performance outcome of its standard setting activity (i.e. its impact on what the auditor does), should result in users[^11], those charged with governance and oversight of the audit relationship (in many cases the audit committee), and other stakeholders, having greater insight into the audit process and audit firm governance. In turn, such insight should enhance:

[^11]: A ‘user’ for the purpose of this response letter is the intended user of the financial statements as described in paragraph 2 of ISA 320 Materiality.
General Questions

− engagement when it is believed that action is needed to better meet user expectations;
− the accountability of audit firms and audit engagement partners for meeting their audit quality responsibilities; and
− user and public confidence and trust in the value of audit.

In relation to the issues raised in the ITC, we believe that the IAASB should aim to further strengthen the transparency of how audit firms meet their responsibilities for audit quality (including through their networks), and of how engagement partners meet their responsibilities for audit quality at the engagement level, by establishing enhanced requirements and application material. This should include greater transparency about audit firm governance and how the firm’s quality management system enables the delivery of high quality audits in an evolving business and audit environment and, for particular audits, as well as how quality control is managed and delivered at the engagement level. Such transparency could be achieved as appropriate through, for example, communications with audit committees, and further enhancements to the auditor’s report or transparency reporting (as described further in this Appendix).

• The User Perspective

Related to transparency for users, as explained in our response to PS1, we concluded that the ISAs need to embed the importance of considering the user perspective more widely. Whilst auditors are already required to consider the perspective of users through their application of the concept of materiality in identifying and addressing potential misstatements, the ISAs do not require the auditor to apply this process in other aspects of the audit. In meeting a “User Perspective” principle, the IAASB would aim to ensure that the performance outcome of its standard setting activity should result in an enhanced auditor focus on ensuring that the nature and extent of actions they take throughout the audit are aligned with the user perspective. In our experience users are increasingly seeking information and insight to support their stewardship of the entities in which they invest.

Not dissimilar to the objectives of a conceptual framework, a soundly developed set of core public interest principles could also assist auditors and other stakeholders in better understanding and interpreting auditing standards, including when there is no specific material dealing with a particular circumstance that arises.

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

Development of future work plans

With respect to the development of future work plans, we draw attention to the following:

Using the work of experts
General Questions

- The FRC response to the Post-Implementation Review of the Clarified International Standards on Auditing\(^{12}\) highlighted a number of issues that have arisen from the implementation of ISA 620\(^{13}\) and we recommended a number of revisions that could be made to improve audit quality in this regard. Paragraph 95 of the ITC also specifically highlights concerns that have been raised about situations where the auditor's considerations around using the work of auditor's experts, such as understanding the expert's field of expertise and evaluating the adequacy of the expert's work, are not adequately performed or demonstrated. ISA 620 also affects other active IAASB projects, particularly ISA 540\(^{14}\), where the IAASB have already noted the need to consider if the requirements and application material should be enhanced in relation to the work of experts when dealing with complex accounting estimates. Accordingly, we recommend that ISA 620 should be revised in order to address the issues that have been identified and we encourage the IAASB to include a new project related to the possible revision of ISA 620, in its Work Plan 2017–2018.

ISA 320 – Materiality

- In the IAASB’s Clarified ISAs Post-Implementation Review—Report on Findings, it was noted that concerns were expressed about the inconsistency in the determination of both materiality and performance materiality, with a general call for greater guidance. In particular, the need for a strengthened framework for auditor judgments regarding materiality; to improve the consistent application of the concept in planning and performing the audit; and to enhance the consistency by which misstatements identified in an audit are accumulated and evaluated. More recently, many respondents to the Disclosures ED\(^{15}\) including the FRC, echoed these concerns noting that more requirements and guidance would be needed to address how the concept of materiality is to be applied to disclosures. We understand that the IAASB further explored the implications and feasibility of introducing new requirements and guidance at the time of the disclosures project, but agreed to make minor changes to guidance to address some of the concerns raised about qualitative disclosures and instead to wait for the IASB to progress its work on materiality before proceeding with the development of significant changes to the requirements in ISA 320. In this respect whilst we supported the decision of the IAASB, the matter of materiality, as a result of its learnings from the post-implementation review and the disclosures project, should be included in the IAASB’s Work Plan 2017–18.

ISA 330\(^{16}\) - Sufficient appropriate audit evidence

- In the IAASB’s Clarified ISAs Post-Implementation Review—Report on Findings, it was noted that concerns were expressed about the challenges auditors face in respect of obtaining sufficient appropriate audit evidence. A few respondents, including the FRC, noted concerns relating to testing internal controls, including inadequate testing of general IT controls. More recently, some respondents to the Disclosures ED\(^{17}\) suggested additional guidance was needed to address the challenges in obtaining sufficient appropriate audit evidence when auditing certain disclosures. The IAASB did note in the Disclosures project—

---


\(^{13}\) ISA 620 Using the Work of an Auditor’s Expert

\(^{14}\) ISA 540 Auditing Accounting Estimates Including Fair Value Accounting Estimates and Related Disclosures

\(^{15}\) In May 2014, the IAASB published an Exposure Draft, Proposed Changes to the International Standards on Auditing: Addressing Disclosures in the Audit of Financial Statements (Disclosures ED), which proposed changes to ten ISAs.

\(^{16}\) ISA 330 The Auditor's Responses to Assessed Risks

General Questions

Basis for Conclusions document that as part of its consultations on the Work Plan 2017–2018, the IAASB may determine that it should include a new project related to disclosures, relating to sufficient appropriate audit evidence. However, the challenges raised in the post implementation review and disclosures project, together with the challenges of obtaining sufficient appropriate audit evidence in relation to other active IAASB projects, particularly ISA 540 (and ISA 315), strongly suggest that ISA 330 should be included in the IAASB’s Work Plan 2017-18 and we would encourage the IAASB to include a new project related to the possible revision of ISA 330.

G3. Are you aware of any published, planned or ongoing academic research studies that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.

Published, planned or ongoing academic research studies

Joint FRC/ICAS Research

In 2013, the FRC and ICAS commissioned two international teams of researchers to investigate what mix of skills and qualities are needed in an audit team for it to perform high quality public interest audits in a modern and complex global business environment. The resulting independent research reports were published at the beginning of April 2016, entitled Skills, Competencies and the Sustainability of the Modern Audit and The Capability and Competency Requirements of Auditors in Today’s Complex Global Business Environment. The reports discuss a number of matters that have been highlighted in the ITC, including the need for the profession to keep pace with changing expectations and evolve to meet the needs of stakeholders and society, and may be useful to the IAASB as it deliberates the three topics discussed in the consultation.

FRC Publications

We would also like to draw attention to the work of the FRC in relation to the three topics that we discuss further in this response letter. In particular:

- FRC Audit Quality Review Team Thematic Reviews (see Quality Control)
- FRC Professional Scepticism publications (see Professional Scepticism)
- FRC Audit Quality publications – including the Audit Quality – Practice Aid for Audit Committees (see Quality Control)
- FRC Audit Quality Review Team – Annual Inspection Reports (2014/15 and 2015/16 which will be issued shortly after this letter)

---

18 https://www.ifac.org/publications-resources/addressing-disclosures-audit-financial-statements
### General Questions

#### Revised FRC Audit Firm Governance Code and Audit Firm Culture

Specific to the important role of audit firm and network firm culture in promoting audit quality, we will be issuing a revised Audit Firm Governance Code in 2016. In addition, the FRC are considering ways in which audit firms can most effectively establish firm culture from the findings of our project to review how boards can most effectively establish company culture and practices that embed good corporate behaviour. The findings from this project may be useful to the IAASB in its discussions about the importance of tone at the top and audit governance.
2. Professional Scepticism

<table>
<thead>
<tr>
<th>Professional Scepticism</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>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?</strong></td>
</tr>
</tbody>
</table>

**Interpretation of the concept of professional scepticism**

In 2010, the FRC released a *Discussion Paper: Auditor Scepticism: Raising the Bar*\(^21\) in response to concerns similar to those raised in the ITC regarding the need to strengthen the application of professional scepticism in audits. A feedback paper was published in March 2011\(^22\), which outlined the action that the FRC intended to take. A key first action was to establish a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit. Accordingly in March 2012 the FRC published *Professional Scepticism: Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality*\(^23\) (‘Briefing paper’).

**Elements of the concept of professional scepticism**

The FRC identified and sought input on two elements of the concept of professional scepticism: (a) an auditor’s ‘initial mind-set’; and (b) a ‘sliding scale’ of action by the auditor in applying professional scepticism in response to audit findings.

We found some inconsistency in understanding of the expected initial mind-set. In particular, some supported a view that it should reflect a ‘neutral’ attitude to ‘trust’ in management and to the expectation that there may be misstatements. Others thought that it should reflect a more challenging attitude that exhibits *a heightened awareness of the risk that the figures could be affected by error or dishonesty*, which we had referred to as ‘presumptive doubt’. There was a strong negative reaction to this term from many respondents, on the basis that it could imply a wholly distrusting attitude that might not be justified. As a result, the FRC concluded that the term ‘presumptive doubt’ would not be helpful in establishing a common understanding of the required initial mind-set.

However, the FRC concluded that professional scepticism could not be described as a ‘neutral’ attitude either. The ISAs describe an attitude that includes a ‘questioning mind’ and an awareness of (being alert to) conditions which may indicate potential misstatement, *notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance*. The FRC was concerned that a ‘neutral’ attitude would be seen as too passive and would imply that the auditor’s role could be limited to ensuring that management have appropriate evidence to support its assertions. The FRC did not accept this if it meant accepting the evidence management presents without subjecting it to robust challenge and comparison to alternative sources of evidence.

This was particularly important given that:

\(^{21}\) https://www.frc.org.uk/getattachment/2a1e0146-a92c-4b7e-bf33-305b3b10fcd2


**Professional Scepticism**

- Professional scepticism is applied during the planning process to assess the risk of material misstatement in the different elements of the financial statements and that these risk assessments are fundamental in determining the actions to be taken by the auditor and the nature and extent of evidence to be obtained as the basis for the audit opinion; and
- Many items in the financial statements are accounting estimates, which require management judgment and are susceptible to management bias.

We would encourage the IAASB to consider the Briefing paper more fully in their work but wish to highlight some of the key conclusions that it set out:

**Professional scepticism and its role in the audit**

The FRC concluded that, in essence, the perception and reality of the expression of professional scepticism underpins the confidence and trust in the audit that users develop and in turn the confidence they have in the audited financial statements. This is because professional scepticism underpins the quality of each audit judgment and, through these judgments, the overall effectiveness of the audit in addressing the challenges it faces in meeting the needs of shareholders and other stakeholders (users) for whose benefit the audit is performed. Further, the appropriate application of professional scepticism in the audit therefore requires a mindset which rigorously questions and challenges management’s assertions with an attitude that reflects the expression of an attitude of doubt that is consistent with the expectations of those users. Such an attitude would demand strong evidence to back each audit judgment – and ultimately to back management’s assertion that the financial statements give a true and fair view - that would be convincing and persuasive to users. Accordingly, all judgments made in the course of the audit should be founded on the perspective of the users.

**Aligning performance outcomes with the perspective of users**

In exploring what this would mean from a practical perspective for auditors, we concluded that the ISAs need to embed the importance of considering the user perspective more widely. When conducting the audit, the auditor should focus on ensuring that the nature and extent of the actions they take throughout the audit - i.e. from the understanding and planning phases right through to the conclusion and reporting phases (“performance outcomes”) - are aligned with the user perspective. Auditors are already familiar with this concept because the auditor is required to consider the perspective of users through its application of the concept of materiality in identifying and addressing potential misstatements. However, the ISAs do not require the auditor to apply this process in other aspects of the audit.

**Strengthening the application of professional scepticism in audits**

Accordingly, in order to strengthen the application of professional scepticism in audits, we believe that the IAASB should focus on developing a description of what the application of professional scepticism should look like that can be consistently understood, including embedding the concept of aligning performance outcomes with the user perspective throughout the audit. For example, considering how to require auditors to demonstrate that they have adequately considered what users would expect them to understand about the business, what areas of the business users might consider would give rise to risks of material misstatement, what matters users would expect them to challenge, how far users would expect them to go in challenging those matters, and what evidence users would expect them
Professional Scepticism

To obtain to satisfy those challenges. We would encourage the IAASB to address the following matters in this context:

A. Enhance the description of what the expression of professional scepticism is expected to look like

The three examples in the definition may not be inappropriate in themselves but they are not sufficient and we believe they should be expanded to include:
- not only a questioning mind but one that robustly evaluates management’s assertions;
- not only being alert (a passive, neutral and reactive approach) to the potential for misstatement but remaining open minded, probing and proactive about the potential for misstatement, notwithstanding past experience and the absence of manifest indicators of that potential having been realised;
- not only a critical appraisal of the evidence that management presents but also subjecting it to robust challenge through comparison with other relevant available sources of evidence whether those contradict or corroborate management’s position; and
- the need to reflect the perspective of the user in applying professional scepticism.

B. Review and improve language used in the standards to reflect the enhancements referred to in A above, to support changes in auditor behaviour

We believe that making such changes needs to be co-ordinated with other actions to change behaviour (see C and D below) but we do not believe that simply inserting in the standards further reminders that the auditor should apply professional scepticism would be enough to support behavioural change.

C. Require auditors to identify risks to the appropriate application of professional scepticism and to respond by identifying and implementing appropriate actions to mitigate those risks

This should be a part of developing the quality control standards. Factors that may give rise to such risks and that we believe should be addressed in the quality control standards include:
- insufficient competence in understanding and responding to factors that may incentivise or dis-incentivise the application of professional scepticism by auditors – for example, deadlines or budget constraints and the behaviour of: those who direct, supervise and review the audit work; or management; or those charged with governance;
- the impact of audit firm culture and governance and how this can support or undermine the application of professional scepticism;
- insufficient competence in understanding the entity and its business and the environment in which it operates – to enable informed and independent challenge of management’s assertions; and
- insufficient competence in the identification of risks of material misstatement and in understanding their root causes (including the implications of change, uncertainty, ambiguity and complexity, whether in the financial reporting framework or in the entity and its business and the environment in which it operates or the system of internal control, and the conditioned and motivated behaviour of relevant individuals within the entity or its environment).
Professional Scepticism

D. Work pro-actively with the IAESB to develop a better understanding of the behavioural competence that auditors need and how they can acquire and maintain that competence

We recently recommended that the IAESB should consider behaviour as a separate competence area and should seek to understand behavioural influences over matters such as the appropriate application of professional scepticism and more generally how an individual’s professional skills can be developed to better enable them to self-regulate their own behaviour and to understand and influence others’ behaviours.

We recognise that understanding the user perspective may be challenging for auditors. However, the FRC’s and the IAASB’s auditor reporting initiatives have already made significant progress in this regard. The FRC reviews of the experience of extended auditor reporting in the UK, for example, have demonstrated that extended reporting has given users a real insight into the audit process, allowing them to better understand it, and has generated a platform for enhanced engagement between auditors and users. In the FRC’s most recent review Extended auditor’s reports: A further review of experience, for example, investors commented on areas where auditor reports could be enhanced further, giving insight into areas that are important to them. For example, sensitivity ranges used in testing; how the quality of an entity’s internal controls impact significant risk assessment; the appropriateness of management estimates including assumptions made by management and benchmarks used by auditors; whether there are significant changes in their audit approach; the level of materiality they used and the assessed risks reported from one year to the next. Our reviews could therefore provide one source of input to the IAASB in taking this matter forward.

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?

Drivers for, and impediments to, the appropriate application of professional scepticism

The FRC Discussion Paper: Auditor Scepticism: Raising the Bar and feedback paper published in March 2011 highlighted a number of drivers for, and impediments to, the appropriate application of professional scepticism that have also been expressed in the ITC, particularly those set out in paragraphs 28 to 32 of the ITC. For example:

- We agree that there is potential for a lack of scepticism or perceived lack of scepticism because auditors are engaged by the audited entity in a way that is relatively detached from the users of the financial statements and auditor’s report. Auditors often have little, if any, direct contact with shareholders throughout the audit process. This emphasises the importance of communications between auditors and users, and aligning performance outcomes with the user’s perspective discussed in PS1.
- We agree that it is important to maintain effective working relationships with management and those charged with governance. However, we do not believe...
that it would be appropriate to do so to the detriment of applying professional scepticism throughout the audit. The challenge for auditors is to be professionally sceptical whilst maintaining those working relationships. This is a professional skill which the auditor must acquire and maintain. In this context it is important to recognise that scepticism is neither distrust nor disbelief of management but rather maintaining an open mind (a state of ‘unbelief’) until the auditor has made their independent evaluation and drawn their own conclusions about a matter. Most audit firms’ business models encourage a culture of building strong relationships with audited entities. This can create familiarity (trust) and self-interest threats for the auditor that could compromise their objectivity or willingness to challenge management to the extent required. There is therefore a strong link between ethical considerations and the application of professional scepticism and we encourage the IAASB to further explore these links with IESBA.

• Similarly there are links between the exercise of professional scepticism and the unconscious heuristic biases that may affect auditors themselves and that are becoming better understood through developments in behavioural science and we encourage the IAASB to continue to consider how such understanding can better help auditors to recognise and mitigate risks (as discussed in paragraph 37).

We support consideration of the areas discussed in paragraph 37, in particular:

Clarifying the concept of professional scepticism (bullet 1)

• As noted in PS1, the responses to the FRC discussion paper did indicate a lack of consensus about the initial mind-set required in the context of professional scepticism and its role in the conduct of an audit, and we therefore encourage the IAASB to consider clarifying and extending the description inherent in the three examples of its expression so that it can be consistently understood.

• The FRC briefing paper, Professional Scepticism: Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality (‘briefing paper’), links the performance outcome of the application of professional scepticism to the user perspective and a wider consideration of the nature of professional scepticism.

Clarifying in the ISAs what is expected from auditors (bullets 2, 6)

• There is a strong call from regulators, the IAASB Consultative Advisory Group and other key stakeholders that the IAASB has responsibility to reinforce the concept of professional scepticism within the ISAs to enhance the robustness and consistency with which it is applied and improve audit quality. Accordingly, as noted in our response to PS1, we agree that professional scepticism needs to be enhanced in the ISAs and that this should be prioritised. However, we believe the IAASB should focus its work on the more practical aspects of professional scepticism that we have proposed in PS1 (embed the perspective of users more widely in the performance outcomes of an audit).

Developing an audit firm environment in which sceptical behaviour is encouraged (bullets 3, 4, 8, 9)

• We also support the IAASB exploring actions set out in paragraph 37 that focus on fostering conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism. As noted in our Briefing paper, the prospects for a sceptical audit are more likely to be enhanced if the environment in which the auditor operates recognises and supports the important role that scepticism plays in the audit. Exploring professional scepticism at the level of the firm is
Professional Scepticism

therefore critical to this project and should be prioritised. For example, consistent with our earlier comments regarding the importance of understanding the user perspective, it is imperative that embedded within the firm culture is the importance of understanding and pursuing the perspective of the users in making audit judgments. In addition, professional scepticism should be embedded in the firm’s training and competency frameworks used for evaluating and rewarding partner and staff performance. We also agree with the IAASB that rigorous engagement quality control reviews that challenge engagement teams’ judgments and conclusions are critical in influencing the appropriate application of professional scepticism.

PS3. Is the listing of areas being explored in paragraph 38–40 complete? If not, what other areas should we or the Joint Working Group consider and why? What do you think are the most important area to be considered?

In December 2012, the FRC responded to calls for input to the IAASB’s Post-Implementation Review of the Clarified International Standards on Auditing and highlighted a number of matters the IAASB could explore in relation to professional scepticism that were drawn from the FRC’s Briefing paper discussed earlier. We propose that, along with our response to PS1 and PS2 above, the IAASB consider these matters in their deliberations. For example, a matter not specifically highlighted above is documentation. As already highlighted in the ITC, the ISAs have a number of documentation requirements that can help demonstrate that a degree of scepticism has been applied, but more needs to be done to make this more transparent both for internal and external review purposes. During our outreach activity, some users suggested that the auditor’s report should set out how scepticism has been exercised (see PS1).

PS4. Do you believe the possible actions we might take in the context of our current projects relating to quality control and group audits will be effective in promoting improved application of professional scepticism? If not, why?

We support the approach outlined in paragraph 38 of the ITC, subject to our response to PS1 that proposes that the IAASB should explore embedding an approach that aligns performance outcomes with the perspective of users, and our response to PS2 and PS3, particularly in relation to developing an audit firm environment in which sceptical behaviour is encouraged.

PS5. 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 IAESB, the IESBA, other international standards setters or NSS, those charged with governance (including audit committee members), firms, or professional accountancy organizations)? Are there activities already completed or underway of which we and the Joint Working Group should be aware?

In addition to our comments on work that we have encouraged the IAESB to take forward (referred to in response to PS1) we support the actions already outlined by the IAASB with regard to the IAESB and IESBA joint working group activities.

---

3. Quality Control

### Quality Management Approach

<table>
<thead>
<tr>
<th>QC1  Quality Management Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Would use of a QMA help to improve audit quality? If not, why not? What challenges might there be in restructuring ISQC 1 to facilitate this approach?</td>
</tr>
<tr>
<td>(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 paragraphs 64 and Table 3, are there other elements that should be included? If so, what are they?</td>
</tr>
<tr>
<td>(c) In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?</td>
</tr>
<tr>
<td>(d) If ISQC 1 is not restructured to require the firm's use of a QMA, do you believe that we should otherwise address the matters described in paragraph 59 and table 2, and if so, how?</td>
</tr>
</tbody>
</table>

We agree that the past decade has seen tremendous change in the economic, technological and regulatory aspects of the capital markets in which audit firms operate. The audit profession plays an essential role in the functioning of the global capital markets by building public trust and confidence in the financial reporting process and stakeholders expect the audit profession to adapt and overcome these multiple and complex challenges, whilst remaining committed to delivering consistently high quality audits. It is therefore essential that as a global standard setter, the IAASB promulgate standards that are sufficiently adaptable for auditors to address the evolving challenges they face and remain committed to delivering consistently high quality audits. A key foundation for delivering consistently high quality audits rests in the audit firm's system of quality control, and we believe that ISQC 1 is no longer sufficiently flexible to deal with the rapidly changing business environment and support a broader revision of ISQC 1, including the introduction of a quality management approach (QMA).

### Outcome of a high quality audit

However, we believe that an important starting point for any discussion of quality control is to agree what the outcome of a high quality audit looks like. That is not to disregard the relevance of the audit quality factors as set out in the Framework for Audit Quality (Framework) (inputs, processes, outputs, interactions and contextual factors). These are important considerations along the way but ultimately each of those factors must be driving towards the desired outcome. We therefore believe it is important for the IAASB to set out the expected outcome of a high quality audit and then to demonstrate how the various factors identified in the Framework are addressed in the quality control standards in the context of that outcome.

We believe that there are two key outcomes of a high quality audit:

1. The audit has obtained a high level of assurance (subject to the inherent limitations of an audit) that misstatements (if any) in the financial statements would have been detected and either corrected or identified in the auditor's report; and
2. This has been achieved in a manner that serves the intended purpose of an audit to enhance the degree of confidence and trust of intended users in the financial statements through meeting their expectations.
Quality Control

In May 2015, the FRC published Audit Quality Practice Aid for Audit Committees (Practice Aid). The Practice Aid is intended to provide audit committees with guidance on audit quality and best practice to provide them with a collective ability to challenge the auditor to demonstrate that they have performed a high quality audit, and evaluate the auditor’s responses. The Practice Aid therefore focusses on assessing audit quality and has been developed based on feedback from audit committee members, investors, financial management and auditors. As well as providing a framework for the committee’s evaluation, the Practice Aid sets out practical suggestions on how audit committees might tailor their evaluation in the context of the company’s business model and strategy; the business risks it faces; and the perception of the reasonable expectations of the company’s investors and other stakeholders. It also identifies an overall audit quality outcome that is broadly consistent with those described above.

Quality Management Approach

If implemented well, the QMA described in paragraphs 45–67 of the ITC will allow for the flexibility needed to respond to the diverse challenges being raised in the ITC, and is an approach that supports proportionality in the application of the International Standards. This approach will also emphasise the responsibility of firm leaders to embed a more proactive, scalable and robust response to managing risks to audit quality that can be adapted as necessary to a rapidly changing business environment, and should therefore be more effective in future proofing the International Standards, and enhancing audit quality, in the face of such change. It also has the potential to drive audit firms to embed a culture that strives to provide users with consistently high quality audits. However, for it to deliver the success described above, we believe that the concept of quality management should be embedded at both the firm level through ISQC and at the individual audit engagement level through ISA 220.

We note the proposal to address specific quality control matters alongside the QMA by introducing requirements and application material in most instances (paragraphs 105 to 190). It will be important for the IAASB to ensure that the revised ISQC maintains an appropriate balance between overarching QMA principles - that help firms’ leadership determine how to run the firm in a manner that supports consistent quality - and targeted or specific requirements. The principles should be internationally applicable and sufficiently high level to allow firms of all sizes to pursue their unique business activities. They should also be both aspirational and credible and guide the firms’ leadership to develop, as necessary, more detailed policies and procedures that are quality focused and in the public interest.

We support the elements of a QMA introduced in Table 3, but would like to emphasise that it is important that the IAASB ensures that professional scepticism is embedded in audit quality objectives and the public interest perspective is appropriately reflected by firms in setting their audit quality objectives (linked to maintaining public confidence in audit and through this to user-focused performance outcomes for audit quality discussed in PS1).

Finally, for reasons expressed above regarding the importance of pursuing this step change in quality control standards, we would not support an approach that does not incorporate a QMA in ISQC 1. We also support the IAASB pursuing the matters set out in paragraph 59, with regard to the need to address firm culture (including focus on leadership accountability for quality) which is dealt with in QC5 below.

26 https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf
27 ISA 220 Quality Control for an Audit of Financial Statements
28 Governance of the firm, Engagement Quality Control Reviews and Reviewers; Monitoring and Remediation; Engagement partner performance and rewards; Human Resources engagement partner Competency; Transparency reporting (page 19 of the ITC).
Quality Control

QC2. Engagement Partner Roles and Responsibilities

(i) Which of the actions outlined in paragraphs 85–86 would be most meaningful to address issues related to engagement partner responsibilities? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Describe any potential consequences of possible actions that you believe we need to consider further.

Engagement Partner Role and Responsibilities

There is a common theme running through the ITC, first identified in paragraph 74, that in today’s environment engagement partners are finding it increasingly challenging to meet their overall responsibility set out in ISA 220 for the performance of audits, including demonstrating appropriate direction, supervision and review throughout the audit (‘overarching issue’). For example, where there are issues in demonstrating sufficient involvement in the work of the audit team, component auditors, or in the work of specialists, experts or other auditors. This is particularly observable in the issues described in the group audits section of the ITC and we discuss this further in our response to GA1. As this overarching issue is core to a number of concerns and issues being raised in the ITC, it is critical that the IAASB address it by implementing a response that will: address the various identified challenges, will be sufficiently adaptable to address new challenges in a constantly changing environment, and will enhance audit quality.

Some of the actions outlined in paragraph 85 may be helpful to engagement partners in this regard. For example, providing further clarity in ISA 220 about what is meant by ‘performance’, ‘direction’, ‘supervision’ and ‘review’. However, in our view, as expressed in our response to QC1, the most meaningful response in supporting engagement partners address this overarching issue would be to embed a quality management approach and a user perspective principle at both the firm level and the engagement level, as explained further below.

Engagement Level Quality Management (QMA-EL) as an holistic response to the overarching issue

In response to the overarching issue discussed above, paragraph 73 of the ITC notes that any changes to ISQC 1 to incorporate a QMA may better support the engagement partner in performing their audit. We agree with this premise noting in our response to QC1, that a key foundation for delivering consistently high quality audits rests in the firm’s system of quality control. Under a QMA approach, this means that the firm’s leadership and senior management collectively have responsibility and accountability for setting the firm’s quality objectives, performing assessments of risks to audit quality, defining strategies to achieve those objectives, and establishing governance structures and processes to manage the risks effectively in accomplishing those quality objectives. However, as audit quality is intrinsically linked to the performance of the audit engagement partner (and the engagement team) in effectively planning and executing the audit, the audit firm’s leadership and senior management (firm’s leadership) actually need to be able to hold engagement partners accountable for quality at the engagement level to ensure the effectiveness of the firm’s quality management framework. In essence, engagement partners are the ‘first line of defence’ in ensuring the effectiveness of the firm’s quality management framework, through ownership, responsibility and accountability for directly assessing, controlling and mitigating risks to audit quality at the engagement level. However, ISA 220 currently offers very little guidance to the engagement partner in discharging this responsibility.

We therefore strongly support the IAASB proposal in paragraph 85 to embed a more proactive, scalable and robust approach to the management of risks to audit quality at the engagement level (i.e. QMA-EL). This would ensure a consistent approach to audit quality management at both engagement and firm level.
<table>
<thead>
<tr>
<th>Quality Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>At engagement level this will:</td>
</tr>
<tr>
<td>• enhance decision-making, planning and prioritisation</td>
</tr>
<tr>
<td>• lead to more effective and efficient allocation of resources (including those outside the engagement team)</td>
</tr>
<tr>
<td>• increase the probability that the engagement partner will deliver a high quality audit</td>
</tr>
<tr>
<td>• be flexible enough to deal with evolving business environments</td>
</tr>
<tr>
<td>• improve stakeholder confidence and trust</td>
</tr>
</tbody>
</table>

We support many of the other specific actions outlined in the ITC (including in paragraphs 85) to address audit quality at the engagement level, particularly in relation to enhancing the quality of group audits, but these should be bound together in the context of a QMA-EL framework that also requires a proactive, tailored approach. This approach would also emphasise the responsibility and accountability of engagement partners for directly assessing, controlling and mitigating risks to audit quality at the engagement level (which is largely absent in ISA 220), and will therefore be more effective in future proofing the International Standards, and enhancing audit quality.

A QMA-EL would also build on the engagement partners’ current responsibilities under ISA 300. The auditor is required to establish an overall audit strategy that sets the scope, timing and direction of the audit under ISA 300.8. Whilst ISA 300 does not specify the need to consider risk to audit quality, it does include a requirement for the auditor to consider the factors that are significant in directing the audit, for example, if the complexity of the engagement necessitates the need to include engagement team members with specific skills or competencies.

Better dialogue with engagement quality control reviewers, audit committees and regulators

For audit engagements that are required to have an engagement quality control review, the engagement quality control reviewer needs to make an objective evaluation of the quality of the engagement partner’s performance. Under QMA-EL, the engagement partner would have a better basis on which to engage in a more constructive and effective dialogue with the engagement quality control reviewer in demonstrating how they have directly assessed, controlled and mitigated risks to audit quality at the engagement level. Many jurisdictions now require audit committees of public interest entities to engage with, and oversee, the relationship with the external auditor, including making assessments of the effectiveness of the audit process. In those circumstances, audit committees will expect engagement leaders to demonstrate how they have delivered a high quality audit. Under a QMA-EL, the engagement partner would also have a better basis on which to engage in a more constructive and effective dialogue with audit committees. They should be better able to articulate how they will achieve a high quality audit by explaining the risks to quality that they have identified and how they intend to mobilise the engagement team and other resources needed to deliver the required outcome. Similarly, in respect to their dialogue with audit regulators. Overseeing such an approach would provide a potentially direct role for (and enhanced communications with) the audit firm’s governance function, particularly where this includes independent representation. Indirectly, this such an approach may also provide a basis for enhanced Transparency Reporting by audit firms and related engagement with audit stakeholders, and for enhanced communications with the audit firm’s governance function, particularly where this includes external representation.

---

29 ISA 300 Planning an Audit of Financial Statements
### Quality Control

#### QC2. Engagement Partner Roles and Responsibilities (cont.)

(b) Do you think it is necessary for the ISAs to include requirements or otherwise address the circumstances in which an individual other than the engagement partner is required to or otherwise customarily sign(s) the auditor’s report or is named therein? If yes, please explain why, and provide your views about how this could be done (including describing the work effort you believe would be necessary for such an individual).

We note the suggestion in paragraph 86 that consideration could be given to clarifying the expected performance requirements for individuals (other than the engagement partner) who sign or who are named in the auditor’s report. We would not support any such action if the effect were to reduce the responsibility of the engagement partner for the performance of the audit. We believe that a fundamental principle in the ISAs is that the engagement partner has overall responsibility for the engagement. We do not support any action that would undermine this principle and we believe it is the engagement partner who should be responsible for signing the audit opinion and who should be named in the auditors’ report. For example, we would not support disclosing the names of such individuals in the auditor’s report in a manner that would undermine this principle.

#### QC3. Others Involved in the Audit

(a) Paragraphs 87–104 set out matters relating to involvement of others in the audit:

(i) Which of the actions outlined in paragraphs 100–104 would be most meaningful to address issues related to others participating in the audit? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Describe any potential consequences of possible actions that you believe we need to consider further.

(b) Should we develop further requirements or application material for circumstances when other auditors are involved in an audit engagement (i.e., auditors that don’t meet the definition of component auditors)?

### Others involved in the audit

We agree that the use of other auditors, experts and specialists in audits is becoming increasingly prominent. We support the IAASB’s proposal to re-address the quality aspects of the involvement of such parties in the audit in response to the issues that have been raised in paragraphs 94 to 96, including in respect of other auditors that are not component auditors. As noted in our response to G2, the FRC response to the Post-Implementation Review of the Clarified International Standards on Auditing highlighted a number of issues that have arisen in relation to the use of experts and specialists in particular, and recommended a number of revisions that could be made to improve audit quality in this regard.

As articulated in paragraph 94 of the ITC, the involvement of other parties in the audit contributes to the **overarching issue**, discussed in our response to QC2. As explained in our response to QC2 some of the actions outlined in paragraph 85 and 100 may be helpful to engagement partners in understanding their roles and responsibilities in these circumstances, particularly in relation to providing further clarity in ISA 220 about what is meant by ‘performance’, ‘direction’, ‘supervision’ and ‘review’ in relation to the work of such parties. However, in our view, the most meaningful response in supporting engagement partners’ to address this...
Quality Control

An overarching issue would be to embed a QMA-EL. As previously noted, a QMA-EL, in conjunction with embedding a user perspective principle, would help bind these together and provide a framework for developing them.

Making reference to other parties in the audit report

With regard to the issues that have been raised in paragraphs 97 and 98 and the action articulated in paragraph 101 to explore the ability to use another auditor’s report as audit evidence in certain circumstances, we would not support such action. Please see our response to QC2, which explains that we believe the IAASB should maintain the fundamental principle in the ISAs that it is the engagement partner who has overall responsibility for the audit engagement.

We do not believe that it would be appropriate to consider an auditor’s report issued by another auditor on the financial information of a component as audit evidence for the group audit. At best, this is evidence that the other auditor performed an audit and of their conclusions. However, the group audit provides the basis for the opinion of the group auditor on the consolidated financial information of the group, including that of its components. The essence of an audit is the conclusion reached and expressed in the auditor’s report. In the case of a group audit, that conclusion is premised upon each of the judgments made by the group auditor throughout the audit. The fundamental principle in the ISAs today is that the group auditor must be sufficiently involved in the work of any other auditor to effectively direct, supervise and review that work and therefore be in a position to stand behind the key judgments made in performing the work of any such other auditor. Access to such auditors and to their work is therefore a fundamental requirement (and is a matter that should be considered prior to acceptance of the engagement). In the absence of such access, there is a limitation imposed on the group auditor and there are consequences for the group auditor’s report unless the group auditor is able to perform the necessary audit work in some other way. This is a principle that is not just reflected in the ISAs but has also been reflected in law, including most recently in EU Law.30

It has been suggested that considering another auditor’s report as audit evidence might provide a solution to such access issues, particularly with respect to components that may be consolidated as a result of significant influence rather than control. As noted above, we believe that such an approach would undermine the fundamental principle that the group auditor has sole responsibility for the audit. Furthermore, we do not accept that this would somehow be in the public interest because users would get an auditor’s report that addressed the whole group. Our view is that building such an approach into the ISAs would tacitly endorse a situation in which access to the underlying information of a component (which could be a significant part of the group) is denied to both the entity’s management and those charged with governance and the auditor - i.e. the agents of the investors in the group. We believe that this situation is not in the interests of the investors and is far more likely to be resolved in a manner that is in their interests (i.e. by action to obtain appropriate access) if the auditor’s report is qualified in those circumstances. In the meantime a qualification will appropriately signal to investors that such a situation exists and that the auditor was not able to protect investors’ interests by providing an independent view on the component’s financial information. This will also enable investors to hold the entity’s management and those charged with governance to account for their actions to resolve the issue.

Enabling the group auditor to use the other auditor’s report as audit evidence would not change the underlying issue, yet the group auditor’s report would give an unqualified opinion. This risks obscuring the issue and giving it a semblance of regularity. We also do not accept that such an approach is ‘necessary’ to address...
situations where a qualified report would prevent a company’s access to capital markets. Capital market rules have been established on the basis of the existing ISAs, which would not permit ‘divided responsibility’ auditor’s reports under the ISAs. A change to the ISAs could in fact be seen as undermining those rules.

QC4. The Firms’ Role in Supporting Quality (incl. audit delivery models)
(a) Paragraphs 106–123 set out matters relating to networks of firms and use of ADMs.
   (i) Which of the actions outlined in paragraphs 114–116 and 122–123 would be most meaningful to address issues related to firms operating as part of a network of firms and firms’ changing business models and structures? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Describe any potential consequences of possible actions that you believe we need to consider further.
(b) Specifically:
   (i) What could we do to address the issues identified in the context of networks of firms? For example, should we develop more detailed requirements and application material to address reliance on network-level policies and procedures at a firm or engagement level?
   (ii) Do you think it would be feasible for us to develop requirements and guidance for networks? Please provide a basis for your views.
   (iii) Paragraphs 117–123 set out matters relating to the use of ADMs and related issues. a. How should our standards emphasize the importance of appropriate quality control processes in relation to use of ADMs? B. Are you aware of ADMs that raise issues not discussed in paragraphs? If so, please provide details.

The Firms’ Role in Supporting Quality

Reliance on other network firms

We strongly support the IAASB proposal to re-address the quality aspects of ‘network firms’ in response to the issues that have been raised in relation to undue reliance by firms and engagement teams on the network’s system of quality control in the circumstances set out in paragraphs 109 to 111.

In particular, we support the IAASB to develop guidance that helps audit firms and/or engagement partners consider the extent to which they can ‘rely on’ network quality control and monitoring policies and procedures, and the nature of that ‘reliance’. The nature and extent of reliance that may be appropriate will vary depending on a number of factors, including the structure and organisation of the network and central or local enforcement policies. For example, during our outreach activity, certain stakeholders noted that many organisations that describe themselves as ‘network’ firms (or ‘part of a network’) do not in fact operate under common quality control policies and procedures and have very loose connections with each other. Other ‘network firms’ may claim to have common quality control policies and procedures, but there are significant variations in the central or local enforcement of those common quality control policies and procedures.

Our starting point is that the ISAs should provide a robust basis for the use of the work of any other auditor (whether or not a network firm) in the performance of an audit (whether or not a group audit). This should reflect the current fundamental principle that the principal auditor takes responsibility for all of the other auditor’s work and the conclusions drawn from that work for all aspects of quality control over that work. Such quality control could, in principle, be exercised at the firm level or at the engagement level or both. That should be the underlying position in the ISAs. As noted above, there are a variety of ‘network’ arrangements that exist. Quality control over the work of any other firm whose work is used in the audit should, in our view, involve a ‘risk-based’ (proposed firm level QMA and a QMA-EL)
Quality Control

approach. In some network arrangements, the network may have established network level controls over audit quality that address the work performed by a network firm, other than principal auditor, that is used by the principal auditor. Where the principal auditor believes it is appropriate to place some reliance on network level controls over risks to audit quality relating to the use of the work of another network firm, the ISAs should clearly set out the principal auditor’s responsibilities. We believe that the principles in ISA 315 and ISA 330 in relation to reliance on entity controls over risks of material misstatement are a reasonable source of analogous material. In that context, we believe that the IAASB should consider at least the following matters:

(a) The principal auditor should be responsible for making audit quality risk assessments in relation to the use of the work of network firms at the firm level (as part of the proposed QMA) and at the engagement level (as part of a QMA–EL) – these risk assessments should be interconnected.
(b) The principal auditor should be responsible for understanding the network level controls and evaluating their design and implementation (both generally and in relation to the specific network firm and the work it is performing).
(c) On the basis of the risk assessment and control evaluations in (a) and (b), the engagement team should decide whether it wishes to place reliance on any network level controls that are designed to mitigate particular audit quality risks at the engagement level in relation to the use of network firms’ work in the audit. If not, then the auditor should take a wholly ‘substantive’ approach in responding to those audit quality risks, through direction, supervision and review of the work performed and the quality control established at the level of the other network firms engagement to perform the work used in the audit.
(d) If network level controls are to be relied upon, the ISAs should establish the necessary testing of those controls – this should clearly identify any differences in approach that may be considered appropriate for different aspects of the network’s system of quality control (e.g. control environment vs control activity). Such testing could be performed either at firm level or at the engagement level and the ISAs and ISQC 1 would need to address the interface between firm and engagement levels in this context.
(e) The IAASB should also consider the implications of the inherent limitations in any system of internal control and the resulting need to require some ‘substantive’ testing to respond to identified risks to audit quality even where some reliance is placed on network level controls.
(f) The ISAs should recognise that this approach is dependent upon there being network level controls (though not necessarily a comprehensive network level system of internal control over audit quality). However, the emphasis should be on the nature of the controls/control system rather than on whether the other firm meets the definition of a network firm unless that definition is closely aligned with the existence of such controls at the network level.

In addition, in the context of our proposal above, we support the IAASB’s suggested action to strengthen the material in the standards in relation to internal and external audit quality reviews/inspections that have taken place across the network and related communications, including how the firm responds to findings and the impact on the firm’s own system of quality control.

Audit Delivery Models

As explained in our response to QC1, stakeholders expect the audit profession to adapt and overcome the multiple and complex challenges that have resulted from changes in the global business environment, and we acknowledge the point made in paragraph 117 of the ITC that audit delivery models (ADMs) have often been implemented in response to changes in the global business environment in order to better facilitate the delivery of the audit engagement.
Quality Control

We support the IAASB’s proposal to explore quality matters in relation to the use of ADMs, and agree that it would be useful to explore how ISQC 1 and ISA 220 could address the use of ADMs, as it is critical that there are appropriate quality control policies and procedures in this area. We suggest that the IAASB should consider the use of ADMs as part of the development of requirements and guidance to embed a QMA and a QMA-EL.

This approach would ensure that, for example:

- Improvement activities that the firm undertakes (such as ADMs) are planned and organised as part of an integrated audit quality management system.
- Firms that currently use ADMs perform quality risk assessments to ensure that there are appropriate quality control policies and procedures in place to safeguard against inappropriate use of ADMs, or insufficiently skilled or competent personnel.
- At the engagement level, engagement partners perform quality risk assessments to establish the appropriate level of direction and supervision of the work being performed, regardless of who performs the work and where it is performed.

We also suggest that similar principles to those set out above in relation to network level controls should form the basis for the approach adopted for ADMs’ quality risk assessment (based on appropriate understanding of the ADM) and appropriate response (addressing both substantive and reliance on controls strategies). The IAASB should also recognise that ADMs may be established within the same firm as the principal auditor or within another network firm and that in the latter case there may or may not be network level controls. Accordingly, the suggestions made above in relation to placing some reliance on network level controls will need to recognise that the ADM controls could be designed, implemented and operated by the same firm as the principal auditor, by another network firm on a standalone basis or at the network level.

Developing requirements and guidance for networks

With regard to the suggestion to explore the development of requirements for networks set out in paragraph 116, network firms exist in a number of jurisdictions whose local laws, regulations and culture could make it difficult to develop an effective compliance framework. Accordingly, we believe it may be very difficult to develop auditing standards that could be imposed by a firm on its network that would be effective in enhancing quality. Instead, we suggest that the IAASB should focus, as indicated amongst their suggested possible actions, on strengthening ISQC 1 and ISA 220 in relation to the extent to which firms and engagement teams respectively can place some reliance on network quality controls. We reiterate our position that any requirements or application material in this regard should not undermine the fundamental principle that the engagement partner has overall responsibility for the direction, performance, supervision and review of an audit engagement.
Quality Control

(i) Do you believe it is necessary for us to explore how the governance of a firm could be addressed in ISQC 1?

(ii) Should ISQC 1 specifically address accountability of firm leadership, or appropriate personnel within firm leadership, for matters related to quality, including independence-related matters? If so, how should this be done, and what direction should ISQC 1 provide to firms in appointing appropriate individuals to assume these responsibilities?

(iii) Would the use by firms of a QMA provide better support or context for the importance of quality-related responsibilities for firm leadership, and related accountability, and therefore better facilitate the ability of firms to address these matters?

Governance of the Firm

Audit firm’s leadership collectively has responsibility and accountability for modelling and articulating the audit firm’s culture and values, demanding the highest standards of ethical behaviour throughout the firm, encouraging transparency, and a willingness to challenge and make difficult decisions to maintain the firm’s culture and values. Audit firm governance is therefore a critical component of quality. Yet the importance of embedding a robust governance framework is largely absent in the quality control standards and we therefore strongly support the IAASB’s proposal to enhance the international standards in this area.

In exploring the topic of audit firm governance, we would encourage the IAASB to take account of the FRC’s work on audit firm governance and the experience of UK firms’ adoption of the code, discussed below.

UK Audit Firm Governance Code

Audit firms in the UK are already familiar with the topic of audit firm governance. In January 2010, the FRC, jointly with the ICAEW, introduced the Audit Firm Governance Code31 (AFGC). The AFGC applied to firms auditing 20 or more listed companies. Essentially it resulted in audit firms introducing governance structures that are applied elsewhere in the corporate environment, including the introduction of independent non-executives, and a publication (‘transparency reports’) of a statement of the firms’ values, culture and compliance to create an opportunity for dialogue with stakeholders.

The intended benefits of the AFGC was to support audit firms in their objectives of performing high quality work, giving confidence to shareholders, and play four additional roles:

- enhance the stature of firms as highly visible exemplars of best practice governance;
- enrich firms’ transparency reports;
- encourage changes in governance which improve the way that firms are run; and
- strengthen the regulatory regime by achieving transparent and effective governance without disproportionate regulation.

The AFGC includes comply or explain governance provisions, similar to the list of governance principles set out in paragraph 127 of the ITC. Under a “comply and explain” regime, there is no requirement to comply with the provisions of the code (provided firms can explain why not), recognising that not ‘one-size-fits-all’ and that principles should be adapted appropriate to the size and nature of the audit firm. In addition to complying with professional regulations and requirements, firms

---

Quality Control

are also expected to publish an annual “transparency report” explaining how the firm has complied with the main independence requirements of the AFGC and integrated other provisions called for by the code. We have commented on this aspect of the AFGC in our response to QC10 below.

The FRC recently consulted on the implementation and operation of the AFGC and published the findings which summarised the comments received and outlined potential actions that the FRC could take to enhance the code further. Overall, the vast majority of respondents, including investors, saw the introduction of the AFGC as a positive development which has enhanced audit firm governance. In addition, the FRC consultation specifically asked if the concept of the AFGC should be spread elsewhere in the world, and whilst recognising there would be some challenges, respondents, including investors, were broadly in favour of the promulgation of the AFGC internationally.

Addressing audit firm governance in ISQC 1

We fully agree that a firm’s governance, culture and strategy are at the core of a QMA and foundational to its effectiveness. To avoid making ISQC 1 too complex and unwieldy, we believe that detailed considerations relating to audit firm governance could be addressed in a separate standard with only high level requirements established in ISQC 1. Audit firm governance could be addressed through overarching principles along with specific requirements in relation to certain issues raised in the ITC, such as accountability and independence (paragraph 122 and 134 respectively), culture and values. As noted earlier, these principles would need to be internationally applicable and sufficiently high level to allow firms of all sizes to pursue their unique business activities. They would also need to be both aspirational and credible and guide the development, where necessary, of more detailed principles, rules and guidance. It will also be necessary to consider whether any requirements relating to particular aspects of audit firm governance should be applied to all or some firms and, if only some, where the balance of the public interest would lie. The comply or explain approach described above may assist in developing more detailed requirements, as appropriate, from principles.
Quality Control

### Engagement Quality Control Reviews and Engagement Quality Control Reviewers

The engagement quality control review (EQC review) is a critical component of the audit firms’ quality monitoring processes. As part of the EU Audit Reform, the EQC review is now incorporated into Article 8 of the EU Audit Regulation. As such, the EQC review is seen of such importance that it has become a formal and legal obligation for the audit of every public interest entity in the European Union. In the FRC’s Annual Inspection Report 2014/15, we noted that the number and nature of findings arising from our inspection of individual audits continues to indicate that firms’ internal quality control and monitoring procedures require further strengthening or improved application in practice. In light of these findings, our 2015/16 thematic inspections included a review of firms’ internal quality monitoring procedures and the EQC review in the audit of financial statements. The findings from the FRC’s Thematic Review on EQC Review were consistent with some of the concerns raised in paragraph 137 of the ITC such as the selection of the EQC reviewer (second bullet); issues regarding timely and effective involvement (third and fourth bullet), and sufficient evidence of the review (last bullet) as follows:

- **Eligibility** – There was evidence that an EQC reviewer had insufficient specialist knowledge to perform the role, limiting the ability to evaluate key judgements and conclusions.
- **Evidence and Effectiveness of the Review** – There was insufficient evidence in a number of reviews that an EQC reviewer had performed an adequate and timely review. In addition, there was evidence that the EQC reviewer’s involvement in the planning, performance and/or completion stages of the audit was left too late for the EQC reviewer to provide meaningful input and insufficient evidence of the nature or extent of the EQC reviewer’s work. On some audits, the EQC reviewer’s questions had not been satisfactorily resolved by the audit team.

Other findings from the FRC’s Thematic Review on EQC Review included:

- **Objectivity** – The review noted issues regarding limited guidance or training in some cases as to the matters the EQC reviewer should consider in evaluating their objectivity. In addition, there was evidence that audit tender documents included information about the EQC reviewer that implied the EQC reviewer was part of the audit engagement team. Recent outreach activity has also highlighted that there is often a misunderstanding within some audit firms as to the purpose of an EQC review. In particular, in some instances, engagement teams consider the EQC review as part of the engagement team performance.
- **Monitoring** – The FRC review noted that whilst some firms have formal processes for EQC reviewers to obtain feedback from audit teams or as part of the firms’ monitoring processes to evaluate contribution to quality, not all firms’ monitoring considers the effectiveness of the EQC review.

### Addressing issues related to EQC reviews and EQC reviewers

In respect of addressing the issues outlined in the ITC in paragraph 137, and the FRC review findings set out above, whilst we do not disagree with suggestions set out in paragraph 143, we believe that the IAASB would better address the issues if they were to approach the topic of EQC review in a more holistic manner, and of course in the context of a QMA. This would mean first clarifying the purpose of the EQC review (in the context of a QMA), from which the IAASB would be in a better

---

33 Regulation (EU) No 537/2014 Of The European Parliament And Of The Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities
34 as defined by the Member States
Quality Control

position to determine the most appropriate procedures to be performed, and the appropriate level and skill of the person performing the EQC review, as explained more fully below:

- In clarifying the purpose (or objective) of the EQC review, the IAASB can address some of the issues raised above, including certain misunderstandings as to where within the firms’ quality management framework, the EQC review resides. In our view, an EQC review forms part of the firm’s quality risk control (and compliance) oversight function — effectively a firm’s control over the engagement team’s work. Drawing again on the three lines of defence model, the engagement partners are the ‘first line of defence’ in directly assessing, controlling and mitigating risks to audit quality at the engagement level, then the EQC review, as an objective evaluation of the quality of the engagement team’s performance in that regard, is part of the firm’s ‘second line of defence’. We believe it would be helpful to clarify that the role of the EQC review is a firm level control. As such, for example, it should not be a responsibility of the engagement team to determine whether an EQC review is required and ISA 220 should address only the responsibilities of the engagement team.

- Having clarified the purpose, or objective, of the EQC review, the IAASB would be in a better position to establish the appropriate nature, timing and extent of procedures to meet that objective. In this context, we agree with the suggestion in paragraph 143 to strengthen the requirements and application material by further specifying the nature and extent of matters to be considered in the EQC review. However, given the EQC review falls outside the performance of the audit, we expect such enhancements to be made to ISQC 1 as opposed to ISA 220. This will address concerns raised by stakeholders that the EQC review is misunderstood as part of the performance of the audit. In exploring enhancements to the nature, timing and extent of procedures, we suggest that the IAASB explore the new requirements for EQC reviews set out in the EU Audit Regulation. In addition, there are a number of suggestions in the FRC’s Thematic Review on EQC Review where enhancements could be made in practice that we would encourage the IAASB to consider. For example, emphasising the importance of conducting the review in a timely manner at appropriate stages during the engagement.

There are matters in relation to the EQC review that would lend themselves to enhancements in ISA 220, particularly in relation to the engagement team’s response and reactions to matters raised during the review. For example, as noted above, the findings from the FRC’s Thematic Review on EQC Review highlighted that on some audits, the EQC reviewer’s questions had not been satisfactorily resolved by the audit team. In this regard, it is the engagement team’s responsibility to ensure that the firm’s oversight procedures are adhered to.

- The person performing the EQC review (i.e. eligibility, skills and competencies). We support the suggestions made in paragraph 143 to strengthen the requirements and guidance regarding the selection of the EQC reviewer. For example, it is important that EQC reviewers perform their work with an objective mindset, otherwise they cannot deliver on their oversight role effectively. As set out in the FRC’s Thematic Review on EQC Review, ‘objectivity’ is one area where there is evidence that firms need to make improvements to their policies and procedures and would welcome greater prominence of this topic in that regard. We also believe that the IAASB should give greater prominence to the importance of the EQC reviewers’ ability to confidently challenge engagement team’s judgements.

Mandate the performance of EQC reviews beyond audits of listed entities

With respect to the question as to whether ISQC 1 should mandate the performance of EQC reviews beyond audits of listed entities, under EU Audit Regulation an
Quality Control

Engagement quality control review is already required for audits of financial statements of public interest entities, and this requirement is included in ISQC (UK and Ireland) 1 (Revised June 2016). We support the decision of the European Parliament in this regard, as, given the importance and value placed on the EQC review and the role of the EQC reviewer by stakeholders, particularly investors, it is in the public interest to do so. Accordingly, we would support the IAASB’s proposal to extend the EQC review requirement beyond listed entities to other entities of a particular public interest.

Cooling-off period

With respect to the question relating to a minimum “cooling-off period”, we support the IAASB’s recognition that a “cooling-off” period is beneficial to audit quality in safeguarding objectivity. In that regard, we would support a requirement that defines an appropriate period that an individual who had previously been involved in the audit, including in the role of the engagement partner, would not be eligible to fill the role of the EQC reviewer.

Separate EQC review standard

In respect to the question as to whether the IAASB should develop a separate EQC review standard, we support the IAASB’s recognition that the importance of the role should be given additional prominence in the standards. As we believe that EQC reviews are a firm level control, this should be in the ISQCs – either ISQC 1 or a new standard in that series. Whilst we are not convinced that a separate standard as set out in paragraph 122 is required, we would encourage the IAASB to continue to consider this option.

QC7. Monitoring and Remediation

(a) Paragraphs 147–159 set out matters relating to monitoring and remediation.

(i) Which of the possible actions outlined in paragraphs 156–159 would be most meaningful in addressing issues related to monitoring and remediation? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.

(b) Specifically:

(i) Do you support the incorporation of a new requirement(s) in ISQC 1 for firms to understand the causal factors of audit deficiencies relating to inspection findings and other reviews? If not, why? Are there any potential consequences or other challenges of taking this action that you believe we need to consider?

(ii) Do you support the incorporation of a new requirement(s) in ISQC 1 for the results of the firm’s monitoring of the effectiveness and appropriateness of the remedial actions to be considered in the design and assessment of the effectiveness of the firm’s system of quality control? Please provide further detail to explain your response.

Monitoring and Remediation

We support the IAASB’s proposal to enhance audit firms’ monitoring processes, including remedial actions, through the quality control standards. As noted in our
Quality Control

response to QC6, in the FRC’s Annual Inspection Report 2014/15\(^{37}\) we noted that the number and nature of findings arising from our inspection of individual audits continues to indicate that firms’ internal quality control and monitoring procedures require further strengthening or improved application in practice. In light of these findings our 2015/16 thematic inspections included a review of firms’ internal quality monitoring procedures\(^{38}\) (FRC AQM Thematic Review). The FRC AQM Thematic Review echoes some of the matters outlined in paragraph 150 of the ITC, including the importance of investing the appropriate time and resources to monitoring activities. However, overall it highlights that a number of firms allocate substantial resources to their monitoring of the quality of audits and this is to be commended.

As a consequence, notwithstanding that firms are keen to develop this area further, a number of good practices have been described in the FRC AQM Thematic Review that the IAASB may wish to consider when enhancing the guidance on this topic in the International Standards.

Using a QMA to provide a stronger link to monitoring and remediation

With regard to the suggested solutions set out in paragraphs 156 to 158 of the ITC, we would like to emphasise the importance of the IAASB’s proposal in paragraph 159 that the use of QMA by the firm would create an opportunity to provide a stronger link to monitoring and remediation within the firms’ system of quality control. In fact, as components of the quality management system are put in place, processes for monitoring are essential to ensure that the policies and procedures are being adhered to and quality benchmarks and standards are being met. Monitoring and remediation are therefore essential to the primary goal of a quality system, which is continuous improvement (as also mentioned in our response to QC4). It is therefore critically important that the IAASB ensures that the introduction of any new application material or requirements related to monitoring processes are embedded within the QMA.

Understanding the causal factors of audit deficiencies and monitoring of the effectiveness and appropriateness of the remedial actions

Regarding the incorporation of requirements for firms to understand causal factors and monitoring the effectiveness and appropriateness of the remedial actions, we strongly support the IAASB incorporating material into ISQC 1 on this matter in relation to both external inspection findings and internal monitoring findings, and the effectiveness of remedial actions thereon. As explained in the FRC AQM Thematic Review, the identification of effective remedial actions by firms is a challenge. Whilst certain remedial actions may address a particular deficiency, they may not address the underlying cause and the deficiency may therefore reoccur. It is therefore important that firms gain a clearer understanding of the underlying causes of recurring deficiencies to enable them to implement remedial actions which are likely to be effective. However, as mentioned above a QMA model is a cycle of continuous improvement, and accordingly, any remedial actions implemented into the firm’s processes and procedures should naturally be subject to the firm’s monitoring processes. In 2016/17, the FRC will conduct further thematic reviews, including the firms’ performance of root cause analysis, and the IAASB may wish to consider the findings of that review in their work.

QC8. Engagement Partner Performance and Rewards Systems

Parágraphs 160–170 set out matters relating to engagement partner performance and rewards systems.

(a) Do you believe that establishing a link between compensation and quality in ISQC 1 would enhance audit quality? Why or why not?

(b) What actions (if any) do you believe we should take in this regard? Are there potential consequences of possible actions that you believe we need to consider?
Quality Control

Engagement Partner Performance and Rewards Systems

We support the IAASB exploring what steps could be taken to improve audit quality through performance and rewards systems for all audit staff i.e. not just engagement partners, but would not support an approach that would mandate the structure of an engagement partner’s remuneration. Instead, we would support an approach where formal and transparent policies in relation to remuneration are required, and any policies on partner and staff remuneration could be designed to promote and secure audit quality. In the EU, a link to compensation and audit quality has been introduced in the Audit Directive (Article 24a), but it does not mandate the structure of the remuneration, stating that a statutory auditor or an audit firm shall have in place adequate remuneration policies, including profit-sharing policies, providing sufficient performance incentives to secure audit quality. Embedding such an approach would be more effective in enhancing audit performance and improving audit quality provided it was part of a firm’s overall commitment to quality, where delivering consistently high quality audits is part of the firm’s culture from firm leadership through to the most junior members of the audit team.

QC9. Human Resources and Engagement Partner Competency

(a) Paragraphs 171–187 set out matters relating to human resources and engagement partner competency.

(i) Which of the possible actions outlined in paragraphs 176–178 and 187 would be most meaningful in addressing issues relating to human resources and engagement partner competency? …Describe any potential consequences of possible actions that you believe we need to consider further.

(b) Specifically, which of the possible actions outlined, or other actions not described, in paragraphs 176–178 and 187 would most positively impact audit quality: (i) Arising from issues related to knowledge, skills, competence and availability of a firm’s partners and staff? (ii) Related to engagement partner competency? (iii) Why do you believe these actions are necessary? If you would not support a particular action, please explain why, including any potential consequences of those actions that you believe we need to consider.

Human Resources and Engagement Partner Competency

We agree with the IAASB that the knowledge, skills and competence of firms’ employees and the manner in which those employees are assigned to specific roles within the organisation and to specific audit engagements is essential to quality management. We agree that such human resource matters should be included as an important element of a QMA. An audit firm needs to put in place a process that identifies and establishes the appropriate knowledge, skills and competence (“competencies”) required by personnel who perform work that impact the firms’ audit quality objectives, and for the purpose of this response, this includes adhering to ethical standards. The audit firm also needs to evaluate, through its monitoring process, the effectiveness of the actions taken to satisfy the competence needs such as training, career development, promotion and performance appraisals and evaluation. This would ensure that audit quality objectives are not compromised. Ultimately, competencies of all the firm’s employees, including engagement partner competencies, must be a vital consideration in the firm’s determination of risks to audit quality in a QMA.

We therefore agree with the proposed actions set out in paragraph 176 to clarify, in the context of a quality management framework, the importance of career development, promotion, performance appraisals and evaluation. We also support the IAASB exploring further guidance, in the context of a quality management framework, of the importance of effective continuity planning. In addition to those actions described in the ITC, as it is ultimately the engagement partner’s
FRC Response to IAASB Invitation to Comment – Enhancing Audit Quality

Appendix 1

Quality Control

responsibility to ensure that the engagement team have sufficient competence and objectivity to undertake the engagement, we propose that the IAASB develop additional application material, in the context of QMA-EL, to support the engagement partner’s assessment of risks to audit quality, and what responses may be necessary considering the particular facts and circumstances of the engagement.

Exploring the topics of knowledge, skills and competence of audit firm employees is also an area that lends itself well to a coordinated approach with other IFAC boards, particularly the International Accountants Education Standards Board (IAESB), and also agree with the IAASB that a more detailed review of the relationship between International Education Standard 8 (and other relevant International Education Standards), and ISQC 1 and ISA 220 would be beneficial to the IAASB’s research in this regard.

QC10. Transparency Reporting

Paragraphs 188–190 set out matters relating to transparency reporting.

(a) Do you believe we are able to positively contribute to the evolving developments related to transparency reporting? If so, what, in your view, would be the most appropriate action we could take at this time?

(b) If you would not support us taking actions as described in paragraph 190(b), please explain why, including any potential consequences of those actions that you believe we need to consider.

Transparency Reporting

In the UK, audit firms are already familiar with Transparency Reporting, as the Statutory Audit Directive, which came into force in 2006, introduced a mandatory requirement for annual transparency reporting by auditors of UK companies with securities admitted to trading on a UK regulated market. In its first year when the requirement to report was optional, seven of the ten largest firms chose to publish a voluntary transparency report. Since then the number of firms required to produce transparency reports has fluctuated year on year. As mentioned in our response to QC5, findings from the FRC’s recent review of the implementation and operation of the Audit Firm Governance Code (issued in May 2015), outlined feedback and potential actions that the FRC could take in relation to transparency reporting. Overall, the vast majority of respondents saw the introduction of transparency reports as a positive development, noting that further improvements could be made if firms adopt a more tailored approach and include content which is less boilerplate and of greater relevance to investors, regulators and other stakeholders.

As noted in paragraph 188 of the ITC, there is clear evidence that firms across many jurisdictions issue publicly available reports that provide transparency regarding certain elements of the firm and its operations, most typically in respect of matters related to audit firm governance. In our view, transparency reporting is in essence the only realistic means to increase confidence that the firms’ governance structure is working in the interests of investors and the public interest. We would also like to draw attention to the recent report issued by IOSCO39 in November 2015 that states that “Transparency reporting can foster internal introspection and discipline within audit firms and may encourage audit firms to sharpen their focus on audit quality”.

As the IAASB has a clear role in contributing to enhanced quality and consistency of practice throughout the world, and through that strengthen public confidence in the global auditing and assurance profession, it is feasible for the IAASB to set principles and guidance to assist firms in delivering transparency reports that can be tailored to their specific circumstances. Given this, the successes we have seen in the UK, and the recent report by IOSCO, we strongly support the IAASB exploring developments related to transparency reporting.

The following questions are overall questions relating to quality control:

QC11. Are there any other issues relating to quality control that we have not identified? If yes, please provide details. What actions should we take to address these issues?
QC12. Are there any other specific actions that others could take in relation to quality control? If yes, please provide details.
QC13. Are there any specific considerations for SMPs related to the issues and potential actions described in this section? Are there any other considerations for SMPs of which we should be aware? If so, please provide details and views about these matters.
QC14. Are there any specific public sector considerations related to the issues and potential actions described in this section? Are there any other public sector considerations of which we should be aware? If so, please provide details and views about these matters.

We have no further comments.
4. Group Audits

**Group Audits**

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 194–198)? 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) 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?

**Revision of ISA 600**

Overall, we support the IAASB’s plan to revise ISA 600 to respond to the issues and challenges with performing group audits. We agree with the IAASB that ISA 600 is no longer sufficient to support engagement teams’ address the audit challenges that arise in audits of groups in today’s evolving environment. This is for a number of reasons that have already been comprehensively explored in the ITC, but we believe can be summarised into two key categories:

- **Performance of the audit** – as explained in our response to QC2, the common theme running through the ITC is that in today’s environment engagement partners (including group engagement partners) are finding it increasingly challenging to meet their overall responsibility set out in ISA 220 for the performance of audits, including demonstrating appropriate direction, supervision and review throughout the audit. This is particularly observable in the issues and challenges described in the group audits section of the ITC, for example in:
  - acceptance and continuance of the group audit engagement (e.g. obtaining a sufficient understanding of the challenges the group engagement team will face before commencing the work);
  - communication between the group engagement team and component auditors;
  - using the work of the component auditors;
  - review and evaluation of the work of component auditors;
  - and other sections in the ITC that address challenges related to managing the group engagement.

- **The mechanisms for focusing the determination of the necessary work effort across the group** – we question the validity of the mechanisms in ISA 600 for focusing the necessary work effort across the group. We particularly question the validity of the two-tier scope mechanism (based on whether components are considered significant or non-significant) and the two-tier approach to risk assessment (at the group level and at component level). These mechanisms may inadvertently emphasise a “bottom-up” approach to planning the audit and we believe that the emphasis should be on a “top-down” approach based on understanding the group and the environment in which it operates and an assessment of the risks of material misstatement at the level of the group financial statements. We believe that these mechanisms may be one cause of a number of issues that are discussed in the ITC, for example in relation to:
  - Lack of understanding and variation in practice in relation to the concepts of component materiality and performance materiality;
Inappropriate understanding and consideration of group-wide risks and/or whether such risks also exist at some or all of the other components;

- Lack of understanding of the concept of an “audit of a component”, and insufficient work being performed on non-significant components;

and other issues in the ITC related to challenges that arise from the requirements and guidance in ISA 600 that are included to support these mechanisms.

We discuss this matter further in our response to GA5 below.

*Performance of the audit*

We believe that what we explain as the “overarching issue” in QC2 is core to a number of concerns and issues being raised in this section of the ITC and it is therefore critical that the IAASB address this overarching issue holistically. Accordingly, the actions the IAASB are exploring in relation to ISA 600 may improve the quality of group audits but, as explained in detail in our response to QC1 and QC2, the most effective response in supporting engagement partners to address this overarching issue and improve audit quality would be to embed quality management principles at both the level of the firm and the engagement level.

We believe that group audits could be managed much more effectively under a QMA-EL because by directly assessing risks to audit quality at the group engagement level, the group engagement partner will have a much greater understanding of where the challenges in the group audit lie and therefore better able to determine where the risks to audit quality lie across the entire group. As a result they will be better able to tailor the direction, supervision and review procedures to control and mitigate those risks. (Please read our response to QC1 and QC2 that give more detail on the benefits to embedding this approach). As ISA 600 builds on the requirements of ISA 220 as well as other ISAs as relevant, issues relating to the performance of group audits, particularly in terms of direction, supervision and review may be better dealt with through changes to ISQC 1 and ISA 220 as relevant, with appropriate strengthening of the links in ISA 600 to the requirements in ISQC 1 and ISA 220. In this regard our responses to each of the questions in GA2 – GA9 (that discuss matters related to the performance of audits) regarding the IAASB’s proposals to address issues arising are premised on the point made earlier that providing further clarity in ISA 220 about what is meant by ‘performance’, ‘direction’, ‘supervision’ and ‘review’ and embedding a QMA/QMA-EL approach will be the most effective means to enhance audit quality.40

GA1(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?

*Making reference to another auditor in an auditor’s report*

No. Please see our response to QC2, which explains why we do not believe this should be further explored.

---

40 PCAOB Proposals: We note that, at the time of writing, the PCAOB is suggesting similar proposals in their April 2016 discussion paper on improving standards for group audits. In particular, the PCAOB note they are proposing to amend their auditing standards to strengthen the existing requirements to improve the approach of the lead [group] auditor in their supervision of other auditors [e.g. other auditors used in a group audit situation] by introducing, among other things, a risk-based approach to supervision. The PCAOB propose that requirements for supervision should be risk-based and scalable, and the necessary extent of supervision varies depending on, for example, the associated risks of material misstatement, the nature of the work performed, and the qualifications of individuals. (See PCAOB Release No. 2016-002 - April 12, 2016 - PCAOB Rulemaking Docket Matter No. 042 - Proposed Amendments Relating To The Supervision Of Audits Involving Other Auditors (PCAOB Group Audit Release April 2016)).
Which of the possible actions outlined in paragraphs 215–216 would be most meaningful in addressing issues related to acceptance and continuance procedures? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.

Specifically:

(i) Are access issues as described in paragraph 207(a) still frequently being experienced in practice? If yes, please provide details and, where possible, explain how these are being addressed today.

(ii) Do you agree that ISA 600 can or should be strengthened in relation to addressing access issues as part of acceptance and continuance?

(iii) Would expanding the understanding required for acceptance and continuance, as described in paragraph 215 (b), be achievable in the case of a new audit engagement?

Acceptance and Continuance of the Group Audit Engagement

We support the IAASB’s proposals that ISA 600 should be strengthened in relation to addressing access issues as part of acceptance and continuance. Overall, we would support the IAASB’s proposals in paragraph 215(e) to provide more guidance about the different circumstances that may lead to access issues (including how to obtain the necessary understanding prior to accepting the engagement) including providing some examples about how some of the issues may be addressed, as this application material will support auditors in identifying, through a QMA-EL approach, the risks to delivering a high quality audit, and putting in place appropriate responses to those risks.

Access to evidence

We also agree with the proposals to strengthen the links in ISA 600 to ISA 210\(^41\) and ISA 705 (Revised)\(^42\) regarding access issues in relation to obtaining sufficient appropriate audit evidence. In particular:

- It is fundamental that management acknowledges that they have responsibility for preparing the group financial statements and for keeping the records necessary to enable them to do so, i.e. it is not the auditor’s responsibility to obtain records on management’s behalf. In this regard, we agree that greater prominence should be given to the link to ISA 210.6, which requires [group] management to agree with the pre-conditions for the [group] audit, including agreeing to provide the auditor with access to all information relevant for the [group] audit.

- Where access issues do arise, and group management (or the auditor) cannot obtain the information necessary to support the financial statements, then it may be necessary for group management to inform the market through appropriate disclosure as it is in the public interest to do so. If the auditor concludes that they are unable to obtain sufficient appropriate audit evidence then the auditor is required to express a qualified opinion or disclaimer of opinion. In this regard, we agree that greater prominence should be given to the link to the requirements in ISA 705 (Revised).

Explicit conclusion that the performance responsibilities have been fulfilled

We are not convinced that the possible action in paragraph 216 that implies the introduction of a requirement for the group engagement partner to make an “explicit

---

\(^{41}\) ISA 210 Agreeing the Terms of Audit Engagements

\(^{42}\) Modifications to the Opinion in the Independent Auditor’s Report
conclusion” would be effective (particularly on its own) in ensuring that the group engagement partner can fulfil their responsibility relative to the engagement overall, including for the direction, supervision and performance of the engagement. We believe the group engagement partner would be encouraged to fulfil their responsibility more effectively by introducing a QMA-EL approach in ISA 220, the level of formality and documentation of which would be commensurate with the level of risks to audit quality.

With regard to the specific question in GA2(b)(i) as to whether access issues are still frequently being experienced in practice, and if so, how these are being addressed today, our Audit Quality Review Team (AQRT) have noted that access issues do still arise in practice, but audit firms are demonstrating innovative ways to overcome such issues. One particular example identified by the AQRT was in relation to where regulation in a certain jurisdiction prohibited certain access rights to component information. In this situation, the firm was able to situate a partner of the firm in the jurisdiction in order to gain an understanding of the access issues and facilitate the group engagement partner in obtaining the necessary information about the component.

Communications between the group engagement team and component auditors

We support the IAASB’s proposals to address concerns relating to communications between the group engagement team and component auditors. We are aware that communications with component auditors who are not part of the engagement team do pose additional challenges for group engagement partners in performing group audits, and in this regard we would support the IAASB’s proposals to strengthen the requirements and enhance the related application material regarding such communications. In particular:

- The IAASB should emphasise the need to embed effective two-way communication, as effective two-way communication facilitates the proper integration of the nature, timing and extent of the component auditor’s procedures with other work being performed on the group audit, by the group engagement team and others involved in the group audit. Such communication is necessary at all stages of the audit and could be emphasised more in relation to, for example, understanding the entity and assessing risks of material misstatement at the level of the group financial statements.

- As explained in the ITC, not only does the nature, scope and objectives of the component auditor’s work vary considerably with the circumstances, but also the respective roles and responsibilities of the component auditor and the group engagement team. The engagement partner should always have overall responsibility for the group audit engagement, and the level of engagement with the component auditor should be risk-based and scalable through introducing a QMA-EL into ISA 220. That said, ISA 600 could include additional guidance that would assist the group auditor and the component auditor to discuss and agree:
  - The nature, scope and objectives of the component auditor’s work;
  - The respective roles and responsibilities of the component auditor and the group auditor;
  - The nature, timing and extent of communication between the group auditor and the component auditor (building on the importance of effective two-way
Developing a new standard for auditors who serve as component auditors

With regard to the IAASB’s proposal that a potential action to improve ‘communications’ could be through the development of a separate standard containing specific requirements and application material directed at component auditors, we have heard through our outreach activity, particularly from SMPs, that ISA 600 does not effectively recognise the importance of two-way communications. For example, some SMPs have noted that because of a lack of effective two-way communication, component auditors get group instructions that have not been tailored to the particular component. In addition, in some situations they are not made aware of issues at the group level sufficient to allow a component auditor to determine if such a matter is relevant to their statutory audit of the component. We are not yet convinced that a separate standard containing specific requirements and application material directed at component auditors would resolve these issues. However, we support the IAASB further exploring this matter, perhaps through outreach with firms who primarily perform component audits in particular, to determine whether additional requirements and application material relevant to such issues could be developed in ISA 600 (or other relevant ISAs as appropriate) to support component auditors in their role supporting group engagement teams. We also believe that it is important for the IAASB to also include a requirement in the standard that ensures that the work performed by component auditors that is used for the group audit complies with all relevant requirements of the ISAs.

GA4. Using the Work of the Component Auditors

(a) Paragraphs 226–242 set out matters relating to using the work of the component auditors.
   (i) Which of the possible actions outlined in paragraph 234 and 242 would be most meaningful in addressing issues related to using the work of the component auditor? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.

(b) Specifically:
   (i) Should the nature, timing and extent of involvement of the group engagement team in the work of the component auditor vary depending on the circumstances? If yes, how could changes to the standard best achieve this objective?

   (ii) Should ISA 600 be strengthened to require the group engagement partner to make an explicit determination about whether the group engagement team can use the work of a potential component auditor?

Overall, we support the IAASB’s proposals to address concerns relating to the need to obtain an understanding of the independence, competence and capabilities of component auditors, and issues in relation to the group engagement team’s involvement in the work of component auditors, and to provide more guidance about the different circumstances that arise, including providing some examples about how some of the issues may be addressed, as this will support auditors in identifying, through a QMA-EL approach, the risks to delivering a high quality audit, and putting in place appropriate responses to those risks.

Understanding of the independence, competence and capabilities of component auditors (understanding)
We have heard, through our outreach activity, that group auditors continue to face complex challenges in obtaining the necessary understanding when component auditors sit outside the group auditors’ jurisdiction (as set out in paragraphs 227-228). In this regard, we would support the IAASB’s proposals to strengthen the requirements and enhance the related application material regarding the required understanding set out in paragraph 234. In particular:

- We note that, in relation to the engagement partner’s work with other parties such as internal auditors (ISA 610 Using the Work of Internal Auditors) and experts (ISA 620 Using the Work of Experts) the engagement partner is required to make a robust challenge in determining whether their work should be used, including whether those parties possess the appropriate competence and capabilities to carry out the work. We believe that the requirement for challenge is largely absent in ISA 600. In that regard, we agree with the suggestion to include a requirement for the engagement team to make an explicit determination about whether to use a component auditor’s work.

- The application material could be enhanced by highlighting some of the challenges that group engagement teams may face when trying to obtain the relevant ‘understanding’, including more specific examples that address some of the practical challenges that have been identified, to help auditors identify whether the independence, competence and capabilities of component auditors are sufficient for their purpose.

The group engagement team’s involvement in the work of component auditors

We agree with the concerns set out in paragraphs 238 to 239 relating to insufficient involvement of the group engagement team in the work of component auditors. The FRC response to the Post-Implementation Review of the Clarified International Standards on Auditing highlighted that our AQRT had seen many cases during their inspections where the group engagement partner or group engagement team had not demonstrated sufficient participation in the performance of the group audit, including in the audit of the consolidation process.

The FRC findings highlight a possible misconception that determining the necessary “Involvement in the work performed by component auditors” is different to the determination that is made to achieve compliance with the requirements of ISA 220 relating to the performance of the audit. There may be additional challenges when the group engagement team are working with component auditors who are not part of the same firm (e.g. they can be based in different countries, with different market conditions, language and cultures, and subject to different quality control procedures, professional training practices and ethical requirements). However, as noted in the ITC, the engagement partner has responsibility to determine the appropriate direction, supervision, review and overall performance of the engagement, whether or not it is a group engagement. Using the work of other parties does not diminish that responsibility, as also explained in our response to QC3. Therefore, as noted in our response to GA1, it would be beneficial to have greater emphasis on the links between ISA 600 and other relevant ISAs. In addition, the guidance in ISA 600 (and more critically ISA 220) is deficient with respect to how an engagement partner uses information they have acquired (or need to acquire) on skills and competencies of the engagement team and component auditors to determine the appropriate nature, timing and extent of involvement of the group engagement team in the work of the component auditor. In this regard, we support the IAASB strengthening the requirements and enhancing the related application material to provide greater clarity on the factors a group engagement partner would need to consider in making their determination, as to the appropriate nature, timing and extent of involvement in the work of component auditors.

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

(a) Paragraphs 243–253 set out matters relating to identifying and assessing significant risks in a group audit: (ii) Which of the possible actions outlined in paragraphs 251–253 would be most meaningful to address issues relating to identifying significant risks for the group audit? (ii) Why do
Identifying and Assessing the Risks of Material Misstatement in a Group Audit

As noted in our response to GA1, we support the IAASB’s proposal that in addressing the concerns set out in paragraphs 244 to 245, there is a need to include more material in ISA 600 regarding the principles, requirements and related application material of ISA 315, and other relevant ISAs such as ISA 330, so as to better support the application of those ISAs in the context of a group audit engagement. In particular, these changes will help reinforce the risk-based approach i.e. that the understanding of the group and its components, the identification and assessment of risk, and the response to the risk, should be founded on the requirements and guidance in ISA 315, and the responses to the assessed risks of material misstatement are to be framed in terms of ISA 330, in each case applied at the level of the group financial statements (a ‘top-down’ approach). This will help group engagement teams better consider all aspects of where risks may exist in a group audit, and how those risks should be responded to, regardless of whether the response is then executed at a ‘component’ level or not.

Re-examine the mechanisms in ISA 600 for focusing the work effort across the group

We refer to these mechanisms in our response to GA1. We believe that the IAASB should re-examine the validity of these mechanisms as we question whether it appropriately reflects a ‘top-down’ approach to the assessment of risks of material misstatement and responses as set out in ISA 315 and ISA 330. During our outreach activity, we heard that because the group auditor scopes the work to be performed on a group audit by first allocating group financial information into “components” and then, having identified those components, has to allocate them into different levels of significance (i.e. “two-tier mechanism”), the group audit may not always result in an appropriate top-down approach to the assessment of the risks of material misstatement at the group financial statement level in accordance with the principles of ISA 315. As a result, the responses to those risks, even if correctly determined in accordance with ISA 330, may not be appropriate in the circumstances. We agree with the IAASB’s observation in paragraph 197 of the ITC that this “two-tier mechanism” may not appropriately focus the work of a component auditor on those aspects that are likely to be most significant in relation to the group financial statements (e.g. audit resources are targeted on testing transactions and account balances of the component’s financial information, without any particular focus on areas of risk of the group financial statements).

There are a number of other requirements and guidance (or concepts) that have been included in ISA 600 as a result of the work effort being driven on the basis of whether components are considered significant or non-significant. One particular example is the concept of component materiality (and component performance materiality). During our outreach activities, stakeholders alerted us to this matter by expressing the view that the ISA 600 two-tier mechanism exacerbates the issues surrounding the application of materiality in a group audit discussed in paragraphs 254-261 of the ITC. The concepts of component materiality and component performance materiality, being introduced to support the ISA 600 two-tier mechanism, are not well understood and there are many variations in practice. We question whether these concepts are even necessary. Absent the ISA 600 two-tier mechanism, component materiality and component performance materiality may not need to be determined by the group auditor, as ISA 320 would simply be applied instead (please also refer to GA6 in respect of component materiality matters).

We have identified a number of other issues explained in the ITC that relate to inappropriate or ineffective performance of requirements and guidance that may be, in part, resolved through a return to a ‘top-down’ risk-based approach in accordance with ISA 315. For example, a lack of understanding of what is required under...
the ISAs to “audit a component” and challenges regarding the work effort for non-significant components. These challenges might be related to the fact that work effort is related to the size or nature of the component and not, per ISA 330, based on or responsive to the risks of material misstatement of the group.

Accordingly, changing the scoping process in ISA 600 to align it more directly with the risk-based approach in ISA 315 and ISA 330 i.e. identifying and assessing the risks of material misstatement for the group as a whole, rather than focusing the determination of the necessary work effort on the determination of whether components are considered significant or non-significant, in our view would deliver a more effective audit of high quality and address a number of issues raised in the ITC.

GA6. Issues Relating to Component Materiality and Other Aspects of Materiality Relevant to Group Audits
(a) Paragraphs 254–261 set out issues relating to applying the concept of materiality in a group audit. Do you agree with the possible actions recommended in paragraph 261 to clarify the different aspects of materiality in a group audit? If not, please indicate which actions are not appropriate and describe why.
(b) Recognizing that significant changes to ISA 320 will not be contemplated until a review of ISA 320 has been performed in its entirety (potentially as part of a future project to address materiality more broadly), please describe any other relevant issues or additional actions that you think may be appropriate relating to component materiality, component performance materiality or the clearly trivial threshold at the component level

Issues Relating to Component Materiality and Other Aspects of Materiality Relevant to Group Audits

We support the IAASB’s view that many of the issues related to component materiality, summarised in paragraphs 254-255 of the ITC, are intrinsically linked to the requirements and guidance in ISA 320, and therefore, if retained cannot be resolved in the context of a project that is addressing ISA 600 more broadly. As noted in our response to G2, we acknowledge that work currently being undertaken by the IASB may also give rise to further implications for ISA 320.

However, during our outreach activity, stakeholders confirmed the view expressed in paragraph 254 of the ITC that there is confusion about, and variation in practice in relation to, the concepts of component materiality and component performance materiality, and that the concept of aggregation risk that underpins the requirements and application material in ISA 600 is also not well understood. In this regard, notwithstanding our response to GA5 regarding the link between the ISA 600 two-tier mechanism and the determination of component materiality, we support the proposal by the IAASB that more topic-specific guidance relating to group materiality, that would not infringe on the basic principles in ISA 320, could be explored further.

GA7. Responding to Identified Risks of Material Misstatement in a Group Audit (Including Issues Relating to the Group Engagement Team’s Involvement in the Consolidation Process)
(a) Paragraphs 262–292 set out matters relating to responding to identified risk of material misstatement in a group audit (including the group engagement team’s involvement in the consolidation process).
(i) Which of the actions outlined in paragraphs 272–273, 279, 288 and 292 would be most meaningful to address issues relating to responding to identified risks of material misstatement in a group audit? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.
(b) Specifically:
(i) What are your views on scoping the audit based on identifying and assessing the risks of material misstatement for the group as a whole, rather than focusing the determination of the necessary work effort on the determination of whether components are considered significant or non-significant? Are there any practical challenges that we need to consider further?
Are there other possible actions related to auditing groups where there are a large number of non-significant components that we should explore? Are there other approaches to auditing such groups that need to be considered? Do the possible actions presented lead to any additional practical challenges?

Should the standard be strengthened for the group engagement team to be more involved at the sub-consolidation level in the appropriate circumstances? Are there further issues or practical challenges that have not been considered?

Should the requirements or application material relating to subsequent event procedures be strengthened or clarified? Are there further issues or practical challenges that have not been considered?

Responding to Identified Risks of Material Misstatement in a Group Audit (Including Issues Relating to the Group Engagement Team’s Involvement in the Consolidation Process)

Please see our response to GA5 above where we:

- Strongly support the IAASB’s proposal to make more explicit reference to the principles, requirements and related application material in ISA 315 and ISA 330, so as to better support the application of those ISAs in the context of a group audit engagement, supplemented with additional examples for relevant aspects and principles of those ISAs; and
- Strongly encourage the IAASB to re-examine the validity of the ISA 600 two-tier mechanism as we question whether it appropriately reflects the risk-based approach (or ‘top-down’ approach) set out in ISA 315 and ISA 330. In that regard, we believe the IAASB would need to also revisit the work effort specified in 600.26-28 i.e. “specified audit procedures”, “specified procedures”, “audit of a component”, and “analytical procedures”, as the work effort would no longer be linked to a “component”, but to the risk, as required under a risk-based approach.

Non-significant components

Scoping the group audit by applying the risk-based approach i.e. identifying and assessing the risks of material misstatement for the group as a whole, rather than focusing the determination of the necessary work effort on the determination of whether components are considered significant or non-significant, would respond to a number of issues that have been raised in relation to ‘inappropriate work effort’ for non-significant components. This is because the work effort would be related to the risk at the level of the group as a whole, even if it happens to require further audit procedures to be carried out in a ‘non-significant component’.

Consolidation

We support the IAASB’s proposals to explore the group engagement team’s responsibilities in relation to sub-consolidations. In the FRC’s AQRT inspection work, we have found that issues arising in respect of work on the consolidation process tend to be a result of insufficient involvement by the group engagement team. In particular, the AQRT have found cases where there is a very significant sub-consolidation in another jurisdiction but the audit work is often being performed by the local component auditor, with the group audit team performing work on a very limited final consolidation in their own jurisdiction. We also believe there may be merit in revisiting the emphasis in the requirements in ISA 600.33 and 600.34 on the performance of those requirements by the group engagement team, particularly in the context of sub-consolidations.
(a) Paragraphs 293–303 set out matters relating to the review and evaluation of the work of component auditors by the group engagement team.

(i) Which of the actions outlined in paragraphs 299 and 303 would be most meaningful in addressing issues relating to the review and evaluation of the work of component auditors by the group engagement team? (ii) Why do you believe these actions are necessary? (iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why. (iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.

Review and Evaluation of the Work of Component Auditors

We support the IAASB’s proposals to strengthen the requirements and application material in the ISAs regarding review procedures. For example, the IAASB should consider enhancing the application material by highlighting some of the challenges that group engagement teams may face when reviewing the work of a component auditor, and including more specific examples that address some of the practical challenges that may be identified in responses to the ITC.

In addition, the AQRT have found cases where the determination of whether it is necessary to review other relevant parts of the component auditor’s audit documentation is deferred until the group auditor has evaluated the component auditor’s communications. We believe that this determination should take place at the planning stage of the audit. As explained in our response to GA1 above, providing further clarity in ISA 220 about what is meant by ‘performance’, ‘direction’, ‘supervision’ and ‘review’ and embedding a QMA-EL approach will be the most effective means to enhance audit quality in this regard, and for other matters relating to the review and evaluation of the work of component auditors by the group engagement team.

In addition:
- We do not understand the concern behind the statement in the ITC that care will be needed to ‘ensure that, all other things being equal, the extent of the review required or expected by the group engagement team does not exceed that which would be undertaken in a non-group audit situation’. However, we believe that under a QMA-EL approach, the group engagement partner (and group engagement team) will adjust their efforts regarding direction, supervision and review according to the level of risk to quality at the group engagement level, regardless of whether the engagement is a group audit engagement or a non-group audit engagement.
- We support the IAASB’s proposal in paragraph 303 of the ITC to strengthen the documentation requirements in ISA 600, but through enhanced links to the requirements in ISA 220 and ISA 230, including ensuring the group engagement team appropriately documents and evaluates communications with component auditors.

The following questions are overall questions relating to group audits:

GA10. Are there any other issues relating to group audits that we have not identified? If yes, please provide details. What actions should we take to address these issues?
GA11. Are there any other specific actions that others could take in relation to group audits? If yes, please provide details.
GA12. Are there any specific considerations for SMPs related to the issues and potential actions described in this section? Are there any other considerations for SMPs of which we should be aware? If so, please provide details and views about these matters.
GA13. Are there any specific public sector considerations related to the issues and potential actions described in this section? Are there any other public sector considerations of which we should be aware? If so, please provide details and views about these matters.

44 ISA 230 Audit Documentation
Regarding the proposals identified in our response and in the ITC related to the risk based approach, we would encourage the IAASB to ensure that any enhancements to ISA 600, as described above, are undertaken with appropriate co-ordination with other relevant projects, particularly in relation to ISA 315. We also wish to emphasise our support for the proposals of the IAASB to explore the development of requirements or application material in ISA 600 that emphasise the need for the engagement team to focus on the impact of disclosures in the audit of group financial statements throughout the audit engagement.
About the FRC
The Financial Reporting Council is the UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. We promote high standards of corporate governance through the UK Corporate Governance Code. We set standards for corporate reporting and actuarial practice and monitor and enforce accounting and auditing standards. We also oversee the regulatory activities of the actuarial profession and the professional accountancy bodies and operate independent disciplinary arrangements for public interest cases involving accountants and actuaries.