IAASB International Auditing and Assurance Standards Board®

Overview

ENHANCING AUDIT QUALITY IN THE PUBLIC INTEREST

A FOCUS ON PROFESSIONAL SKEPTICISM, QUALITY CONTROL AND GROUP AUDITS

AN OVERVIEW OF THE IAASB'S INVITATION TO COMMENT

Why is this consultation important to you?

Auditors play a key role in contributing to the credibility of the financial statements on which they are reporting. High-quality audits support financial stability. As the global auditing standard setter,[1] we have a public interest responsibility to develop standards and guidance for auditors to facilitate high-quality audits being achieved – which in turn builds public trust and confidence in financial statements and financial reporting more broadly.

Who should respond?

We want to hear from all of our stakeholders. In particular, this publication is targeted at:

- Financial statement users.
- Preparers.
- Audit committees.
- Organizations representing these groups.

What does our consultation address?

Our auditing and quality control standards need to stay relevant in the face of continually changing circumstances in diverse jurisdictions. We are focused on three priority topics – professional skepticism, quality control, and group audits.

What do we want to hear from you and why are we reaching out now?

This Overview outlines the public interest issues we believe should be addressed as a matter of priority and provides high-level insight into the direction we could take. We want you to tell us:

- Have we identified the right issues?
- What do you think causes these issues?
- What changes to our standards might be necessary?
- What else might be needed to complement changes to our standards?

Our work is at an early stage. We want to make sure we understand your needs and expectations about where enhancements to audit quality are needed and your views about what direction our work should take. We want to hear about matters we should address in the public interest. We have learned that asking questions at an early stage helps us more effectively develop and revise our standards.

Specific questions are included on pages 30 and 31.

We are not the only organization that can influence audit quality. As the global auditing standard setter, we encourage cooperation and debate among regulators, policymakers, national auditing standard setters and other stakeholders. Therefore, we are also asking for your views about what others can do to improve audit quality.

[1] The IAASB develops auditing and assurance standards and guidance by use for all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board (PIOB), which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance.

The objective of the IAASB is to serve the public interest by setting high-quality quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthened public confidence in the global auditing and assurance profession.

How can you learn more?

Some readers may want more detail on areas described in this consultation. You can find more information in the *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits.*

The Invitation to Comment goes into more depth about:

- How our standards currently address various matters.
- Concerns we have noted about these matters.
- Possible actions we may take in response, including highlighting specific areas in our standards that we might improve to enhance audit quality.
- More specific questions we would like to have answered.

How will your feedback be considered and how can you send it to us?

We describe possible actions to enhance audit quality in this Overview and the Invitation to Comment – specifically in relation to professional skepticism, quality control and group audits. This does not limit us to these actions if stakeholders believe others may be more effective to respond to the public interest issues. This consultation may also help us identify actions to address in the future.

You are welcome to respond to this Overview, the Invitation to Comment, or both. Both set out questions to answer. If you choose to answer the questions in the Invitation to Comment, you need not answer the questions in this Overview. All responses to both documents will be considered.

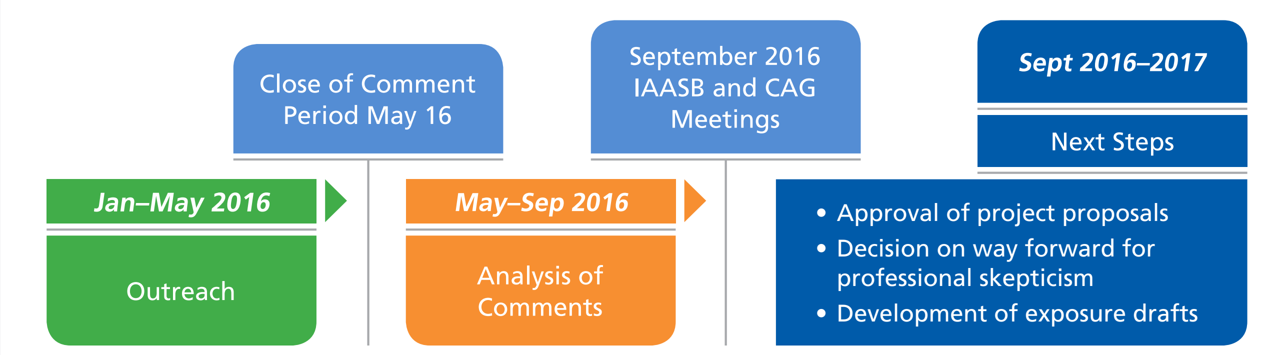
To send us your views in writing, please submit your comments online at this link no later than **May 16, 2016.** All responses will be published on our website.

We also plan to supplement our outreach program with additional events focused on this consultation. For more information on events, or to notify us of events your organization may be planning, visit www.iaasb.org/focus-audit-quality or contact us at IAASBcommunications@iaasb.org.

What happens next?

Your input will help us decide on our next steps – for example, by changing certain of our standards or by taking other actions. We intend to use your responses as the basis for moving forward as quickly as possible. We plan to decide on next steps later in 2016, including tabling project proposals for approval. Once we do so, we will start preparing exposure drafts of potential changes to selected standards – with a focus on those relating to quality control and group audits. We will also determine how we should progress actions related to professional skepticism, including in conjunction with our planned standard-setting activities on quality control and group audits.

Key aspects of our expected timeline for the three projects (quality control, group audits and professional skepticism) are as follows:



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Our Standards Frequently Mentioned in this Publication

- International Standards on Auditing™ (ISA™)
- International Standard on Quality Control™ (ISQC™ 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
- ISA 220, *Quality Control for an Audit of Financial Statements*
- ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- ISA 200, *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing*
- ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment*

WHAT IS DRIVING OUR AREAS OF FOCUS?

1 The ISAs and ISQC 1 are fundamental in supporting high-quality audits, which in turn builds public trust and confidence in financial statements. This will be achieved by consistent implementation of our standards around the world. We need to know if our public interest aims are being achieved.

> The primary output of an audit is an auditor's opinion that provides users with confidence as to the reliability of the audited financial statements. For the majority of users, the absence of a modified auditor's opinion is an important signal about the reliability of the financial information.
>
> - Paragraph 20 of the IAASB's Framework for Audit Quality (2014)

2 Our efforts to clarify the ISAs and ISQC 1 represented a big step in our commitment to audit quality. The clarified ISAs and ISQC 1 became effective in 2009. Soon afterwards, we began our first post-implementation review (the ISA Implementation Monitoring Project), which was completed in July 2013.

3 We continue to work closely with our stakeholders to understand where we should focus our future efforts and why – and now we seek your views in determining our way forward.

ACTIVITIES THAT HAVE INFORMED US

IAASB's ISA Implementation Monitoring project

The July 2013 findings from the ISA Implementation Monitoring project[2] reflect the experience of **firms, national auditing standard setters, professional accountancy organizations** and others with implementing the clarified ISAs and ISQC 1, as well as input from **audit inspection bodies** and **regulators**. The findings showed the need for us to make some improvements to our standards to achieve more consistent and effective application.

Ongoing Outreach

As part of our rigorous outreach program, we are collaborating with **audit inspection bodies and regulators**. We also talk and listen to **firms, national auditing standard setters** and others. All this tells us where we may need to act to improve standards or auditor performance. We have stepped up our efforts to reach **investors, audit committees and preparers** to better understand their expectations of auditors and of us.

Public consultation on *IAASB's Strategy for 2015–2019* and *Work Plan for 2015–2016*

IAASB's *Strategy for 2015–2019*[3]

The IAASB's Strategy sets out three strategic objectives. The first, and most important, is to **ensure that the ISAs continue to form the basis for high-quality, valuable, and relevant audits conducted worldwide by responding on a timely basis to issues noted in practice and emerging developments.**

IAASB's *Work Plan for 2015–2016*[4]

Our public consultation on our current Work Plan highlighted our commitment to addressing significant findings from the ISA Implementation Monitoring project on a timely basis. Respondents to the consultation urged us to do so in the public interest. Their input was the basis for our choice of projects. With the strategic objectives in mind, we gave priority to:

- The three topics explored in this consultation – **professional skepticism**, **quality control**, and **group audits**; and
- Special considerations in audits of financial institutions (including a potential revision of our standard that deals with auditing accounting estimates).

Prioritizing Work on Auditing Accounting Estimates

While we will continue to consider issues relevant to audits of financial institutions, we have decided it would be in the public interest to focus more broadly on auditing accounting estimates. We have already begun to assess the need for enhanced requirements and better guidance for auditors, and have approved a project proposal at our December 2015 meeting to commence standard-setting actions to revise ISA 540. We think it is essential to quickly make progress in this area in light of developments in financial reporting standards, and will continue to dedicate resources in 2016 to doing so. However, this publication does not explicitly address that project, although certain aspects of it are highlighted due to the links to professional skepticism, quality control and group audits.

[2] www.iaasb.org/publications-resources/clarified-isas-findings-post-implementation-review

[3] www.iaasb.org/publications-resources/iaasb-strategy-2015-2019

[4] www.iaasb.org/publications-resources/iaasb-work-plan-2015-2016

WHAT ARE THE MOST RELEVANT PUBLIC INTEREST ISSUES AND HOW CAN WE TAKE ACTION?

4 While we are committed to fully exploring the three topics, we will be successful if we fully understand what you believe needs to be addressed in the public interest. We have identified key public interest issues and have been asking ourselves questions to frame these issues. Our views are set forth in the following table.

Table 1: Our Views on the Most Relevant Public Interest Issues Related to Professional Skepticism, Quality Control and Group Audits

- **Fostering an appropriately independent and challenging skeptical mindset of the auditor** – Professional skepticism is a fundamental concept and core to audit quality. Can we better articulate how we and others expect auditors, especially engagement partners, to appropriately apply professional skepticism? Can the concept be reinforced more within the ISAs, or through other activities by us or others?
- **Enhancing documentation of the auditor's judgments** – How might an audit file more appropriately demonstrate the auditor's decision-making processes, essential interactions and communications, in order to support the auditor's judgments and the audit opinion overall? How can the application of professional skepticism be better evidenced?
- **Keeping ISAs fit for purpose** – Do the ISAs contain robust, yet sufficiently flexible, requirements and guidance to drive appropriate engagement partner and engagement team performance, regardless of the circumstances? Do they promote audit quality at the engagement level in the varied and complex scenarios that arise today, and that are likely to evolve in the future? For example, how can we improve the ISAs to enhance the quality of multi-national audits, considering possible challenges arising from law or regulation (including mandatory auditor rotation) and the use of evolving audit delivery models?
- **Encouraging proactive quality management at the firm and engagement level** – Could we improve audit quality by taking a fresh look at our quality control standard for firms? What can be done to encourage a scalable and robust approach to quality that is fostered by proactive firm leadership and management, and becomes a pervasive aspect of the firm's culture and strategy? How can important processes like engagement quality control reviews and processes to respond to internal and external inspection findings be strengthened in our standards?
- **Exploring transparency and its role in audit quality** – Transparency reporting is increasing globally. How could investors and other financial statement users obtain greater insights into a firm's system of quality management (e.g., through firm-level transparency reporting or other mechanisms to demonstrate the application of effective quality management at the engagement level)?
- **Focusing more on firms (including networks) and their internal and external monitoring and remediation activities** – Should our standards more explicitly address expected actions to remediate audit deficiencies or inspection findings? Would audit quality improve if we enhanced requirements as to how firms communicate internally and with other network firms and how they respond to internal and external inspection findings across the network? How can we safeguard against firms relying on network policies and procedures when it is not appropriate to do so?
- **Reinforcing the need for robust communication and interactions during the audit** – Are there opportunities to strengthen our standards in relation to interactions and communication among those involved in an audit? This might affect, for example, interactions between engagement partners, their teams, and others involved in the audit, or between group engagement teams and component auditors – as well as communications with audit committees.

QUESTIONS FOR YOU

We have identified 9 key questions in this Overview specifically for you in light of what we have been exploring. These questions are found on pages 30 and 31. It is important that we hear from our stakeholders about what they believe are the root causes of audit quality issues (including those raised in inspection findings) and whether our potential actions are likely to be responsive to these issues.

AUDIT QUALITY: WHAT DO WE MEAN AND HOW CAN IT BE ENHANCED?

How are quality audits achieved?

The term **audit quality** encompasses the key elements that create an environment which maximizes the likelihood that **quality audits** are performed on a consistent basis.

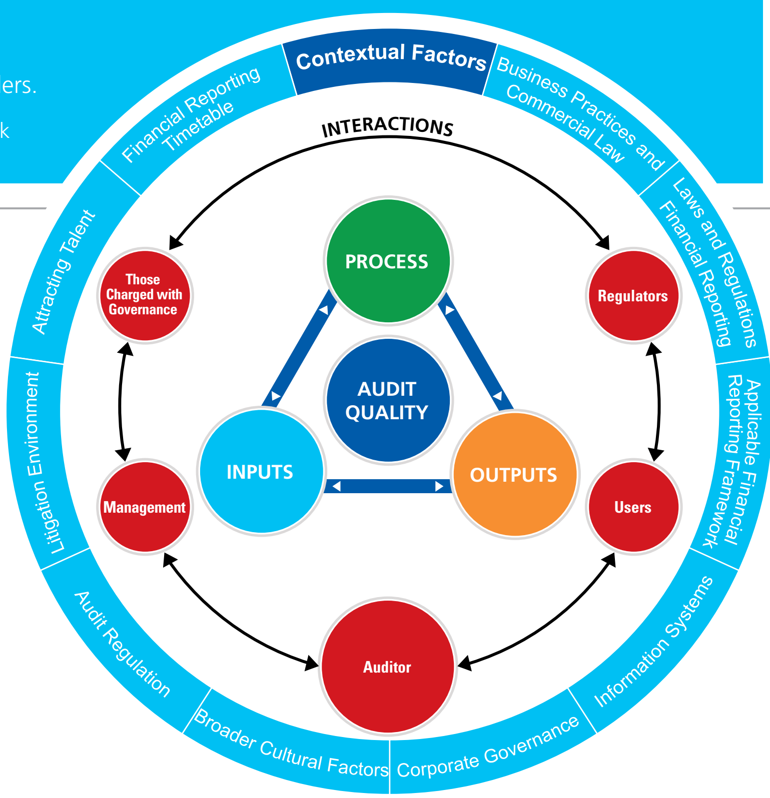
The objective of an audit of financial statements is for the auditor to form an opinion on the financial statements based on having obtained sufficient appropriate audit evidence about whether the financial statements are free from material misstatement and to report in accordance with the auditor's findings. **A quality audit** is likely to have been achieved by an engagement team that:

- Exhibited appropriate values, ethics and attitudes;
- Was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work;
- Applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
- Provided useful and timely reports; and
- Interacted appropriately with relevant stakeholders.

- Paragraphs 1–2 of the AQ Framework

5 The IAASB's *Framework for Audit Quality*[5] (the AQ Framework) was developed to:

- Raise awareness of the key elements of audit quality.
- Encourage stakeholders to explore ways to improve audit quality.
- Facilitate dialogue between key stakeholders[6] - acknowledging the shared goal of improving audit quality.



[5] www.iaasb.org/publications-resources/framework-audit-quality-key-elements-create-environment-audit-quality

[6] In the graphic, "those charged with governance" means the people responsible for overseeing strategic direction of the entity and obligations related to its accountability. That includes overseeing the financial reporting process, Examples of those charged with governance are Boards of Directors and Audit Committees. Governance structures vary, reflecting influences such as different cultural and legal backgrounds, size and ownership.

6 Primary responsibility for audit quality rests with auditors, but each stakeholder plays an important role in supporting high-quality financial reporting. The AQ Framework highlights important inputs, processes and outputs. In quality audits, auditors apply rigorous processes and quality control procedures that comply with law, regulation and standards.

7 In recent years, audit oversight bodies have become more active and internationally cooperative. They have intensified inspections, and their publicly reported inspection findings highlight aspects of the audit where improvements to audit quality are needed. For example, in 2014, the International Forum of Independent Audit Regulators – IFIAR – reported persistent deficiencies in important aspects of audits, including the three topics addressed by this consultation.

8 We have begun exploring where specific standards could be enhanced. Making changes to our standards in key areas – with the goal of strengthening auditor performance – is one way to enhance audit quality. For example, in addition to considering enhanced engagement-level requirements, our planned work on firms' system of quality control should help firms increase the prospect of delivering quality audits and expressing appropriate opinions.

> While IFIAR recognizes that inspection findings do not on their own mean that changes are necessarily needed to the standards, IFIAR comment letters encourage the international standard setters [such as the IAASB] to pursue their efforts to consider the themes identified by IFIAR's inspection surveys in defining and conducting its standard-setting projects, with a perspective towards identifying how the international standards might further contribute to improving the quality of the audits globally. IFIAR believes these areas where the IFIAR Survey reports audit deficiencies, especially where those findings are numerous or recurring, deserve the specific attention in the international standard setters' processes. IFIAR believes further investigation in those areas, with a perspective to evaluate if and how standards could contribute to prevent a recurrence of those findings in audit firms and audit engagements, would be beneficial to their relevance.
>
> - IFIAR 2014 Summary of Inspection Findings[7]

9 Broader environmental factors – referred to in the AQ Framework as "contextual factors" – have the potential to impact the nature and quality of financial reporting and, directly or indirectly, audit quality. As countries develop, growing businesses need finance from capital markets, and the environment becomes more complex. Decision-makers need and expect reliable financial reporting. In response, law, regulation, financial reporting requirements and corporate governance processes continue to develop and adapt. The evolving business environment and increasing complexity can challenge those who must prepare high-quality financial statements and related disclosures, as well as those who oversee their preparation. Those who oversee these tasks, such as audit committee members, are also affected by change and complexity.

10 The following contextual factors and developments are particularly relevant to our efforts:

- **Business practices and commercial law** – Law or regulation may create tax or other incentives based on domicile. These may influence how entities are structured. Entities are also increasingly using shared service centers to improve effectiveness and efficiency.
- **Laws or regulations relating to financial reporting and the applicable financial reporting framework** – Financial reporting frameworks increasingly require significant management judgment and use of forward-looking information as the basis for recognition or measurement, and expect this information to be disclosed in the financial statements.
- **Information technology** – Technological change is occurring at a rapid pace, ushering in the capability to capture and communicate data digitally, on an unprecedented scale and on almost instantaneous timescales. This has resulted in increasing focus on "big data," whether structured or unstructured. Comprehensive and powerful digital information systems are increasingly capable of handling, analyzing, communicating and responding to these data related changes. Businesses are rapidly changing their business

[7] www.ifiar.org/IFIAR/media/Documents/General/IFIAR%20Global%20Survey%20Media%20Coverage/IFIAR-2014-Survey-of-Inspection-Findings.pdf

models in innovative ways in response to these developments. These changes are feeding into the information systems for financial and broader corporate reporting, and therefore have implications for audits. Audits are also increasingly being conducted using advanced technologies, including the evolving use of audit data analytics.

- **Corporate governance** – Audit committees are important in enhancing audit quality. Reflecting this, audit committees are being called on to play a more active role on behalf of investors and other external stakeholders;[8] not only in overseeing the financial reporting process, but also their oversight of, and interactions with, auditors. In particular, external stakeholders expect audit committees to challenge auditors' judgments.
- **Audit regulation** – Increasingly, inspections of audits of listed entities must be done by independent audit regulatory bodies. Audit inspections are important for evaluating auditors' compliance with auditing standards and, in some cases, other aspects of audit quality. Inspections can identify weaknesses which firms are then expected to address.
- **Attracting talent** – Auditing is a demanding intellectual activity requiring good judgment, an questioning mind, fortitude, and business, financial reporting and auditing knowledge. The changing business and regulatory environment has led to challenges for auditors, and has affected how audits are carried out. This is perhaps most extensively experienced in audits of multi-national entities (which are often group audits). As a result, firms are reorganizing their own structures. They are reviewing how best to organize engagement teams and conduct audits to get appropriately skilled and competent personnel to perform high-quality audits at a reasonable cost. Engagement team members may not all work together in the same place, as they might have in the past. Now, they may be in different jurisdictions or time zones. We refer to these evolving models as audit delivery models – an expression intended to cover terms such as "firm shared service centers," "centers of excellence," "on-shoring," "offshoring," or "outsourcing."

11 As we set standards, and with a view to keeping the ISAs fit for purpose, we need to help auditors appropriately react to the challenges of the evolving environment – so that quality audits can be achieved. Our standards need to strike the right balance. They must promote a "thinking audit" yet remain principles-based (and therefore applicable across a wide range of circumstances). But we know robust guidance to help auditors achieve quality audits and deliver against expectations is essential. As an example, some firms have pointed out a need to develop their own guidance for circumstances not expressly addressed in the international standards. Awareness of this material and the rationale for it is useful as we consider what more may be needed within our standards or as non-authoritative guidance or tools that we could develop for use on an international basis.

12 Our standards must also be capable of being applied to audits of all types of entities globally. We have been called upon to better support small and medium practices in applying our standards to audits of smaller or less complex entities, in particular by firms who do not audit listed entities. We are also interested in whether there are specific implications relating to public sector audits that we should consider, given the public interest importance of many public sector organizations (e.g., central banks and other governmental agencies).

13 We know we need to address key public interest issues relating to professional skepticism, quality control and group audits on a priority basis. Our international standards need to better address increasing complexity, taking into account the rapidly changing technological developments in both the business and audit environment. Our stakeholders and the public at large have high expectations of audit quality, and the role of auditors – and are looking for us to take action.

14 We need to reinforce that auditors will continue to be critical challengers, supported by a regime focused on public interest and quality management. We acknowledge the importance of strengthening our standards and demonstrating responsiveness to concerns about audit quality not being achieved. Taking action will enable us to achieve our strategic objective about global use of our standards. The next sections suggest how we might proceed.

[8] For example, in 2015, the Organisation for Economic Co-operation and Development (OECD) issued revised *Principles of Corporate Governance*. These were endorsed by the G20 Finance Ministers. They also formed the basis for guidelines on banks' corporate governance issued by the Basel Committee on Banking Supervision. Audit committees may also be required to report externally on how they discharged their responsibilities (as happens, for example, in the UK).

HOW CAN WE STRENGTHEN THE APPLICATION OF PROFESSIONAL SKEPTICISM IN AUDITS?

15 How can we reinforce the fundamental concept that auditors need to apply appropriate professional skepticism throughout the audit? This question is at the core of the IAASB's efforts to improve audit quality.

How Our Standards Address Professional Skepticism

ISA Definition: 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.[9]

Our standards explicitly recognize the fundamental importance of professional skepticism. Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.[10]

The February 2012 IAASB Staff Questions and Answers publication[11] focuses on considerations in our standards that are of particular relevance to the proper understanding and application of professional skepticism. Amongst other matters, it discusses:

- What firms and auditors can do to raise awareness of the importance of professional skepticism;
- Aspects of an audit where professional skepticism may be particularly important; and
- How professional skepticism can be evidenced.

16 In conducting an audit in accordance with ISAs, the auditor is required to apply professional skepticism – recognizing that circumstances may exist that may cause the financial statements to be misstated. Professional skepticism is essential in all aspects of the audit – from planning and risk assessment through to the critical assessment of audit evidence in forming the auditor's conclusions. We believe it is in the public interest to explore what can be done to re-emphasize the important role of professional skepticism in audits of financial statements.

[9] ISA 200, paragraph 13(l)

[10] See ISA 200, paragraphs A18 and A21.

[11] www.iaasb.org/publications-resources/staff-questions-answers-professional-skepticism-audit-financial-statements

CALLS FOR ACTION

17 Investors, regulators and other stakeholders expect auditors to challenge management's assertions, including when management has used an expert to help prepare financial statements. Unless auditors do so, they cannot appropriately plan and perform an audit – nor can they conclude, with confidence, whether an entity's financial statements are fairly presented in accordance with the applicable financial reporting framework.

18 Concern about instances in which auditors did not appropriately apply professional skepticism in their audits is a globally recurring theme in audit inspection findings, and has been central to our discussions about audit quality. IFIAR has suggested that enhanced professional skepticism by auditors will contribute significantly to improving the quality of audits and that firms should prioritize efforts in this area.

> The PIOB noted that professional skepticism, as a state of the mind and attitude, should govern the performance of auditors, and inspire the attitude of other accountants, e.g., accountants in business. When accountants (practitioners, non-practitioners, accountants in business) do not display proper professional skepticism it is recognized as a barrier to effective performance.
>
> - September 2014 Conclusions from the PIOB Public Interest Workshop[12]

19 We are seeking to understand what our stakeholders think about the "root causes" of these inspection findings, including their views about why auditors are not, or do not appear to be, appropriately applying professional skepticism. In particular, we want to know how auditors in practice are able to conclude that they have appropriately applied professional skepticism.

20 Questions have also been raised about how auditors can more clearly demonstrate the application of professional skepticism, in particular how to better describe the basis for the auditor's professional judgments and conclusions and how the auditor's mindset has affected the nature, timing and extent of audit procedures performed.

21 We have noticed that research studies sometimes describe the concept of professional skepticism in a manner that differs from how the concept is defined and addressed in the ISAs. For example, some studies describe the application of professional skepticism by referring to outcomes such as auditors assessing certain accounts as more susceptible to risk, obtaining more evidence or explicitly searching for inconsistent evidence, challenging management's judgments, or investigating differences between management's and the auditor's judgments.

22 The existence of various ways to describe the application of professional skepticism indicates that the concept of professional skepticism, and the expectations of how auditors should appropriately apply it, may need to be more clearly articulated in our standards.

12 http://www.ipiob.org/index.php/news-details?nn=10&ns=5

FACTORS INFLUENCING PROFESSIONAL SKEPTICISM

23 The topic of professional skepticism is addressed in the IAASB's standards and is also touched on in the International Accounting Education Standards Board's (IAESB) International Education Standards (IESs) and the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), referred to collectively in this consultation as the International Standards. The table below depicts the concepts in the IESs and the IESBA Code that are relevant to the application of professional skepticism in audits.

Relevant Concepts in the IESs

- Technical competence for professional accountants
- Professional skills
- Professional development, including with respect to values, ethics and attitudes

Relevant Concepts in the IESBA Code

- Integrity
- Objectivity
- Independence of mind
- Professional competence and due care
- Professional behavior

Professional Skepticism, Professional Judgment and Documentation

24 The concepts of professional skepticism and professional judgment are closely related, and together are key inputs to audit quality. Professional skepticism often facilitates the appropriate exercise of professional judgment by an auditor. Similarly, the application of professional skepticism requires professional judgment. Both concepts are essential to the auditor's decision-making.

25 Professional judgment is defined in the ISAs as the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about appropriate actions in the audit engagement.[13] The application of professional skepticism is especially important in the context of audit work on those areas of the financial statements that are highly judgmental or subjective – areas that are influenced, for example, by recent developments in financial reporting standards.

26 While professional skepticism is an attitude, this attitude is applied in making professional judgments that provide the basis for auditors' actions. The documentation of professional judgments made, and actions taken, may provide evidence that professional skepticism was applied. The diagram to the right is a simple illustration of how professional skepticism drives action. Other relevant concepts in accounting, auditing and ethical requirements, including independence of mind, objectivity, and competence, as well as firm-specific and environmental factors may impact the application of profession skepticism.

27 Documentation of professional judgments and actions provides evidence that professional skepticism was applied. The ISAs require auditors to document discussions of significant matters with management, those charged with governance and others, including the nature of the significant matters discussed and when and with whom the discussions took place.[14] We have heard that the additional reporting requirements in the new and revised Auditor Reporting standards, in particular, new ISA 701[15] may serve to improve documentation of professional judgments made during the audit, thereby better evidencing the application of professional skepticism.

How Professional Skepticism Drives Action

Professional skepticism **is an attitude**

▼

Professional skepticism is applied in making **professional judgments**

▼

Professional judgments prompt **actions**

▼

Documentation of professional judgments and related actions

[13] ISA 200, paragraph 13(k)

[14] See ISA 230, *Audit Documentation*, paragraph 10.

[15] New ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, will soon be effective, and will require auditors to communicate key audit matters in the auditor's report for audits of financial statements of listed entities. Key audit matters are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. See www.iaasb.org/new-auditors-report.

Enhancing Professional Skepticism – Role of Individual Auditors, Firms and Others

28 Adopting and applying a skeptical mindset is a personal and professional responsibility for every auditor. The application of professional skepticism is influenced by personal traits, including fortitude (i.e., the strength of mind that enables the auditor to deal with matters arising during the course of the audit with courage), and the auditor's competence (e.g., knowledge, skills and experience).

29 Individual behavior, (including an auditor's), is also influenced by inherent cognitive biases as well as by external factors (such as familiarity threats). Questions have been raised about whether the existing client service relationships, in particular long-term ones, and the payor model affect auditors' ability to appropriately apply professional skepticism. Some stakeholders have asked whether situations arise where auditors unduly accept the fact that management is honest and prepares the financial statements accurately.

30 Firms also have an important role to play in cultivating a skeptical mindset in auditors. This includes designing and implementing policies, procedures and incentives that promote a culture that recognizes and reinforces professional skepticism as being essential – and therefore expected as audits are conducted. A firm's approach to training its auditors, including mentoring, reflective activity and practical on-the-job training, may also enhance the effective development of professional skepticism. Firms' policies and procedures may also focus on how to reward or incentivize auditors who demonstrate skeptical behavior. In addition, effective performance of engagement quality control reviews may contribute to the appropriate application of professional skepticism.

31 It is important to acknowledge, however, that other factors related to the audit can inhibit auditors' application of professional skepticism. Examples of such factors include tight financial reporting deadlines, and heavy staff workloads, as well as time and resource constraints more generally. Our stakeholders have suggested that auditors may approach an audit with a skeptical mindset at first, and appropriately identify issues that need attention, but may not always apply professional skepticism in following through with appropriate actions (i.e., revising risk assessment, designing and performing responsive audit procedures or properly documenting their findings and conclusions). This may ultimately call into question whether professional skepticism was appropriately applied in the audit.

32 Environmental and contextual factors can also affect the application of professional skepticism. These include the business environment, laws and regulations, as well as the local norms and culture in which an auditor operates. For example, we have learned from discussions with stakeholders that auditors in certain jurisdictions may be less comfortable challenging management when auditing areas in the financial statements that are highly judgmental or subjective.

33 Outreach and research suggests that firms, national auditing standard setters, and others are well-positioned to take on initiatives to assist in addressing the concerns that have been raised about professional skepticism. We have identified those parties as "direct influencers" (listed in the box to the right). We believe that the "direct influencers", in particular audit committees, have a significant role to play in challenging and questioning the auditor's application of professional skepticism.

Stakeholders who can directly influence professional skepticism

- Firms/Networks of firms
- Standard setters, including national auditing standard setters
- Professional accountancy organizations
- Educational institutions
- Those charged with governance, including audit committees
- Regulators and audit oversight bodies
- Management/those responsible for preparing the financial statements

34 National auditing standard setters and professional accountancy organizations, educational institutions and others can positively influence the training and education of auditors, thereby developing and promoting the necessary competence to apply professional skepticism and raising awareness of the factors that may inhibit its appropriate application.

OUR PRELIMINARY VIEWS ON A POSSIBLE WAY FORWARD

35 We raised the possibility of undertaking work on professional skepticism in our consultation on our Strategy for 2015–2019 and current Work Plan. Stakeholders who responded to this consultation acknowledged the complexities and challenges we would face in addressing this topic. In general, respondents did not support a discrete standard-setting project leading to changes to ISAs as the primary or only response to the concerns and issues that have been identified. Rather, they suggested that it would first be necessary for us to further explore behavioral, training and other issues in order to have a better basis for understanding what more we and others could do in this area.

36 We are committed, in the public interest and with an open mind, to delving into this complex subject. We want to find meaningful actions that we and others could take to enhance the application of professional skepticism – in a way that takes into account personal traits and their influence on auditor behavior and the importance of developing auditor competencies, recognizing that external factors or barriers will continue to exist.

Our Activities to Date

- Feedback from the consultation[16] on our *Strategy for 2015-2019* and *Work Plan for 2015-2016*
- Professional Skepticism Panel Discussion[17] hosted during our June 2015 meeting
- Feedback provided by the IAASB Consultative Advisory Group at its September 2015 meeting,[18] following a presentation from an academic specializing in professional skepticism
- Consideration of conceptual issues related to professional skepticism during our September 2015[19] meeting
- Summary of academic research on professional skepticism undertaken in 2013–2015 and related discussion at our December 2015 meeting[20]
- Incorporating discussion of professional skepticism into our outreach and liaison activities with a wide range of stakeholders

Areas Being Explored

37 We believe that responding to the concerns raised about professional skepticism will involve a coordinated approach by the IAASB, IAESB and IESBA. Accordingly, a Joint Working Group of representatives from these boards is exploring the following areas to inform our deliberations, including:

- Whether it is clear what is meant by "professional skepticism" and whether the concept is consistently described across the ISAs, IESs and IESBA Code – for example, whether the links between the term professional skepticism and other concepts (such as professional judgement, integrity, independence of mind, objectivity, and sufficient appropriate audit evidence) are clear and well-understood.
- Whether the current requirements and guidance in the International Standards that refer to professional skepticism are clear as to what is expected from auditors, including:

[16] http://www.iaasb.org/publications-resources/basis-conclusions-iaasb-work-plan-2015-2016

[17] http://www.iaasb.org/news-events/2015-06/professional-skepticism-panel-discussion

[18] http://www.iaasb.org/cag/meetings/new-york-usa-0

[19] http://www.iaasb.org/meetings/new-york-usa-10

[20] http://www.iaasb.org/meetings/new-york-usa-11

- Whether the manner in which requirements in the International Standards, in particular those that address the audit of highly judgmental or subjective areas, are designed effectively and use appropriate terminology and language to drive appropriate auditor behavior.
- Whether guidance can be developed to support auditors in their consideration of whether they have appropriately applied professional skepticism in the context of an individual engagement – for example, has enough of the right kind of work been done, and at the right time, as a basis for the auditor's conclusions?
- Whether there is a need for clarification in the ISAs about what constitutes evidence of the application of professional skepticism and how auditors should document the application of professional skepticism in their working papers.

- Whether there are specific actions that firms should take to address professional skepticism, including consideration of the effect of firm culture on the application of professional skepticism.
- How auditors can be effectively trained and how their competencies can be further developed to enhance the application of professional skepticism.
- How the International Standards should recognize and address the nature of auditors' personal traits and biases that may inhibit the appropriate application of professional skepticism.
- How the technical nature of these concepts can be better brought to life in the auditor's understanding of the purpose of an audit and with respect to stakeholders' expectations about how professional skepticism is to be applied.
- The potential effect of evolving use of technology in audits, together with increasing business complexity, for example, whether auditors use technology (such as audit software applications and checklists) appropriately to support the application of professional skepticism.
- The role of engagement partners, engagement quality control reviewers, audit committees, audit oversight bodies and others in influencing the appropriate application of professional skepticism.
- How the local norms and culture impact the application of professional skepticism.
- Whether a professional skepticism framework or a professional judgment framework that focuses on professional skepticism (a topic already explored by some firms) should be developed.

We plan to emphasize the importance of professional skepticism in revising specific standards

Our Current Projects – A Step Forward

38 We believe our current efforts on quality control and group audits, as well as our project on accounting estimates, provide opportunities to reinforce the concept of professional skepticism. Our efforts related to quality control and group audits are described in this consultation, for example:

(a) How firm leadership responsibility and accountability (i.e., "tone at the top"), firm culture and strategy, as well as actions by the engagement partner, can better promote the application of professional skepticism in audits (see paragraphs 61–64). For example, we will explore:

(i) How to reinforce that quality is essential in performing audits and highlight the importance of an internal culture that sets expectations for the appropriate application of professional skepticism throughout the audit, and allows engagement team members to raise concerns without fear of negative consequences.

(ii) How a firm's policies and procedures reward and incentivize auditors who demonstrate skeptical behavior in performing audits.

(b) Steps that could be taken to better encourage appropriate application of professional skepticism with respect to judgments made by the group engagement partner and group engagement team in a group audit, including more robust interactions and communications with component auditors (see paragraphs 76 and 96).

39 As part of its work to revise ISA 540, we will seek to stress the importance of professional skepticism and its role in making professional judgments in relation to the auditing of accounting estimates that are complex or have been identified as having high estimation uncertainty. These accounting estimates generally involve significant management judgment and therefore there is an increased risk of unintentional or intentional management bias. In this regard, consideration could be given as to how the requirements in ISA 540 are drafted, with a view to making amendments that improve the focus on auditors approaching accounting estimates with a more questioning mindset rather than one of corroboration. The revised standard could also highlight the need to consider the effect of contradictory audit evidence that comes to the auditor's attention.

40 Other areas that could benefit from more emphasis on professional skepticism may emerge from our:

(a) Information-gathering about the use of audit data analytics.

(b) Future projects, such as the project to address issues relating to the auditor's identification and assessment of risks (ISA 315 (Revised)).

RELEVANT IAESB AND IESBA DEVELOPMENTS

41 The IAESB's consultation on its future strategy acknowledges the relevance of the topic of professional skepticism and poses a question to stakeholders about what actions can be undertaken by the IAESB to improve auditors' professional competencies related to the application of professional skepticism.

42 The IESBA is actively contributing to the activities of the Joint Working Group, with a view to determining whether there are areas within the IESBA Code where there would be benefit in elaborating on, emphasizing or clarifying ethical considerations relating to professional skepticism in ways that would support and complement the discussion of professional skepticism in the ISAs and the IESs.

HOW YOUR FEEDBACK WILL BE USED

43 The Joint Working Group will consider various inputs, including the feedback to this consultation and the IAESB's next steps in developing its future strategy, as well as relevant national developments and the results of academic research. The group will make observations or recommendations for further actions for the standard-setting Boards to consider. These will include whether standard-setting activities may be appropriate and what other potential actions might be necessary in the public interest.

44 The Joint Working Group's work, feedback from this consultation, and our planned outreach in 2016 is intended to open the dialogue about these fundamental issues. This input will help us consider whether changes to some of our standards could more directly encourage the application of professional skepticism. We will also consider other appropriate actions that we can take either alone, or in coordination with others. By late 2016, we expect to be in a position to decide on our way forward.

HOW CAN WE STRENGTHEN OUR STANDARDS ADDRESSING QUALITY CONTROL?

45 In addition to setting global auditing standards, we also set global quality control standards for firms. Our standard, ISQC 1, provides the foundation for the approach to quality for firms of all sizes. It sets out what we believe is needed in a firm's system of quality control for audits and reviews of financial statements, and other assurance and related services engagements. An effective system of quality control supports consistent quality in all the services a firm provides and is one of the essential components of how a firm manages itself.

46 ISQC 1 requires a firm to develop policies and procedures addressing key elements of a system of quality control. These elements include:

- Leadership responsibilities for quality within the firm
- Acceptance and continuance of client relationships and specific engagements
- Monitoring
- Relevant ethical requirements
- Human resources
- Engagement performance

\- Paragraph 16 of ISQC 1

47 ISA 220 complements ISQC 1 by addressing quality at the engagement level – that is, for each audit. ISA 220 is premised on the basis that the firm is subject to ISQC 1 or to national requirements that are at least as demanding as ISQC 1.

48 In the wake of the financial crisis, many companies have responded to the changing environment and emerging corporate governance risks by revisiting their business practices and relevant activities. As the environment in which firms operate evolves and the focus on quality intensifies, questions have arisen about whether ISQC 1 could be revised to adopt more robust requirements – more explicitly and better addressing certain matters.

POST-IMPLEMENTATION FEEDBACK ON ISQC 1

49 Further, our ISA Implementation Monitoring project identified concerns related to applying ISQC 1. Regulators and audit oversight bodies have urged us to take steps to improve the standard in terms of what they expect from firms, in particular in relation to:

(a) More direct firm leadership responsibility and accountability for quality. Firm leadership needs to set an appropriate "tone at the top" to focus the firm and its personnel on continually achieving and enhancing quality;

(b) Understanding causal factors of findings from both external and internal inspections. Firms are also expected to take action to respond to these findings, referred to as remediation or remedial actions;

(c) Monitoring the effectiveness of those remedial actions and making adjustments to them if they are not achieving the desired results; and

(d) Establishing a more explicit link between accountability for quality within policies and procedures addressing human resource matters (e.g., recruitment, retention, training and remuneration).

50 Some of our stakeholders, in particular some small and medium practices, see ISQC 1 as having a "one size fits all" approach to quality control. They have encouraged us to think about how we can improve the standard to deal with differences in the size and nature of the firm or its services.

A NEW QUALITY MANAGEMENT APPROACH

Introduction

ITC Paragraphs 45–67

51 We have to find a way to respond to the diverse challenges raised – how to improve the standard while acknowledging its application by firms of all sizes and to engagements other than audits. Considering the feedback received, we support what we call a new "quality management approach" (QMA). The approach we propose would emphasize the responsibility of firm leaders for a more proactive, scalable and robust response to managing quality risk that would more easily adapt to a rapidly changing business environment.

52 To meet the objectives of ISQC 1, firms today apply many different policies and procedures, which vary depending on the firm's circumstances. Some firms may have already moved towards using more proactive approaches to managing quality – as they have been challenged to focus more on particular elements of their system of quality control as a result of external inspection findings.

53 A QMA would integrate a firm's policies and procedures within its quality system through identification of relevant risks to quality and design of appropriate policies and procedures to address those risks. This consultation provides an opportunity to obtain views and further input to assist us in moving forward with a revision of ISQC 1, including the possibility of incorporating a QMA in ISQC 1.

54 Revising ISQC 1 to incorporate the use of a QMA may provide us with the opportunity to provide guidance as to how firms might, in appropriate circumstances, consider whether and how corporate governance principles[21] may be helpful or relevant in the context of identifying, assessing and responding to quality risks.

55 While retaining robust requirements, incorporating a QMA into ISQC 1 (discussed further in paragraphs 60–65) would involve a broader revision and restructure of ISQC 1 and not just targeted amendments to specific requirements and guidance. In reconsidering the structure of the standard, we will concurrently address the specific issues and concerns with the current quality control requirements discussed in paragraphs 67–83, potentially strengthening the requirements and enhancing the application material in the standard.

[21] For example, the OECD Principles of Corporate Governance include principles in priority areas such as remuneration, risk management, board practices and the exercise of shareholder rights.

56 A redesign of our quality control standards also gives us a chance to further demonstrate how the management of quality is scalable, especially for firms that do not audit listed entities (or perform audits at all).

57 We believe that requiring a QMA would help firms in designing and implementing effective quality management systems that:

(a) Take account of the size and nature of the firm, the services the firm provides, and the nature of the entities to whom those services are provided, and

(b) Are flexible enough to take account of changes in the firm's environment.

58 ISA 220 could also be revised for the adoption of a more proactive, scalable and robust approach to audit quality at the engagement level. For example, there may be a need in ISA 220 to establish more explicit requirements for the engagement partner to more proactively manage quality risks at the engagement level.

59 We will also consider the implications of a QMA at the firm level for group audits. For example, the existence of a firm-level QMA may impact the engagement level considerations about acceptance and continuance of group audits.

Incorporating a QMA into ISQC 1

60 A QMA would increase the focus in ISQC 1 on the importance of and need for effective firm leadership as a foundation to the ability of the firm to achieve quality at all levels. Specific requirements may address the need for:

(a) Creating the appropriate culture and tone within the firm, including a focus on leadership accountability for quality and the important role leaders in the firm have in this regard; and

(b) Setting the basis for how the risk of not meeting the firm's quality objectives (referred to as quality risk) is viewed and addressed by the firm and its personnel, which includes consideration of integrity and ethical values and the environment in which the firm operates.

For more details on areas to be explored in considering changes to ISQC 1, see Table 2 of the ITC.

Interaction of a QMA with the Firm's Culture and Strategy

61 A firm's culture, like other aspects of the environment in which the firm operates, influences the engagement partner and the rest of the engagement team. Environment and culture can affect their mindset, their values, ethics and attitudes, and consequently the way they discharge their responsibilities. While the audit is designed to protect the public interest, firms are commercial entities. Each firm's culture is an important factor in determining how its partners and staff are successful in serving the public interest as they perform audits and at the same time achieve the firm's commercial goals. A QMA would make it clear that firm leadership, as part of the firm's governance structure, is responsible for establishing the firm´s overall culture and strategy, and thereby accountable for quality overall.

62 A QMA may help to more effectively integrate the firm's quality management system into other aspects of its management structures and business processes. We believe that this would further enhance a firm-wide culture of quality, and leadership accountability for quality. Integration of the firm's quality management system with corporate governance and risk management systems may lead to more proactive processes for understanding and responding to internal and external inspection findings.

63 A firm's culture and strategy are at the core of a QMA, and foundational to its effectiveness. The firm's overall strategy would be required to incorporate its quality objectives, which, consistent with ISQC 1, would be to establish and maintain a quality management system that provides the firm with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) Reports issued by the firm or engagement partners are appropriate in the circumstances.[22]

[22] These quality objectives align with the objectives of ISQC 1, as described in paragraph 11 of the standard.

64 Effective operation of the quality management system, including embedding quality in all of the firm's activities, requires a transparent and clear definition, and communication, of roles and responsibilities, as well as sufficient and appropriate resources in terms of human capital, policies, methodologies, tools and other guidance.

Elements of a QMA

65 Revising ISQC 1 to incorporate the use of a QMA may include using an approach that is similar to, or aligned with, principles in existing risk management and governance frameworks.[23] Key aspects of our preliminary thinking about how ISQC 1 could incorporate a QMA include:

- The relevant activities in support of the continually evolving process of a QMA, the elements of which are set out in the following diagram.
- Retaining the existing objectives and robustness of requirements in ISQC 1, although the way that the standard is structured would likely be revisited.

ELEMENTS OF A QMA
Establish quality objectives—The firm's quality objectives would be an integral part of its overall strategic objectives, set in the context of its business model and culture and could consider the quality implications for each business area.
Perform quality risk assessment—Identifying events and conditions that may have a significant effect on the firm's ability to achieve the quality objectives.
Design and implement responses to quality risks—Designing appropriate responses to identified quality risks. The quality objectives serve as a framework for these decisions. For example, in an audit context, policies and procedures designed to respond to the identified quality risks would increase the prospect of delivering a quality audit.
Implement the quality control activities—Implementation of the quality control policies and procedures.
Inform, communicate and document—Identifying and capturing relevant risk information, and communication thereof, to relevant individuals to provide timely and relevant information to the firm's leadership regarding the operation of the firm's quality management system.
Monitor quality—Performing both integrated and distinct monitoring activities. Continually improving the effectiveness of the quality management system, promoting the consideration by firm leadership of all feedback received on quality.

[23] For example, the OECD's Principles of Corporate Governance; and The Enterprise Risk Management–Integrated Framework (2004) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO ERM Framework). The COSO ERM Framework is in the process of being updated to make it more relevant in the increasingly complex business environment. COSO expects to publish an exposure draft for public comment in the first quarter of 2016.

Your Feedback

66 We welcome your views about the elements of a QMA and the relevant activities that have been described in paragraphs 51–65. We believe that revising ISQC 1 to incorporate a QMA:

- Would be responsive to stakeholders' concerns;
- Will require greater accountability for quality by firm leadership;
- Could be effectively implemented by firms of all sizes; and
- Over time, would result in improved quality.

The following sections, and related discussion in the Invitation to Comment, describe in more detail specific areas for improvement in ISA 220 and ISQC 1, respectively. Regardless of whether we revise ISQC 1 to incorporate a QMA, we are committed to addressing the areas identified for improvement.

SPECIFIC ISSUES TO BE ADDRESSED AT THE FIRM AND ENGAGEMENT LEVEL IN REVISING OUR QUALITY CONTROL STANDARDS

67 We believe that, as the environment changes and new challenges emerge, it is in the public interest that our standards clearly set out:

- Robust roles and responsibilities for firm leadership and engagement partners;
- The basis for any reliance on a firm's system of quality control at the engagement level; and
- The basis, where applicable, for reliance by a firm on network-level policies and procedures.

Firm Level: Monitoring and Remediation

ITC Paragraphs 147–159

68 Since ISQC 1 was developed, the nature and extent of audit regulation has expanded in many jurisdictions around the world. External inspections and related findings are far more common today. Audit regulators expect firms to investigate and understand the root causes of inspection findings, and to use them as the basis for determining remediation activities and assessing the effectiveness of those actions. We are therefore considering strengthening ISQC 1 to include policies and procedures to emphasize the need for, and importance of, actions firms take to respond to inspection findings. Such changes would build on firm leadership's responsibility for sustaining and continuously improving audit quality, and setting the right "tone at the top". The firm must monitor and consider all feedback on quality, including the results of internal and external inspections of a firm's system of quality control and of individual engagements, as well as other quality reviews that a firm might perform. Firms must act to respond and monitor the effectiveness of their actions to decide whether more is needed.

Firm Level: Quality Control Policies and Procedures When Operating as Part of a Network

ITC Paragraphs 106–116

69 ISQC 1 is directed at the firm, not the network. The policies and procedures developed by a firm to comply with ISQC 1 will depend on the firm's size and operating characteristics, whether it is part of a network or alliance of firms and, if so, the nature of such arrangement. Firms that operate as part of a network or alliance may share common methodologies and quality control and monitoring policies and procedures, such as a common audit methodology or audit technology. The degree of commonality of such policies and procedures and the extent to which network firms rely on them will vary. A firm that operates as part of a network may seek to rely on the network's system of quality control (including monitoring policies and procedures) to address some of the firm's responsibilities established by ISQC 1.

70 Our current standards do not establish any requirements at the network level, nor do they explain in detail how or to what extent a firm can rely on a network's policies and procedures to address its own responsibilities for quality control. We will therefore consider the need for more clarity in our standards about what a firm needs to consider and document in this regard.

71 We believe it would likely be very challenging for us to develop requirements for networks, because:

- Networks or alliances may be structured differently.
- The nature and extent of their common policies and procedures will vary.
- Structures may be highly influenced by applicable law or regulation in the various jurisdictions in which networks and individual firms are established.

Firm Level: Transparency Reporting

ITC Paragraphs 188–190

72 Firms are increasingly issuing publicly available reports that provide transparency about certain elements of the firm and its operations. Current practices and requirements for such reporting vary significantly between jurisdictions.[24] Transparency reports are sometimes required by law or regulation, although some firms are issuing them on a voluntary basis. The reports may involve reporting on matters beyond the firm's system of quality control or other areas addressed by our standards.

73 Global organizations like the International Organization of Securities Commissions (IOSCO) are interested in the topic.[25] These organizations can influence globally accepted forms of transparency reporting or common elements of transparency reports. They may also influence requirements for transparency reporting and the elements that reports should contain.

74 We believe we should seek to understand the demand and requirements for transparency reporting around the world, and how investors, regulators and others are using these reports. Doing so will enable us to understand whether establishing requirements to address elements of transparency reporting – for example, requiring firms to provide greater insights into their system of quality control and its effectiveness – could be feasible on a global basis and, if so, how that might be done.

Engagement Level: Engagement Partner Roles and Responsibilities

75 The engagement partner responsible for the audit is responsible for the quality of the engagement and its performance. The engagement partner can rely on some aspects of the firm's system of quality control, but must maintain and demonstrate a proactive quality mindset.

76 We believe there are opportunities to strengthen our standards that deal with the engagement partner's responsibilities to demonstrate appropriate direction and supervision throughout the audit. Audit oversight bodies and others have expressed concerns about how ISA 220 addresses and is applied to the following situations:

ITC Paragraphs 92 and 96

- Situations where other auditors are involved in an engagement that is not an audit of group financial statements (and to which ISA 600 does therefore not apply).[26] Involvement of other auditors may be driven by how an entity is structured (e.g., domiciled in one jurisdiction, but with operations in another), or the circumstances of a particular audit.

[24] Transparency reports are required in the European Union for firms that carry out statutory audit(s) of PIEs. These reports are required to include at least (i) information related to the legal structure and ownership of the firm; (ii) a description of the network the firm belongs to (if applicable); (iii) governance structure of the firm; (iv) a description of the firm's internal quality control system; (v) an indication of when the last quality assurance review took place; (vi) a list of PIEs for which the firm has carried out statutory audits during the preceding financial year; (vii) a statement regarding the firm's independence practices; (viii) the continuing professional education policy of auditors within the firm; (ix) firm financial information; and (x) information on basis for partner compensation. Transparency reports are also required or more commonly used in Australia, Japan and Turkey and are being considered elsewhere.

[25] In November 2015, IOSCO published a report on *Transparency of Firms that Audit Public Companies* (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD511.pdf). This document considers practices employed by firms and provides a guide for transparency reporting.

[26] While ISA 600 contains requirements and guidance to address the involvement of component auditors in a group audit situation, the ISAs do not include specific requirements and guidance to address the involvement of other auditors in non-group situations.

Other auditors may also be involved because of how the engagement team is assembled (including potentially through the use of audit delivery models). We will therefore consider how the engagement team should assess the sufficiency and appropriateness of the work of any other auditors involved in the audit, including considering their professional competence and capabilities. We will also consider how to address the potential implications for audit quality with respect to audit delivery models more broadly. For example, we may consider how the firm should apply its system of quality control and how work should be directed, performed, supervised and reviewed.

- Complex corporate structures, including complex multi-location (group) audits. How the role of the engagement partner is formally defined in the ISAs also raises questions in such circumstances. ISA 600 provides specific considerations for audits of group financial statements, but does not address all the complex structures that are encountered today. We have been told that our standards do not provide engagement partners enough direction or guidance about their roles and responsibilities when issues arise in relation to certain situations (e.g., non-controlled components or an entity's use of a shared service center). These concerns also suggest that ISA 220 may need to focus more on the core requirements for the engagement partner to take responsibility for (i) the direction, supervision and performance of the audit; (ii) the auditor's report being appropriate in the circumstances; and (iii) the performance of appropriate reviews.
- How the engagement partner decides that enough evidence has been obtained to support the auditor's opinion. For example, concern has been expressed about the evaluation of audit evidence supporting significant management judgments. Another concern is how auditor's experts are being used in relation to key areas (such as fair value accounting estimates) and whether and how their work should be relied on.

ITC Paragraphs 69–86

77 Work of other auditors or auditor's experts may be used as evidence to support the auditor's opinion on the financial statements. The ISAs need to clearly reflect this. In exploring changes to the ISAs during the recently completed Auditor Reporting project, we initially questioned whether transparency could be improved by permitting or requiring disclosures in the auditor's report about the role of other auditors in the (group) audit. In finalizing the auditor reporting standards, and based on feedback from respondents to the consultation, we agreed to not pursue this. However, we still hear that providing users with information that enables them to evaluate the participation of other auditors may increase transparency about the audit and how it was performed. We will therefore again explore whether an auditor's report could say more about the nature and extent of the involvement of others in the audit (including other auditors, component auditors and auditor's experts).

ITC Paragraphs 97–98

78 Because of the practical challenges that sometimes arise, we may also again explore the ability to use another auditor's report as audit evidence in certain circumstances. Questions about this approach include when doing so might be appropriate, what the responsibilities of the engagement team would be and whether it might be necessary to communicate in the auditor's report when this circumstance arises.

Firm and Engagement Level: Engagement Quality Control Reviews and Engagement Quality Control Reviewers

79 Firms are required to establish policies for audits of financial statements of listed entities to have an engagement quality control (EQC) review conducted by an EQC reviewer. Firms must also establish criteria to determine when other audits require an EQC review. An EQC review involves objective evaluations of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. An effective EQC review is an important engagement-level quality control. EQC reviews are also a key aspect of the monitoring component of a firm's system of quality control.

ITC Paragraphs 136–146

80 We recognize the importance of the EQC review and the public interest importance ascribed to it by certain stakeholders. However, concerns have been raised about whether EQC reviews are being performed as intended. For example, are appropriate individuals selected to perform the reviews? And how timely and effective are the reviews? Do the requirements and guidance in our standards need to be clarified or strengthened? Should the requirement to establish criteria to have an EQC review apply beyond audits of financial statements of listed entities?

81 We are considering whether strengthening the requirements for EQC reviews and EQC reviewers may be useful to enhance audit quality. Possible changes include:

- Further specifying the nature and extent of matters to be considered by the EQC reviewer and how this review is to be documented.
- Considering whether, and under what circumstances, communication between the EQC reviewer and the audit committee may be appropriate.
- Possibly providing transparency in the auditor's report that the engagement was subject to an EQC review.

82 We are also considering whether to make the EQC review more prominent by moving the requirements and guidance relating to EQC reviews into a separate standard.[27]

83 Acknowledging the important role of an EQC review, an appropriate balance must however be maintained between the responsibilities of the engagement partner and those of the EQC reviewer, in light of the objectives of their respective roles.

[27] In the US, the Public Company Accounting Oversight Board has a separate auditing standard for EQC review, Auditing Standard No. 7 (AS 7), *Engagement Quality Review*.

HOW CAN WE STRENGTHEN OUR STANDARDS ADDRESSING GROUP AUDITS?

STRENGTHENING AND CLARIFYING HOW THE ISAS, INCLUDING ISA 220, APPLY IN A GROUP AUDIT

84 Many audits today are audits of group financial statements (group audits). Group audits generally involve participation of component auditors[28] who perform work on financial information related to components that comprise the group. Component auditors may belong to the same firm as the group engagement partner and group engagement team or to the same network or group of affiliated firms, or they may be from unrelated firms. Group engagement teams face different challenges in determining how to be sufficiently involved in the work of different types of component auditors.

85 Other factors may make group audits more complex and challenging. For example, component auditors may work in jurisdictions with different cultures and languages, law or regulation (including independence and ethical requirements), and financial reporting and auditing requirements. Obtaining the necessary access to information or working papers may also be challenging for group engagement teams.

86 As with any audit conducted in accordance with our standards, all relevant standards apply to group audits. ISA 600 deals with special considerations for group audits, but specifically notes that the group engagement partner applies the requirements of ISA 220 regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. ISA 600 assists the group engagement partner to meet the requirements of ISA 220 where component auditors perform work on the financial information of components.[29]

87 Some stakeholders view the interaction of the requirements, definitions, and guidance in ISA 600 as limiting its flexibility. Questions have arisen as to how to most effectively apply the standard in certain circumstances. For example, practical challenges may arise in terms of:

- Identifying components (e.g., because of the interaction of the definition of component with the requirements of the applicable financial reporting framework).
- Determining the nature, timing and extent of the required involvement in the work of component auditors.
- Addressing matters relating to an entity's use of a shared service center.
- Establishing expectations in relation to consolidations performed at the regional or segment level.

None of these matters are expressly addressed in ISA 600.

[28] A component auditor is an auditor who, at the request of the group engagement team, performs work on the financial information related to a component for the purpose of a group audit.

[29] ISA 600, paragraph 5

88 Significant issues and concerns relating to group audits have also been highlighted by regulators and audit oversight bodies, including concerns about interpretations as to when ISA 600 does or does not apply, and insufficient assessments by group engagement teams of risks of material misstatement and related responses.

89 Audit risk in a group audit encompasses the possibility that a misstatement at the component level, or across components, is not detected, which might result in the group financial statements being materially misstated. For example, a component auditor may fail to identify (or communicate to the group engagement team) a misstatement that could be material to the group, either individually or when aggregated with other misstatements. The group engagement team may fail to evaluate the broader implications of a misstatement identified by a component at either the group level or for affected components.

90 We have heard that scoping a group audit based on the identification of components (and identification of those that are significant) 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, and the planning and performance of appropriate responses to those risks. For example, the requirement to perform an audit of financial information at significant components 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 (i.e., when the risks of material misstatement related to individual components' financial information vary in significance).

91 Given the importance of the identification and assessment of risks of material misstatement and the design of appropriate responses to achieving the outcome of a quality audit, we believe it is essential that the link in ISA 600 to the other standards that are most likely to always be relevant to the planning and performance of a group audit be sufficiently clear. In particular, we believe it is necessary to clarify, and potentially expand on, how a group engagement team is expected to apply the requirements in the standards related to identifying and assessing risks of material misstatement (including in relation to fraud), and responding to those risks. For example, we could:

- Emphasize the challenges in assessing and responding to risks of material misstatement at the group level, including requiring the component auditor to actively address these risks to the component level.
- Emphasize the need for two-way communication with component auditors about identified risks.
- Reinforce the need to appropriately apply professional skepticism.
- Expand on what appropriate responses and outcomes of the component auditor's work could be.

92 ISA 600 addresses the special considerations that apply to the group audit and establishes requirements and guidance for the group engagement partner and the group engagement team. We may find it necessary to develop a new standard for auditors who serve as component auditors, which may be particularly useful to small and medium practices who may often function in this capacity.

93 In considering necessary changes to the ISAs, we need to take into account that group structures are not consistent. Entities that may appear to have similar structures will typically have unique characteristics. Component auditors will also have different competence and expertise. Therefore, ISA 600 cannot be too prescriptive in setting forth the nature, timing and extent of appropriate involvement of the group engagement team in the work of component auditors – nor can ISA 600 be expected to address all the different approaches that might be appropriate.

94 It is important that the principles-based nature of the ISAs be preserved so that they continue to be "fit for purpose" as structures continue to evolve. In this way, the group engagement partner can continue to manage and organize the audit to respond to specific practical challenges related to the structure of the entity and related circumstances. We believe that linking more clearly to important principles in other ISAs (e.g., relating to appropriate direction, supervision and review, and identifying and responding to identified risks of material misstatement) may better illustrate how ISA 600 would be expected to be applied or adapted in particular circumstances. In particular, we recognize that many issues discussed in the context of our work on professional skepticism and quality control are likely relevant to the revision of ISA 600 – in particular, the group engagement partner's responsibilities for the quality of the group audit.

95 As noted in paragraphs 51–66, consideration is being given as to whether the quality control standards should be revised to incorporate a QMA at the firm level, as well as a more proactive, scalable and robust approach to managing audit quality at the engagement level. For example, there may be a need in ISA 220 to establish more explicit requirements for the engagement partner to more proactively manage quality risks at the engagement level. These changes may also give rise to the need for revisions to ISA 600. We will also consider the implications of a QMA at the firm level for group audits. For example, the existence of a firm-level QMA may impact the engagement level considerations about acceptance and continuance of group audits.

SPECIFIC ISSUES TO BE ADDRESSED IN REVISING ISA 600

96 Specific concerns about ISA 600 require our further consideration. Situations where challenges or issues arise, and where we will consider what actions may be appropriate, include:

- The decision to **accept or continue a group audit engagement**, including demonstrating the engagement partner's considerations when doing so, and considering the impact of mandatory auditor rotation in jurisdictions where component auditors are located.

ITC Paragraphs 204–217

- Where **access** by the group engagement team to the relevant financial information of components or component management is restricted, communications with component auditors may be challenging. Specifically, concerns have been noted in practice about difficulties in obtaining access to either management or auditors at components that are non-controlled entities (e.g., when the entity accounts for particular investments using the equity method of accounting), although access issues are not limited to only these types of entities.

ITC Paragraphs 207 and 220

- Where entities are increasingly using **shared service centers** to perform financial reporting or accounting functions for some or all components within a group. When the use of centralized processing by the entity impacts the audit, the group engagement team may use other auditors to perform procedures at the shared service center, highlighting various questions about how to apply the ISAs. This issue also applies more broadly to other situations when shared service centers are involved and the audit is not a group audit.

ITC Paragraphs 244(d) and 252

- Where the **engagement partner is not located where the majority of the audit work is performed** (although, again, this is not solely an issue for group audit engagements). When the engagement partner is not physically located where the audit work is being performed, concerns have been raised about how the engagement partner demonstrates appropriate direction, supervision, performance and review of the work, the adequacy of the audit documentation, and whether and how the engagement partner has become satisfied that sufficient appropriate audit evidence has been obtained to enable the engagement partner to take responsibility for the auditor's report in these circumstances.

ITC Paragraphs 76–79, 96, 209 and 238

- How the group engagement team demonstrates that it has been **sufficiently involved in the group audit.** For example, this could include enhancements to the group engagement team's understanding about the component or the component auditors (e.g., about their competence or capabilities) sufficient to properly evaluate the nature and scope of their involvement to obtain sufficient appropriate evidence for purposes of the group audit.

ITC Paragraphs 235–242

- How **appropriate and effective communication** between the group engagement team and component auditors is taking place.

ITC Paragraphs 218–225

- How the concept of **materiality** is being applied at the component level.

ITC Paragraphs 254–261

- What an appropriate **work effort of the component auditor** looks like in the varying circumstances of group audits.

ITC Paragraphs 262–273

97 We therefore intend to consider clarifying or strengthening the requirements in ISA 600 (and other ISAs as appropriate). We will also consider whether more practical guidance (in the ISA or a Staff non-authoritative publication) would be effective in enhancing the quality of audits of group financial statements.

QUESTIONS

The following questions for respondents relate to the matters set out in this Overview. More detailed questions are included in the Invitation to Comment. We welcome responses to any or all of these questions. Responses will be most helpful when they clearly indicate to which question the response relates and articulate respondents' rationale for their views. A template will be made available to facilitate this.

Question numbers are coded to the consultation topics as follows:

- ***G = General Question***
- ***PS = Professional Skepticism***
- ***QC = Quality Control***
- ***GA = Group Audits***

G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional skepticism, quality control, and group audits. In that context:

(a) Are these public interest issues relevant to our work on these topics?

(b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.

(c) Are there actions you think others need to take, in addition to those by the IAASB, to address the public interest issues identified in your previous answers? If so, what are they and please identify who you think should act.

G2. To assist with the development of future work plans, are there other issues and 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 prioritized?

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

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

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

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

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

(a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?

(b) If ISQC 1 is restructured to require the firm's use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?

(c) In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?

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

QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).

(a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?

(b) Should we take other actions in the public interest to address the issues in paragraphs 67–83?

(c) Should we take action now to tackle other issues? If yes, please describe the actions, why they need priority attention, and the action we should take.

GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.

(a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84–97)? If not, please explain why. What else could we do to address the issues set out in this consultation?

(b) Would the actions we are exploring in relation to ISA 600 improve the quality of group audits? If not, why?

(c) Should we further explore making reference to another auditor in an auditor's report? If yes, how does this impact the auditor's work effort?

(d) What else could the IAASB do to address the issues highlighted or other issues of which you are aware? Why do these actions need priority attention?

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