

**Audit Quality—A Proposed Way Forward****A. Background***Prior IAASB Discussion*

1. Among the various views that were shared during the first discussion of the topic at the Board in December 2009,<sup>1</sup> the following general themes were noted:
  - The behavioral aspects of audit quality (AQ) (e.g. role of professional judgment, concept of individual responsibility) are important and should not be ignored.
  - AQ is intrinsic to the Board's work. It is important to put the ISAs in proper context as they are but one component of the AQ concept.
  - While the inputs to AQ are important, user perceptions of output also matter, notwithstanding the fact that a quantitative measure of AQ is very difficult if not impossible.
  - AQ should not be viewed in isolation, but rather as a critical element of corporate governance and high quality financial reporting. In this regard, it would be important for the IAASB to focus on engaging in dialogue with key stakeholders. Equally, there would be benefit in further communication with users to help raise their level of awareness and understanding of AQ and the audit product.
  - It would be important to manage expectations. This would accordingly call for an initial approach to the project framed in a reasonable and straightforward manner, and with a clearly defined scope and focus.
2. In addition, the Board noted that a number of projects and initiatives on its current work program are of direct relevance to AQ. For example, in the audit reporting project, a number of issues<sup>2</sup> to be explored are related to AQ given that the quality of audits is judged as much by the outputs and user perceptions as it is by inputs applied in the audit process.

*IAASB Steering Committee Discussions*

3. At its meetings in December 2009 and February 2010, the Steering Committee reflected on the preliminary Board discussion, noting that a common thread appeared to be the need for continued engagement with users and other stakeholders as a means of communicating and reinforcing key messages about AQ as well as the role of standards.
4. To help focus the Board's efforts, the Steering Committee proposed that consideration be given to an initial approach consisting of two parts:

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<sup>1</sup> The minutes of December 2009 IAASB meeting are included in Appendix 1.

<sup>2</sup> Such issues include, for instance:

- What is the extent of users' appetite for more information to be communicated about the "black box" of the audit process?
- Is there a need for a different auditor reporting model – and if so, what are the key issues?
- What is the impact of litigation risk on the possibilities for developing alternative auditor communications?

- a) In terms of Board deliverables in the immediate term, development of a thought piece that would aim to place the ISAs in proper context vis-à-vis AQ; and
- b) An annual review of AQ trends and developments by the Board to identify the need and opportunities for specific IAASB action.

The Steering Committee was of the general view that this measured approach would reconcile the need to address stakeholder expectations through a clear deliverable in a reasonable timeframe with the need for ongoing consideration by the Board of relevant AQ developments.

- 5. The Steering Committee suggested that the thought piece could be aimed for publication by the end of 2010. The document would seek to enhance stakeholder awareness and understanding of the role of the IAASB and the ISAs with regard to AQ, and how the standards relate to the objectives and needs of other participants in the AQ debate. It also would help to address any misconceptions or misunderstandings that stakeholders may harbor with respect to the ISAs, thereby assisting in narrowing any related “expectations gap” that may exist. In addition, it would serve as an important platform for the IAASB to engage more broadly with stakeholders on the topic, including assisting in the delivery of key messages about AQ. From an output point of view, it would represent a reasonable, but not necessarily a final, IAASB deliverable in this project.
- 6. The Steering Committee agreed that a Task Force be set up to explore the proposed approach and considered draft Terms of Reference (ToR) for the Task Force (see Appendix 2), developed on the basis of the proposed approach outlined above.

*Discussion with National Auditing Standard Setters (NSS)*

- 7. The topic will be discussed at the June 3-4, 2010 IAASB-NSS meeting. NSS participants will, in particular, be asked for their views on the key areas of AQ on which the IAASB should focus in order to most effectively contribute to the global discussion on AQ. In addition, participants will be asked for their reactions to the Steering Committee’s suggested initial approach to the project.

**B. Task Force Discussions and Proposal**

- 8. The Task Force felt that a thought piece focused on the ISAs might be taking too narrow a view, given the many other important elements that make up the totality of AQ, and risked being seen by some stakeholders as self-serving.
- 9. Rather, the Task Force took the view that there would be greater value in its working towards the development of a consultation paper that would address all the relevant aspects of AQ. As well as assisting stakeholders achieve a common understanding of the main elements of AQ the Task Force felt that such a consultation paper would enable the Board to more proactively identify key contemporary AQ issues on which to invite direct input from all stakeholders, thus enabling the Board to formulate specific proposals for action.
- 10. The Task Force believes that the objectives of the consultation paper could be to:
  - a) Assist stakeholders achieve a common understanding of the main elements of AQ (leveraging, for example, the UK Financial Reporting Council’s AQ framework as a

starting point), and explain how the ISAs address some of these drivers and thus how they contribute to AQ; and

- b) Explore *what more* could be done to enhance AQ, from the perspective of not only the ISAs but also those elements of AQ that are not dealt with by the ISAs, such as ethics, education, regulation, etc.
11. Achieving a common understanding regarding the drivers of AQ could help establish a foundation on which the Board could work with key stakeholders. In particular, it would help provide a common platform from which the Board could work more closely with stakeholders such as the International Forum of Independent Audit Regulators (IFIAR).
  12. In consulting on whether more should be done relative to each driver, questions on which stakeholder views could be sought include whether there are aspects of, or areas within, the ISAs that could be further improved, and whether there are actions that could be taken by other participants such as regulators, firms, educators and other standard setters to encourage effective implementation of the drivers. The Task Force also felt that there could be a role for IFAC to play in this debate in ensuring that the IAASB, the International Ethics Standards Board for Accountants (IESBA) and International Accounting Education Standards Board (IAESB) work together on AQ and not be seen to be tackling different parts of the AQ debate in isolation. However, this aspect would introduce a degree of complexity and a challenge from a coordination point of view, and could be seen as extending the IAASB's remit.
  13. Appendix 3 provides an illustration of the Task Force's proposed approach to the consultation paper.
  14. In relation to timing, the Task Force believes that the issue of the consultation paper could be targeted for the latter half of 2011, which would provide time for the Board to appropriately sound out relevant stakeholders on key issues to be addressed.
  15. The Task Force was hesitant as to whether it had the resources to adequately monitor AQ developments on an annual basis. Such developments could potentially include the findings of audit inspectors, changes in the scope of audit nationally, new techniques within the firms, and new academic research.
  16. Rather, there was support within the Task Force for exploring how the Board could enlist the assistance of relevant stakeholders in monitoring AQ trends and developments, for example:
    - IFIAR at the regulatory level
    - The Global Public Policy Committee<sup>3</sup> at the firm level
    - INTOSAI at the public sector level
    - Academia at the research level
    - NSS at the jurisdictional level.

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<sup>3</sup> The GPPC is made up of the six largest accounting practices.

17. In particular, the Task Force felt that enlisting the help of NSS in monitoring relevant AQ trends and developments within their respective jurisdictions would lead to a meaningful discussion item at the annual IAASB-NSS meeting.
18. Given the above, the Task Force proposes that its draft Terms of Reference be amended as shown in mark-up in Appendix 4.

**Matters for IAASB Consideration**

- Q1. What are the IAASB's views regarding the Task Force's proposal that the Board focus on the development of a consultation paper along the lines suggested above instead of the thought piece suggested by the Steering Committee?  
  
If the IAASB supports the Task Force's proposal, in what ways could the Task Force's proposed model for a consultation paper be enhanced or refined?
- Q2. Does the IAASB agree that there would be merit in seeking to leverage relevant stakeholders in identifying relevant AQ trends and developments for the IAASB's timely consideration?
- Q3. Does the IAASB agree with the Task Force's proposed revised Terms of Reference (in mark-up) in Appendix 4?

## APPENDIX 1

### December 2009 IAASB Minutes

Prof. Schilder introduced the topic, noting the importance in general of the concept of audit quality to IAASB's work. He highlighted the wide range of research, thought leadership and policy analysis work on the topic that already has been undertaken by various parties. Also, he emphasized the importance of dialogue with stakeholders on the topic and the need to develop a deeper understanding of many of the broad issues before identifying where and how the IAASB should best focus its efforts.

Prof. Schilder then asked IAASB members to share their general views on the topic and on the matters raised for discussion.

#### PERSPECTIVES ON, OR APPROACHES TO, AUDIT QUALITY THAT RESONATE WITH IAASB'S WORK

IAASB members broadly supported the UK Financial Reporting Council's Audit Quality Framework as providing a useful starting point for thinking about audit quality. It was noted that there are three key aspects to audit quality, i.e. high quality standards, quality control within firms, and people. In regard to the latter, in particular, the IAASB agreed on the importance of the behavioral aspects as they relate to the profession, particularly the critical role of professional judgment, leadership (tone at the top), and the concept of individual responsibility.

It was acknowledged that there is a wide variety of views on audit quality, and participants in the debate run the range of the financial reporting supply chain, as well as academia, NSS, IFAC, and regulatory and oversight bodies such as the International Forum of Independent Audit Regulators (IFIAR) and the EC. It was noted that audit quality depends not only on setting high quality auditing standards at the international level but also on these standards being adopted and effectively implemented at the national level. Accordingly, it would be important to understand what national professional bodies, NSS and other groups such as the UK Audit Quality Forum and the US Center for Audit Quality are doing in that regard in different jurisdictions.

Some IAASB members noted that while it is useful to consider audit quality from the perspective of the standards, the context also includes other 'quality pillars', such as preparer competence, corporate governance, and regulation and oversight. There was agreement that standards are only one piece of the puzzle, and that the debate about audit quality itself should be put in the broader context of debates about good corporate governance and high quality financial reporting globally.

It was also noted that another element to audit quality that should not be ignored is the feedback loop. In that regard, leveraging the IAASB's relationship with IFIAR would be important relative to identifying areas for improvement in the standards. Additionally, it was noted that there are playoffs among the different drivers of audit quality. In particular, having more standards would not necessarily be the best thing for audit quality as this may adversely affect auditors' motivation and judgments.

#### EXTENT TO WHICH AUDIT QUALITY CAN BE ASSESSED OR MEASURED

IAASB members generally agreed on the difficulty of measuring audit quality objectively, although it was recognized that there might be merit in a qualitative measure to gauge direction of progress. It was noted that while a focus on inputs to audit quality and whether auditors have

been able to prevent or detect material misstatements is important, user perceptions on the output side also matter. These perceptions will vary from the perspectives of different categories of users. In particular, while management and those charged with governance may be in a better position to assess audit quality through their direct interactions with auditors, other users such as investors and regulators may be less able to do so. Accordingly, the IAASB's work on exploring future reporting models would be important relative to enhancing user perceptions of audit quality.

It was noted that while data on inputs are difficult to obtain in the public domain, some regulators have started requiring greater transparency from firms in such areas as level of training effort and systems of quality control applied, which may help to provide some information on inputs. Information on output measures, however, may be more readily available through inspection reports and enforcement cases.

#### SCOPE OF ANY POTENTIAL IAASB PROJECT ON AUDIT QUALITY

IAASB members broadly agreed that the objective of, and approach to, any work will depend on the perspective taken and how the IAASB sees its role. It was acknowledged that the IAASB alone cannot, and should not endeavor to, solve all the questions but rather should make clear what role it intends to take. A focus on how the IAASB develops and disseminates the standards, and putting them in proper context, would therefore seem appropriate, recognizing that while the ISAs are the IAASB's primary product, they also are part of a broader process. In this regard, it was noted that a number of important matters could be considered, such as:

- How to more systematically link the IAASB's thinking and deliberations on the topic to some fundamental concepts associated with audit quality.
- How to enhance the interaction between auditors and those charged with governance, as the latter often have difficulty identifying meaningful areas of discussion with auditors that would be beneficial to audit quality.
- The level of granularity to the ISAs that best contributes to audit quality.
- How to communicate that a quality audit comes at a cost, as undue fee pressures on auditors can have a detrimental effect on audit quality.

As a first step, the IAASB agreed that consideration should be given to compiling a summary of the various initiatives that are underway to help inform the IAASB's thinking regarding potential collaboration with other groups and areas of focus. It was noted that while approaching the topic from a larger firm perspective would be important, the 'smaller audit' dimension should not be ignored as audits of smaller entities far outnumber those of larger entities. It was also agreed that there would be benefit in IAASB including the topic on the agenda for the April 2010 IAASB-NSS meeting. The views and experiences of the various NSS in that forum would help inform the IAASB's deliberations on the topic.

#### WAY FORWARD

Prof. Schilder thanked IAASB members for their input, and summarized some common themes from the discussion:

- The need to invest effort in obtaining a deeper understanding of audit quality developments in different jurisdictions and by different groups.

- The importance of continuing to plan for communications such as on the meaning of audit, which would be helpful from the user perspective.
- The importance of focusing on an approach that helps put IAASB's work and the standards in context, and how the standards influence audit quality as part of the broader context. This would help serve as a platform for further engagement with stakeholders.

He noted that the Steering Committee would further reflect on the discussion and explore the way forward.

**IAASB AUDIT QUALITY TASK FORCE**  
***Draft Terms of Reference***

**Background**

In commenting on the IAASB's proposed strategy and work program for 2009-2011, a number of respondents noted that no common definition of the term "audit quality" currently exists, a situation that may contribute to the "expectations gap". The IAASB acknowledged this point, recognizing that the term is widely used in its communications and those of its stakeholders. The IAASB also recognized that while ISAs are an important contributor to audit quality, there is considerably more to the concept of audit quality than auditing standards. Accordingly, the IAASB's *Strategy and Work Program, 2009-2011* includes a commitment by the IAASB to consider whether to develop a consultation paper on audit quality.

At its December 2009 meeting, the IAASB held initial discussions on this topic, reflecting on the various perspectives on, and approaches to, audit quality that resonate with its work. While noting that there are multiple aspects to audit quality, the IAASB generally supported the view that it is important to consider the ISAs in the context of contributing to audit quality. This consideration is consistent with the IAASB's primary mission to develop auditing standards that support high quality practice by auditors throughout the world. In this preliminary exchange of views, the IAASB also recognized the following:

- The behavioral aspects of audit quality (e.g., role of professional judgment, concept of individual responsibility) are important and should not be ignored.
- Audit quality is intrinsic to the work of the IAASB. It is important to put the ISAs in proper context as they are but one component of the audit quality concept.
- While the inputs to audit quality are important, user perceptions of output also matter.
- Audit quality should not be viewed in isolation, but rather as a critical element of corporate governance and high quality financial reporting. In this regard, a focus by the IAASB on engaging in dialogue with key stakeholders would be important. Equally, there would be benefit in further communication with users to help raise their level of awareness and understanding of audit quality and the audit product.
- It would be important to manage expectations. This would accordingly call for an initial approach framed in a reasonable and straightforward manner, and with a clearly defined scope and focus.

**Task Force Roles and Responsibilities**

The IAASB has established a Task Force on Audit Quality, chaired by an IAASB member and comprising interested parties with relevant perspectives and expertise. The Task Force's mandate is as follows:

- To develop for publication a thought piece aimed at placing the ISAs in proper context vis-à-vis audit quality for consideration and approval by the IAASB.
- To monitor audit quality developments and to brief the IAASB accordingly, and to lead an annual discussion of audit quality trends and developments at the IAASB.



- As appropriate, to undertake further actions as agreed and instructed by the IAASB.

It is not intended that, through this initiative, the IAASB will extend its activities to monitor the effective implementation of its standards. Such monitoring is the responsibility of the regulatory and oversight bodies charged with monitoring the effectiveness of professional auditors.

The Task Force will report its activities to the IAASB Steering Committee and, as appropriate, to the IAASB.

### **Other Matters**

Any implications for budgetary or due process considerations will be communicated by the Chair and staff of IAASB to the IFAC Board and PIOB as appropriate.

The Task Force members' travel expenses will be reimbursed in accordance with IFAC policies.

### **Task Force Membership**

#### Chair

Craig Crawford, IAASB Member

#### Members

Bernard Agulhas, Chief Executive, Independent Regulatory Board for Auditors, South Africa

Jon Grant, IAASB Member

Kam Grewal, Vice President, Canadian Public Accountability Board

Gert Jönsson, IAASB Member

Abdullah Yusuf, IAASB Member

[Other – TBA]

### **Other Involvement**

IAASB staff will provide technical and administrative support to the Task Force.

**APPENDIX 3**

**Illustration of a Possible Approach to a Consultation Paper**

AQ Driver	Specific Provisions in IAASB Standards that Address the Driver	Possible Questions for Consultation
The culture within an audit firm	<p>For example:</p> <p>ISQC 1, e.g.</p> <ul style="list-style-type: none"> <li>• Tone at the top</li> <li>• Policies regarding evaluation, compensation, promotion, etc</li> <li>• Consultation</li> <li>• Monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• Are the drivers complete and appropriate? If not, what is missing or what further refinement would be appropriate?</li> <li>• What further improvement could be made to the ISAs relative to each driver, and why?</li> <li>• What actions can other participants take to encourage or facilitate effective implementation of the drivers, e.g. <ul style="list-style-type: none"> <li>○ IFIAR</li> <li>○ Firms</li> <li>○ Professional institutes</li> <li>○ National standard setters</li> <li>○ The International Ethics Standards Board for Accountants (IESBA)</li> <li>○ The International Accounting Education Standards Board (IAESB)</li> <li>○ Trainers and educators?</li> </ul> </li> </ul>
The skills and personal qualities of audit partners and staff	<p>For example:</p> <p>ISQC 1, e.g.</p> <ul style="list-style-type: none"> <li>• Ethics</li> <li>• Recruitment</li> <li>• Competence</li> <li>• Career development</li> </ul> <p>ISA 200, e.g.</p> <ul style="list-style-type: none"> <li>• Professional judgment</li> <li>• Professional skepticism</li> </ul> <p>ISA 220, e.g.</p> <ul style="list-style-type: none"> <li>• Engagement team with appropriate experience</li> <li>• Direction and supervision</li> </ul> <p>ISA 315, e.g.</p> <ul style="list-style-type: none"> <li>• Understanding clients' businesses</li> </ul>	
The effectiveness of the audit process	<p>For example:</p> <p>ISA 220 – independence, review of work done,</p>	

Audit Quality—A Proposed Way Forward  
IAASB Main Agenda (June 2010)

AQ Driver	Specific Provisions in IAASB Standards that Address the Driver	Possible Questions for Consultation
	consultation, etc ISA 230 – documentation ISA 300 – Planning ISA 315 – involvement of senior engagement team members in planning, risk assessment	
The reliability and usefulness of audit reporting	For example: ISA 260 – communication with TCWG ISA 700 – forming the opinion	
Factors outside the control of auditors	N/A	<ul style="list-style-type: none"> <li>• What specific actions can other participants take relative to this driver to enhance AQ, and how could the IAASB effectively work with those participants, e.g.                             <ul style="list-style-type: none"> <li>○ Those charged with governance</li> <li>○ Preparers</li> <li>○ Investors</li> <li>○ Regulators</li> <li>○ Accounting standard setters?</li> </ul> </li> </ul>

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- ~~To monitor audit quality developments and to brief the IAASB accordingly, and to lead an annual discussion of audit quality trends and developments at the IAASB.~~

- To develop a consultation paper in the latter half of 2011 aimed at:
  - a) Assisting stakeholders in achieving a common understanding of the main elements of audit quality, and explaining how the ISAs address some of these drivers and thus how they contribute to audit quality; and
  - b) Exploring what more could be done to encourage effective implementation of the audit quality drivers, from the perspective of not only the ISAs but also those elements of audit quality that are not dealt with by the ISAs, such as ethics, education, regulation, etc.
- To explore how the IAASB could leverage its stakeholder relationships in identifying relevant audit quality trends and developments for the IAASB's timely consideration.
- As appropriate, to undertake further actions as agreed and instructed by the IAASB.

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The Task Force will report its activities to the IAASB Steering Committee and, as appropriate, to the IAASB.

### **Other Matters**

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### **Other Involvement**

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