

**DRAFT  
FOR DISCUSSION PURPOSES ONLY**

**AN AUDIT QUALITY FRAMEWORK FOR USE BY AUDIT COMMITTEES**

**August 2012**

**Note**

Main changes from full AQ Framework:

- Excludes recommendations from Chairman's introduction
- Excludes firm/country inputs
- Excludes much of material in Nature of Audit section
- Excludes some (but not many) of the interactions
- Excludes much of context – focus on corporate governance and reporting timetable
- Excludes public sector / SME considerations – group audit issues added to Audit Process, including appendix.
- Excludes survey of Stakeholder Perspectives on AQ

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## Preface

Recent financial crises have highlighted the critical importance of credible, high-quality financial reporting in all sectors of the world economy, including the capital markets, small companies, not-for-profit and government organizations. They have also reinforced the need, in the public interest, for high audit quality.

“Audit quality” is a complex subject and there is no single definition or analysis of it that has achieved universal recognition. Furthermore, different stakeholders are likely to have different perspectives about the nature of audit quality. For example:

- Users of the financial statements are likely to expect auditors to verify the financial information, root out fraud and rigorously challenge management. Considering audit quality from this perspective would suggest that the more resources (both in quantitative and qualitative terms) are allocated to an audit the higher its quality would be.
- Management are likely to have an interest in ensuring that the cost of the audit is constrained, that the disruption to the entity’s ongoing operations is minimized and its reporting timetable is not disrupted. Considering audit quality from management’s perspective may suggest that the resources allocated to an audit should be minimized.
- Audit committees are likely to value a robust audit but will also have an interest in it not disrupting the entity’s operations and its reporting timetable. An audit committee’s evaluation of audit quality will likely be strongly influenced by whether the auditor communicates with it in a clear and timely manner.

Balancing these different views suggests that a quality audit involves an effective audit being performed efficiently and on a timely basis and for a reasonable fee. There is, however, subjectivity around the words “effective,” “efficiently,” “timely,” and “reasonable.” Audit committees are well placed to consider these matters. For this reason, audit committees in many jurisdictions have direct responsibilities for considering audit quality and approving, or recommending for approval, audit fees.

Many factors contribute to maximizing the likelihood of high quality audits being consistently performed. The IAASB believes there is value in describing these factors and thereby encouraging audit firms and other stakeholders to challenge themselves about whether there is more that they can do to increase audit quality in their particular environments. For this reason, the IAASB has undertaken a project to develop an Audit Quality Framework.

This document, *An Audit Quality Framework for Use by Audit Committees*, is based on the full IAASB Audit Quality Framework but is focused on those matters likely to be of particular interest to audit committees.

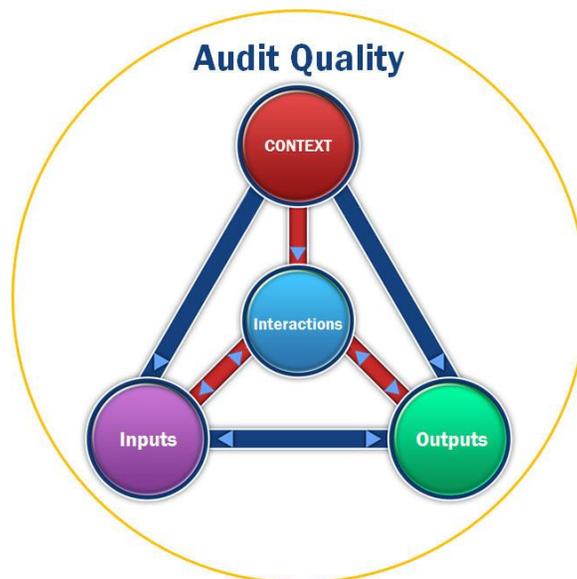
## 1. Introduction

### Background

1. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by auditors gathering sufficient appropriate audit evidence in order to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>1</sup> Usually, that opinion is on whether the financial statements “present fairly, in all material respects” or give “a true and fair view” of the entity’s financial position as at the period end and of its results and cash flows for the period.
2. While national laws and accounting standards provide criteria for “fair presentation,” many aspects of the financial reporting process, and therefore the audit of the financial statements, involve judgment. Furthermore, what is considered to be “sufficient appropriate evidence” is also a matter for judgment reflecting the nature and complexity of the entity as well as the auditors’ assessment of the risks that the financial statements prepared by management could be materially misstated.
3. Audit is therefore a discipline that relies on competent individuals using their experience and applying integrity, objectivity, and skepticism to enable them to make reliable judgments that are supported by the facts and circumstances of the engagement. The qualities of perseverance and robustness are also important in ensuring that necessary changes are made to the financial statements in the face of persuasive and, possibly, intimidating client management, or, where such changes are not made, to ensure that the auditor’s report is appropriately modified.

### Audit Quality Framework

4. The IAASB has developed an Audit Quality Framework (“Framework”) that sets out the key attributes that are conducive to high audit quality taking into account the different perspectives of stakeholders.



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<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 3

5. The Framework, which can be found at [insert web reference], distinguishes between:

<i>Inputs</i>	<p>The inputs are grouped into the following categories:</p> <ul style="list-style-type: none"> <li>• The values, ethics and attitudes of auditors;</li> <li>• The knowledge and experience of auditors and the time they are allocated to perform the audit; and</li> <li>• The effectiveness of the audit process and quality control procedures.</li> </ul> <p>Within these categories quality attributes are further categorized as those that apply directly at:</p> <ul style="list-style-type: none"> <li>• The audit engagement level;</li> <li>• The level of an audit firm, and therefore indirectly to all audits undertaken by that audit firm; and</li> <li>• The national (or jurisdictional) level and therefore indirectly to all audit firms operating in that country and the audits they undertake.</li> </ul> <p>The inputs to audit quality will be influenced by the context in which an audit is performed, the interactions with key stakeholders and the outputs. For example, law and regulations (context) may require specific reports (output) that influence the skills (input) utilized.</p>
<i>Outputs</i>	<p>Outputs from the audit are often determined by the context, including legislative requirements. While some stakeholders can influence the nature of the outputs others have less influence. Indeed, for some stakeholders, the auditor's report is all that is visible.</p>
<i>Interactions amongst Key Stakeholders</i>	<p>While each separate stakeholder in the financial reporting supply chain plays an important role in supporting high quality financial reporting, the way in which they interact can have a particular impact on audit quality. These interactions, including both formal and informal communications, will be influenced by the context in which the audit is performed and allow a dynamic relationship to exist between inputs and outputs. For example, discussions between the auditor and those charged with governance at the planning stage can influence the use of specialist skills (input) and the form and content of the auditor's report to the those charged with governance (output).</p>
<i>Context</i>	<p>There are a number of contextual factors that can facilitate financial reporting quality including corporate governance requirements and the applicable financial reporting framework. The contextual factors, including legislative and regulatory requirements, also shape the interactions amongst key stakeholders and the inputs to, and outputs from, the audit.</p>

6. The IAASB believes that its Framework will:

- Help audit firms and professional bodies reflect on how to enhance the consistent application of auditing standards as well as facilitate them communicate information about audit quality;
- Raise the level of awareness and understanding amongst stakeholders of the important elements of audit quality, particularly in developing countries or emerging economies, or in jurisdictions where there has been little or no debate on audit quality; and

- Enable stakeholders to recognize the elements of audit quality that may deserve priority attention to enhance audit effectiveness.
7. This paper, *An Audit Quality Framework for Use by Audit Committee*, is based on the full IAASB Framework but is focused on those matters likely to be of particular interest to audit committees. In particular, the Inputs (Section 3) are only those that relate to the audit engagement level.

## 2. Context

8. Various environmental factors – contextual factors – can impact the robustness of the processes underlying the preparation of the financial statements and audit quality. Contextual factors include legislative requirements, the applicable financial reporting framework and business practices. They also include corporate governance arrangements and the financial reporting timetable.

### Corporate Governance

9. Oversight of management by those charged with governance establishes expectations for behavior, and provides motivation to management to fulfill their responsibilities. Strong corporate governance practices can have a positive impact on the reliability of the financial information that an entity prepares.
10. Corporate governance practices vary between countries in response to different underlying law and custom. In recent years, Boards of Directors of many larger entities have appointed audit committees to assist the governing body in meeting its responsibilities in relation to financial reporting. The existence of an audit committee, especially when its members are independent of management and have an appropriate degree of financial literacy, can contribute to the strength of corporate governance.
11. As part of the development of the Audit Quality Framework, the IAASB undertook an informal survey on the role of audit committees in larger economies. The survey findings indicate that:
  - There are legal or regulatory requirements, or “comply or explain” provisions, for audit committees to be established for listed entities in the majority of larger economies;
  - In a number of these economies, there are also requirements for audit committees for other public interest entities, regulated entities in the financial services sector, and state-owned enterprises; and
  - For those economies where there are no explicit legal or regulatory requirements for audit committees, voluntary guidelines often exist or they are common practice for certain types of entities.
12. The survey also showed that in many larger economies audit committees have specific responsibilities regarding the appointment of the auditor and the determination and approval of audit fees. Both activities can have a significant impact on audit quality.
13. It is important that audit quality is the prime consideration for audit committees when making audit appointments or reappointments. To achieve this, audit committees will need to develop some criteria for what they mean by audit quality, IAASB hopes that this paper, and in particular the Appendix, will be of assistance in this regard.
14. It is also important that audit committees evaluate whether the audit fee is adequate to allow a high quality audit to be performed. This is especially important when audit fees are negotiated directly between the auditors and management as management may have a different perspective on what audit quality is from the audit committee.
15. The survey of audit committee responsibilities in larger economies showed that other responsibilities with regard to the external audit vary. In particular, some, but not all, also have a

specific responsibility for evaluating the effectiveness of the audit. However, the way in which this responsibility is described varies. Different expressions include:

- “Reviewing the effectiveness of the audit process;”
  - “Overseeing the auditor’s work;”
  - “Monitoring the statutory audit;”
  - “Reviewing the performance of the statutory auditors;” and
  - “Evaluating the appropriateness of the audit”.
16. Audit committees also sometimes have a role in monitoring auditor independence. The survey showed that in some larger economies, activities in this regard included one or more of the following:
- Pre-approval of non-audit services provided by the auditor;
  - Approval of fees paid to the auditor for non-audit services; and
  - Review of hiring policies relating to the employment of ex-partners and staff of the audit firm.
17. Users of audited financial statements are likely to find it helpful to obtain an understanding of the work done by the audit committee and the rationale for the conclusion they have reached. However, only a few of the countries covered by the survey require audit committees to report publicly on their work.

### **The Financial Reporting Timetable**

18. The timeframe within which the audit needs to be completed can influence financial reporting processes and the way in which an audit is performed. From a practical standpoint, the advent of accelerated reporting regimes in many jurisdictions limits the extent to which the auditor can perform detailed work after the end of the reporting period. As a result, it has become increasingly necessary for the auditor to place reliance on systems of internal control and audit procedures performed before the period end.
19. Listed companies may be required, or choose, to release earnings estimates or preliminary results at an early stage. In some jurisdictions auditors are required to agree such releases or perform specific work on them. This has the advantage that the auditor will be comfortable with the financial results before the information is released but adds further time pressure. In jurisdictions where the auditor is not involved with such releases there is a danger that, having announced the results, management will be resistant to suggested changes to them that arise from the audit as it progresses.



### 3. Input Factors

20. High audit quality is achieved where the engagement team, is objective, challenging and independent, is sufficiently knowledgeable about the entity's business and the environment in which it operates, has sufficient time and applies a rigorous process. The necessary inputs to achieve this involve:

- The values, ethics and attitudes of individual members of the engagement team;
- Their knowledge and skills and the adequacy of the time allocated to them to undertake their work; and
- The audit process and quality control procedures applied.

Within each category key attributes that foster audit quality are described below.

#### Values, Ethics and Attitudes

21. The audit engagement partner is responsible for an audit engagement and therefore directly responsible for audit quality. As well as taking responsibility for the performance of the audit, the audit engagement partner has an important role in ensuring that the engagement team exhibits the values, ethics and attitudes necessary to support a quality audit. Key attributes are:

- The engagement team recognizes that the audit is performed in the wider public interest.
- The engagement team exhibits professional skepticism.
- The engagement team exhibits objectivity and integrity.
- The engagement team exhibits professional competence and due care.
- The engagement team is independent.

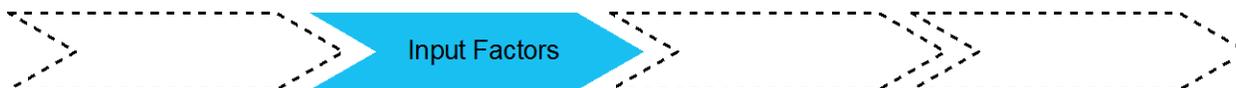
#### *The Engagement Team Recognizes that the Audit is Performed in the Wider Public Interest*

22. The audit team needs to be committed to performing the audit in the interests of the entity's shareholders and in the wider public interest rather. While it will usually be necessary for the auditor to work closely with management in the course of the audit, the audit team needs to provide an appropriate degree of challenge to management and make objective judgments.

#### *The Engagement Team Exhibits Professional Skepticism*

23. Professional skepticism is an important aspect of auditor judgment related to planning and performing an audit. Unless auditors are prepared to challenge management's assertions, they will not act as a deterrent to fraud nor be able to conclude, with confidence, that an entity's financial statements are fairly presented. Professional skepticism involves:

- Having a questioning mind and a willingness to challenge management assertions;
- Assessing critically the information and explanations obtained in the course of their work;
- Seeking to understanding management motivations for possible misstatement of the financial statements;
- Keeping an open mind until appropriate audit evidence has been obtained;



- Having the confidence to challenge management and the persistence to follow things through to a conclusion; and
- Being alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.

#### *The Engagement Team Exhibits Objectivity and Integrity*

24. The principle of objectivity imposes an obligation on auditors not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.<sup>2</sup>
25. The need for auditors, in particular, to be objective arises from the fact that many of the important issues involved in the preparation of financial statements involve judgment. For example, many items included in the financial statements cannot be measured with absolute certainty and estimates have to be made. Auditors need to be objective when they evaluate management judgments to reduce the risk that the financial statements are materially misstated through management, whether deliberately or inadvertently, make a biased judgment or following an otherwise inappropriate accounting practice.
26. Integrity is a prerequisite for all those who act in the public interest. It is essential that the engagement team act, and is seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candor, courage and intellectual honesty.

#### *The Engagement Team Exhibits Professional Competence and Due Care*

27. Professional competence and due care involves all members of the engagement team:
  - Maintaining professional knowledge and skill at an appropriate level;
  - Acting carefully, thoroughly and on a timely basis; and
  - Acting diligently in accordance with applicable technical and professional standards.

#### *The Engagement Team is Independent*

28. Independence is required to avoid individual members of the engagement team or the audit firm from being affected by influences that compromise professional judgment, thereby allowing them to act with integrity and exercise objectivity and professional skepticism (independence of mind). It is also required to avoid facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised (independence in appearance).
29. Issues impacting auditor independence include:
  - Financial interests existing between the auditor and the audited entity. Holding a financial interest in an audit client may create a self-interest threat.
  - Business relationships between the auditor and the audited entity. A close business relationship between the audit firm or a member of the engagement team or an immediate family member may create self-interest or intimidation threats.

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<sup>2</sup> International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), paragraph 120.1



- Provision of non-audit services to audit clients. Audit firms have traditionally provided to their audit clients a range of non-audit services that are consistent with their skills and expertise. Providing non-audit services may, however, create threats to independence. The threats created are most often self-review, self-interest and advocacy threats.
- Partners and staff believe that their remuneration and, indeed, their ongoing careers with the audit firm are dependent on retaining an audit client and maintaining good client relationships.

### **Knowledge, Experience and Time**

30. The audit engagement partner is responsible for being satisfied that the engagement team collectively has the appropriate competence and capabilities and that the team has sufficient time to be able to obtain sufficient appropriate audit evidence before issuing the audit opinion Key attributes are:

- Partners and staff have the necessary competencies.
- Partners and staff understand the entity's business.
- Partners and staff make reliable professional judgments.
- The audit engagement partner is actively involved in risk assessment, planning and supervising the work performed.
- Staff performing detailed "on-site" audit work have sufficient experience, their work is appropriately supervised and reviewed, and there is a reasonable degree of staff continuity.
- Partners and staff have sufficient time to undertake the audit in an effective manner.
- The engagement partner and other experienced members of the audit team are accessible to management and the audit committee.

#### *Partners and Staff Have the Necessary Competencies*

31. The necessary competencies include:

- Applying relevant audit standards and guidance;
- Evaluating applications of relevant financial reporting standards;
- Demonstrating capacity for inquiry, abstract logical thought, and critical analysis;
- Demonstrating professional skepticism;
- Applying professional judgment; and
- Withstanding and resolving conflicts.

#### *Partners and Staff Understand the Entity's Business*

32. A sound understanding of the entity, its business and the industry in which it operates is key to the auditor being able to assess the risks of material misstatement in the financial statements to appropriately focus audit procedures and to evaluate the findings from them. It also underlies skepticism and the ability to make appropriate audit judgments.



33. Industry knowledge, including an understanding of relevant regulations and accounting issues, can be especially important for clients in, for example, the financial services industry. However, it is important that knowledge areas are not so narrow that they prevent the auditor seeing wider issues. Auditors acquire general business knowledge from undertaking non-audit work and from exposure to different clients in different industries. This allows them to stand back from the specifics of a particular entity's business and reflect upon their wider knowledge of business issues, risks, and control systems.

*Partners and Staff Make Reliable Professional Judgments*

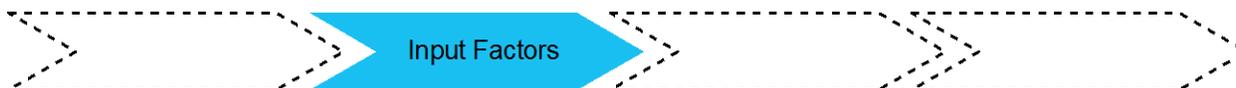
34. Auditing is a discipline that relies on competent individuals using their experience and the values of integrity, objectivity and skepticism to enable them to make reliable professional judgments that are supported by the facts and circumstances of the engagement.
35. Making reliable professional judgments involves partners and staff:
- Remaining objective;
  - Applying knowledge of business, financial accounting and reporting and information technology;
  - Researching the topic and considering different perspectives;
  - Evaluating alternatives in the light of the relevant facts and circumstances;
  - Considering whether a suitable process was followed in reaching a conclusion and whether sufficient appropriate audit evidence exists to support it;
  - Consulting, as appropriate; and
  - Documenting the conclusion and the rationale for it.

*The Audit Engagement Partner is Actively Involved in Risk assessment, Planning and Supervising the Work Performed*

36. As engagement partners are responsible for the audits they undertake, it is important that they are directly involved in planning the audit, evaluating the evidence obtained and in reaching final conclusions. Some believe that partners will be encouraged to take an active responsibility for the quality of work performed if they are named in the auditor's report.
37. While much of the detailed audit work may be delegated to less experienced staff, audit engagement partners need to be accessible to them in order to provide timely input to the audit as it progresses.

*Staff Performing Detailed "On-Site" Audit Work Have Sufficient Experience, Their Work is Appropriately Supervised and Reviewed, and there is a Reasonable degree of Staff Continuity*

38. The structure of many accountancy firms is generally hierarchical – often described as a “pyramid structure” – and the make-up of audit teams for individual engagements generally reflects this structure. As a result, much of the detailed “on-site” audit work is likely to be performed by staff who are relatively inexperienced; indeed, many may still be completing an accounting qualification.
39. While not all members of the team can be expected to have the same level of knowledge and experience, it is the responsibility of the audit engagement partner to ensure that collectively the



team have the appropriate competence and capabilities. This may entail involving specialists with particular skills such as information technology or on particular financial reporting issues either from within the audit firm or from external sources. If specialists are involved, it is important, as with other members of the engagement team, that their work is appropriately directed, supervised and reviewed.

40. Involving the same staff members on an audit, one year after another, is likely to assist them in understanding the entity's business and systems. This is likely to result in effective responses to business risks as well as audit efficiency. However, prolonged involvement can result in a lack of skepticism and threats to auditor independence.

*Partners and Staff Have Sufficient Time to Undertake the Audit in an Orderly Manner*

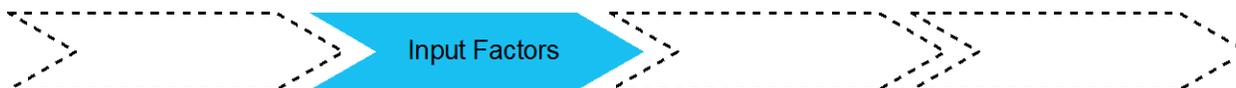
41. Partners and staff often have responsibilities other than the audit of a single entity and audits can be undertaken to challenging timetables. Planning is important, both at the level of an individual audit, and at the level of the audit firm, to ensure that sufficient resources are available to gather sufficient appropriate audit evidence and to interact appropriately with management and those charged with governance.
42. Audit firms are usually profit-making entities and the profitability of an audit firm is usually linked to the relationship between the audit fees charged and the cost involved in gathering sufficient appropriate audit evidence. Audit engagement partners are usually accountable within their audit firms for the financial return on the audits they perform and, if audit fees cannot be increased, this can result in reduced testing and threats to audit quality.

*The Engagement Partner and Other Experienced Members of the Audit Team are Accessible to Management and the Audit Committee*

43. It is important that the audit engagement partner is accessible to senior members of management and those charged with governance. Regular contact allows the audit engagement partner to be well briefed on developments in the entity's business as well as raise issues related to the audit on a timely basis.

**Audit Process and Quality Control Procedures**

44. Audits need to be performed in accordance with auditing standards which provide the foundation for a disciplined approach to risk assessment, planning, performing audit procedures and ultimately forming and expressing an opinion. Sometimes, audit firms' methodologies and internal policies and procedures provide more specific guidance on matters such as who undertakes specific activities, internal consultation requirements; and documentation formats.
45. While the audit firm's methodology and auditing standards will shape the audit process the way that process is applied in practice will be tailored to a particular audit. Key attributes are:
  - The engagement team complies with auditing standards and the firm's quality control procedures.
  - The engagement team makes proper use of information technology.
  - There is effective interaction with others involved in the audit including, where applicable, internal auditors.
  - There is engagement with management so as to achieve audit efficiency.



- There is appropriate audit documentation.
- Group audits are effectively managed.

#### *The Engagement Team Complies with Auditing Standards and the Firm's Quality Control Procedures*

46. Auditors are usually required by national law or regulations to comply with auditing standards. However, not all aspects of the audit process are defined by auditing standards and audit firms will usually have methodologies that provide further specification. Even within the structure created by auditing standards and firm methodologies, there is flexibility for the audit team in terms of what specific audit work is performed, how it is undertaken in practice and the nature and timing of interactions with management. The way that the work is performed in practice can be an important factor in both effectiveness and efficiency.

#### *The Engagement Team Makes Proper Use of Information Technology*

47. The automation of accounting systems allows auditors to spend less time obtaining audit evidence regarding the accuracy of transaction processing and enables them to devote more time to areas of greater potential risk. Information technology also provides an opportunity for auditors to gather audit evidence more effectively through the use of computer-assisted audit techniques, although sometimes these need the involvement of specialists and can be expensive to set up, especially in the first year.

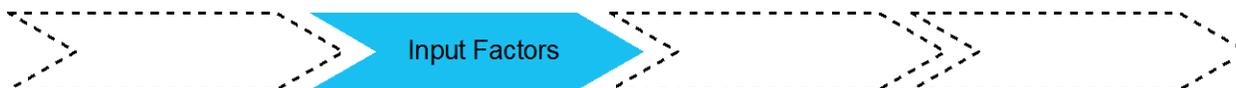
48. Information technology has also had an effect on the way auditors communicate, both within audit teams and with management and those charged with governance. E-mails in particular are increasingly used. While e-mail generally increases accessibility, especially on an international basis, e-mails can have limitations. In particular, there may be a reduced opportunity to obtain useful audit evidence from e-mail exchanges than from the richer interaction that comes through having a fuller open discussion with management. Depending on the circumstances, e-mail might also make it easier for management to provide inaccurate or incomplete responses to the auditor's questions or be less forthright with information if management is motivated to do so.

#### *There Is Effective Engagement with Others Involved in the Audit and, Where Applicable, Internal Auditors*

49. Others involved in the audit could include auditor experts, or, in a group context, the auditors of components. Where others are involved in the audit it is important that:

- The engagement team clearly communicates with them about the work to be performed,
- Other involved clearly communicate the findings from the work performed, and
- The engagement team determines that the work performed is adequate for the auditor's purpose and reacts appropriately to the findings.

50. Many large entities will have an internal audit function. It is likely to be important for both audit efficiency and effectiveness for there to be effective interaction between the external and internal auditors. For example, the internal audit function is likely to have obtained insight into the entity's operations and business risks that will provide valuable input into the auditor's understanding of the entity and risk assessments or other aspects of the audit.



*There is Engagement with Management so as to Achieve Audit Efficiency*

51. Management may have an interest in ensuring that the audit is completed as quickly as possible and the disruption to the entity's ongoing operations is minimized. Engagement teams can assist this through:
- Rigorous planning, including where appropriate agreeing with management information needs and timetable;
  - Timely engagement with management to resolve issues identified during the audit;
  - Striving to meet agreed timelines and reporting deadlines; and
  - Avoiding, as far as possible, duplicate inquiries of management on the same matter from different engagement team members.

*There is Appropriate Audit Documentation*

52. Auditing standards require audit documentation to be prepared sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature timing and extent of the procedures performed, the results of those procedures, the significant matters arising and the conclusions reached. This documentation supports quality control activities both within the audit team, before the audit is completed, and by others who decide to review the quality of work performed after the audit has been completed.

*Group Audits*

53. A number of these attributes need particular consideration in group audits. In particular:
- Group management usually expects the group auditor to co-ordinate the work undertaken on components efficiently. Some believe that this can be facilitated if the audits of components are undertaken by the same audit firm or firms within the same audit network. The firm's geographic reach, and therefore its ability to provide efficient audit coverage for subsidiaries and other components of the group can therefore be important.
  - One of the key attributes relating to the audit process is that there is effective engagement with others involved in the audit. Most large entities will have divisions, subsidiaries, joint ventures or investees accounted for by the equity method (components) and one or more components are frequently audited by audit teams other than the group audit team. It is important for the group auditor to determine the nature, timing and extent of work to be undertaken by component auditors and, for significant components, be involved in it.
  - Some audit firms operate internationally through a network of firms. Network firms often share common methodologies and quality control and monitoring policies and procedures.



#### 4. Output Factors

54. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly by considering the quality of the outputs. However, the outputs available to external users of an audit (including the entity’s shareholders) are usually rather limited and, in many cases, only comprise the auditor’s report on the financial statements.
55. Other stakeholders, especially management, audit committees and some regulators, have more direct insights into audit quality and are therefore better placed to evaluate it. Outputs from these other parties (e.g., reports by external audit inspectors) may provide useful information to external users on audit quality.
56. While outputs can provide insights into audit quality the outputs themselves can be evaluated in terms of their perceived quality.
57. Relevant outputs may include:

Engagement Level	<p>From the auditor:</p> <ul style="list-style-type: none"> <li>• The auditor’s report on the financial statements and such other matters required by law and regulations</li> <li>• Reports from the auditor to those charged with governance (e.g., audit committee reports)</li> <li>• Reports from the auditor to management (e.g., recommendations on internal controls)</li> <li>• Reports from the auditor to regulators</li> </ul> <p>From the entity:</p> <ul style="list-style-type: none"> <li>• The audited financial statements</li> <li>• Reports from audit committees</li> </ul>
Other reports	<p>From the audit firm:</p> <ul style="list-style-type: none"> <li>• Transparency reports</li> <li>• Annual reports</li> </ul> <p>From audit regulators:</p> <ul style="list-style-type: none"> <li>• Reports on the results of inspections of individual audits</li> <li>• Reports on the results of individual firm inspections</li> <li>• Aggregate reports on the results of inspections</li> </ul>

#### Engagement Level Reports

58. Key attributes in relation to an evaluation of the quality of engagement level outputs from the auditor are:
  - The reliability and usefulness of audit reporting to users of audited financial statements.
  - The value and timing of auditor reports to those charged with governance.
  - The value and timing of auditor reports to management.

- The value and timing of auditor reports to financial or prudential regulators.

#### *The Reliability and usefulness of Audit Reporting to Users of Audited Financial Statements*

59. The ultimate objective of an audit is the provision of an auditor's opinion that provides users confidence as to the reliability of the audited financial statements. For the majority of users, the absence of a qualified auditor's opinion is an important signal. However, the value of that signal is influenced by the reputation of the audit firm that has conducted the audit and an assumption about the effectiveness of the audit process employed.
60. Audit reports have evolved over the years to a degree that they are now largely standardized. Research indicates that some users want the auditor's report to contain more information about the entity and about the audit itself than is currently being provided. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as help them evaluate the quality of the audit. Additionally some users also believe that the communicative value of the auditor's report could be improved if changes were made to the current structure and wording of the auditor's report.<sup>3</sup>
61. In addition to expanding the information contained in the auditor's report, its value can also be increased if it contains additional assurance required by law or regulations. In some cases, such assurance can be provided without extending the scope of the audit (for example, confirmation that management have provided to the auditor all the information and explanations required). In other cases, the scope of the audit needs to be extended (for example, providing assurance on the effectiveness of internal financial controls).

#### *The Value and Timing of Auditor Reports to Those Charged with Governance*

62. Auditing standards usually require the auditor to communicate with those charged with governance on specific matters on a timely basis. For example, ISAs<sup>4</sup> require communication about:
- The auditor's responsibilities.
  - The planned scope and timing of the audit.
  - Information about threats to auditor objectivity and the related safeguards that have been applied.
  - The significant findings from the audit.
63. Such matters are often covered in written reports to audit committees. However, the formal requirements of auditing standards are expected to underpin wider and more extensive discussions between the auditor and those charged with governance. Those charged with governance are likely to evaluate the value and timing of both the written reports and the less formal communications when considering overall audit quality.

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<sup>3</sup> The IAASB is undertaking a separate initiative to explore how to enhance the quality, relevance and value of auditor reporting and in June 2012 issued an Invitation to Comment with proposals for improvements to auditor reporting. There are many potential options for changes that might address these concerns, including some shorter-term options that fall under the IAASB's mandate and some longer-term options that would require co-operation with organizations the mandates of which extend to legislative and other regulatory frameworks. While the ideal future content and format are not clear, the IAASB supports the need to enhance the quality, relevance and communicative value of auditor reporting on an international basis.

<sup>4</sup> ISA 260, *Communication with Those Charged with Governance*

### *The Value and Timing of Auditor Reports to Management*

64. During the course of the audit, the auditor will also have extensive communication with management. Many of these communications are informal but sometimes the auditor may decide, or management may request, the auditor to formalize observations in a written report. In such circumstances, management is likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.

### *The Value and Timing of Auditor Reports to Regulators*

65. National laws or regulations may require the auditor to communicate with financial or prudential regulators, either on a routine basis or in specific circumstances. National requirements vary but can include:
- Providing assurance on aspects of the financial reporting process, for example, on internal control.
  - Reporting matters that the regulators believe are likely to be of material significance to them.
  - Reporting illegal acts, including suspicions of money laundering.
66. In such circumstances, the regulators are likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.

### *The Audited Financial Statements*

67. The audit often results in management making changes to the draft financial statements. In addition to quantitative adjustments, this can include qualitative changes such as clarification of note disclosures. While such changes are not transparent to users, faced with high quality financial statements, users may impute that a quality audit has been performed. The converse is certainly likely to be the case, i.e., faced with financial statements that contain arithmetical errors, inconsistencies and disclosures that are difficult to understand, in the absence of a qualified auditor's report users may conclude that a poor quality audit has been performed.

### *Reports from Audit Committees*

68. In a number of countries, audit committees have specific responsibilities for a degree of oversight of the auditor or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.
69. There is potential for fuller disclosure of the activities of audit committees to benefit both actual audit quality and user perception of it. Consequently, some countries<sup>5</sup> are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

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<sup>5</sup> For example, the UK's Financial Reporting Council (FRC) is exploring an enhanced model of corporate governance reporting that could provide a platform for further reporting by those charged with governance to the entity's shareholders (or other external stakeholders), building on the existing two-way communication and dialogue about the audit between the auditor and the audit committee.

### *Reports from Audit Regulators*

70. In some countries, audit regulators make available the results of inspections on individual audits to relevant audit committees although such information is not usually made publically available.

### *Transparency Reports*

71. Audit firms may provide generic information on audit quality issues. A number of countries have introduced requirements for audit firms to provide Transparency Reports that provide information about their governance and quality control systems.<sup>6</sup> Making such information publically available may assist users of audited financial statements understand the characteristics of individual audit firms and this information may assist entities in selecting a new audit firm.
72. Transparency reports also provide an opportunity for audit firms to distinguish themselves by highlighting particular aspects of their arrangements and therefore to compete on aspects of audit quality. Publication of information on, for example, the firm's processes and practices for quality control, for ensuring independence, and on its governance provides a clear incentive to all within the audit firm to live up to both the spirit and the letter of what the firm promises.

### *Annual Reports*

73. Some audit firms and public sector audit bodies issue annual reports. Annual reports provide an opportunity for these bodies to describe key performance indicators in relation to audit quality and initiatives undertaken to increase it. Such information may help them differentiate themselves on audit quality.

### *Reports from Audit Regulators*

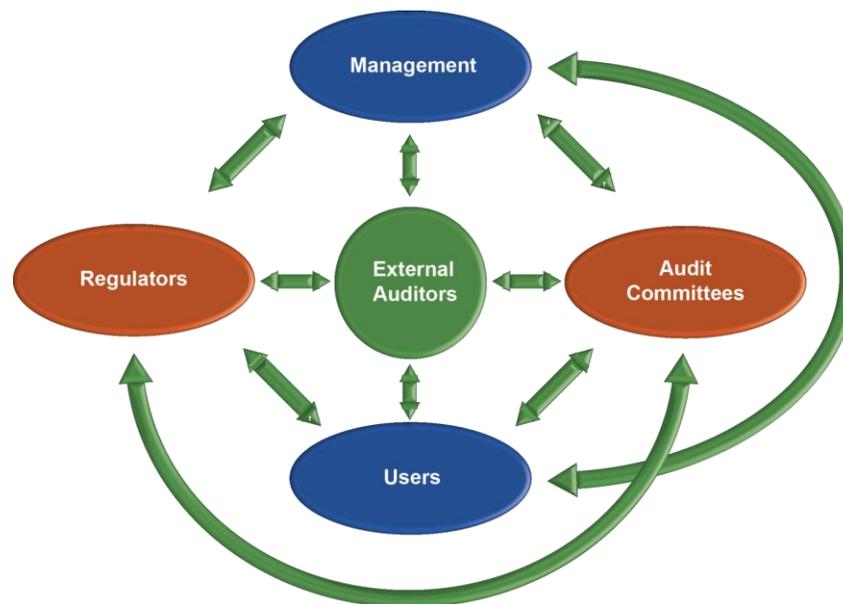
74. In many countries, audit regulators report annually on the outcome of audit inspection activities. The level of detail provided in such reports varies. In some countries, the reports aggregate the results of inspections of all audit firms; in others countries, reports are published for separate audit firms.
75. The debate on whether it is beneficial for audit regulators to report publicly on individual audit firms is finely balanced. Some believe that providing transparency on the inspection findings relating to individual audit firms will assist audit committees fulfill their responsibilities, and will have a positive impact on audit quality (by giving firms the incentive to show year-on-year improvements in the quality of their work). Others believe that public reporting on audit-firm-specific findings may cause audit firms to adopt a more defensive approach to responding to the findings from inspections.

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<sup>6</sup> For EU Member States, for example, the Statutory Audit Directive requires firms that audit public interest entities to disclose annually specified information covering the legal structure of audit firms, any network they are part of, corporate governance and quality control systems, financial information and information about the basis of partner remuneration.

## 5. Key Interactions

76. In its 2008 report *Financial Reporting Supply Chain: Current Perspectives and Directions*,<sup>7</sup> IFAC describes the financial reporting supply chain as “the people and processes involved in the preparation, approval, audit, analysis and use of financial reports.”
77. IFAC observed that all the links in the chain need to be of high quality and closely connected to supply high-quality financial reporting. While each separate link in the supply chain plays an important role in supporting high quality financial reporting, the nature of the connections, or interactions, between the links can have a particular impact on Audit Quality.
78. It is through these interactions, including both formal and informal communications, that participants in the supply chain can influence the behavior and views of others and thereby contribute to improvements in Audit Quality. The nature and extent of the interactions will be influenced both by the objectives of the individuals involved and the context in which the interactions take place.
79. Some of the more important interactions with regard to Audit Quality are described below.



### Interactions between Auditors and Management

80. Management is responsible for the preparation of the financial statements and for such internal control necessary to ensure that the information for preparing the financial statements is reliable and available on a timely basis. Management is also responsible for ensuring that the financial statements comply with the applicable financial reporting framework and, where relevant, represent the underlying transactions and events in a manner that achieves fair presentation.
81. Auditors need full and timely access to relevant information and individuals both within and outside the entity. Furthermore, an open dialogue assists the auditor identify, assess and respond to the

<sup>7</sup> The report can be accessed at: <http://web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf>.

risks of material misstatement, particularly with regard to complex or unusual transactions, or matters involving significant judgment or uncertainty. In the absence of cooperation and open dialogue it is unlikely that a quality audit can be performed efficiently.

82. An open and constructive relationship between auditors and management also helps create an environment in which management can benefit from auditors' observations on matters such as:
- Possible improvements to the entity's financial reporting practices;
  - Possible improvements in internal control over financial reporting; and
  - The reasonableness of accounting estimates.
  - Perspectives on industry issues and trends and opportunities for improvement
  - Observations on regulatory matters
83. While not a direct objective, an audit has the ability to make a valuable contribution to management to assist them in complying with relevant law, regulations and financial reporting standards. It can also provide useful information of weaknesses in controls and accounting systems that can lead to improved efficiency or effectiveness in management's processes.
84. An open and constructive relationship between the auditor and management needs to be distinguished from one of over-familiarity. It is vital for audit quality that auditors remain skeptical and objective and are prepared to challenge the reliability of the information they are given.

#### **Interactions between Auditors and Audit Committees**

85. Those charged with governance are responsible for overseeing the strategic direction of the entity and obligations related to the entity's accountability. This includes overseeing the entity's financial reporting process. Effective two-way communication with auditors can assist those charged with governance fulfill this responsibility.
86. In addition those charged with governance can positively influence audit quality through:
- Providing views on financial reporting risks and areas of the business that warrant particular audit attention;
  - Considering whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this; and
  - Creating an environment in which management is not resistant to being challenged by the auditors and not overly defensive when discussing difficult or contentious matters.
  - Ensuring the fair presentation of the financial statements, especially when the auditor has concerns which have not been acted upon by management.

#### **Interactions between Management and Audit Committees**

87. A strong commitment to honesty and integrity within an entity has a positive bearing on the quality and reliability of its financial reporting process, and therefore on audit quality. Such a culture, which is established and nurtured by those charged with governance working in conjunction with senior members of management, promotes the development and maintenance of appropriate accounting policies and processes as well as the open sharing of information that is necessary for high-quality financial reporting.

88. To achieve this, those charged with governance depend on a transparent and constructive relationship with management in assisting them to discharge their responsibility for oversight of the financial reporting process. This requires a willingness by management to come forward to discuss with those charged with governance matters such as:
- Identified, and potentially significant, issues on financial reporting, regulation and the audit;
  - Performance pressures relative to the achievement of market expectations and what responses may be appropriate; and
  - Areas where the financial reporting process may be strengthened.
89. In the absence of evidence of a transparent and constructive relationship between management and those charged with governance, the auditor needs to be especially alert for significant deficiencies in internal control, errors in the financial reporting process and fraud risks. It will also be important for the auditor to seek to understand the reasons behind such relationships as the nature of any audit responses will depend on the circumstances. For example, an audit response where those charged with governance doubt management's integrity will differ from one where management harbors reservations about the competence of those charged with governance.

#### **Interactions between Regulators and Audit Committees**

90. As with management, the extent to which financial regulators interact with those charged with governance varies between countries and industries.
91. While to date there is relatively little interaction between audit regulators and those charged with governance, the potential for this exists. For example, it is possible that at some stage in the future:
- Audit regulators might communicate, or require the auditors to communicate, the findings from inspections of individual audits to the audit committees of the relevant entities; or
  - Audit inspectors might seek the views of audit committees on the quality of individual audits as part of their inspection activities.

#### **Interactions between Auditors and Financial Statement Users**

92. The primary way in which auditors interact with financial statement users is through the auditor's report. The IAASB acknowledges that some users do not believe that the binary nature of the current audit reporting model fully meets their information needs. The IAASB is therefore undertaking a separate initiative to explore how to enhance the quality, relevance and value of auditor reporting.<sup>8</sup>
93. In addition to the auditor's report, in some countries, the regulatory framework provides users with an opportunity to interact, to some degree, with the auditors. These interactions can provide an added motivation for auditors to perform high-quality audits. For example, in a number of jurisdictions, proposals for the appointment, re-appointment or replacement of an entity's auditor are required to be approved by the entity's shareholders in general meeting. Shareholders may also

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<sup>8</sup> In May 2011, the IAASB issued a consultation paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, setting out possible options for change to the auditor's report. The consultation paper seeks input as to whether such options might be effective in enhancing auditor reporting and the communicative value of the auditor's report. The consultation paper can be accessed at: [www.ifac.org/Guidance/EXD-Details.php?EDID=0163](http://www.ifac.org/Guidance/EXD-Details.php?EDID=0163).

have the right in general meeting to question the auditor on any significant matters pertaining to the audit.

94. More generally users, such as institutional investors, can act as a buttress to audit quality by taking an active interest in exploring with the entity matters on which the auditors have taken a public position – such as by modifying the audit opinion or issuing a statement to shareholders explaining relevant matters.
95. Users may also wish to probe the rationale for a change in auditor. This will be facilitated when information related to the reasons for the previous auditor withdrawing from the engagement, or not seeking reappointment, are made publicly available on a timely basis.

#### **Interactions between Audit Committees and Financial Statement Users**

96. In a number of countries, audit committees have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.
97. There is potential for fuller disclosure of the activities of audit committees to benefit both actual audit quality and user perception of it. Consequently, some countries<sup>9</sup> are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

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<sup>9</sup> For example, the UK's Financial Reporting Council (FRC) is exploring an enhanced model of corporate governance reporting that could provide a platform for further reporting by those charged with governance to the entity's shareholders (or other external stakeholders), building on the existing two-way communication and dialogue about the audit between the auditor and the audit committee.

### Key Questions for Audit Committees Relating to Attributes of Audit Quality

Set out below are those attributes of the Audit Quality Framework which are most likely to be relevant to audit committees, together with possible questions that may help identify areas where they can make improvements to audit quality.

Attributes	Questions
<b><i>Interactions Between the Audit Committee and:</i></b>	
Management	<ul style="list-style-type: none"> <li>• Are audit committee members sufficiently independent of management and financially literate?</li> <li>• Does management openly raise issues related to financial reporting and regulation with the audit committee on a timely basis?</li> <li>• Does management openly discuss the assumptions behind significant accounting judgments involved in the financial reporting process?</li> <li>• Does management openly discuss with the audit committee areas where the financial reporting process may be strengthened?</li> <li>• Does management provide the audit committee with a draft of the complete annual report and react appropriately to comments on overall presentation issues?</li> <li>• Has the audit committee created an environment in which management is not resistant to being challenged by the auditors and are not overly defensive when discussing difficult or contentious matters</li> </ul>
The auditor	<ul style="list-style-type: none"> <li>• Is there effective two-way communication with the auditors?</li> <li>• Did the auditors discuss the planned approach to the audit on a timely basis?</li> <li>• Did the auditors discuss the significant findings from the audit on a timely basis?</li> <li>• Did the audit committee provide the auditors with their views on financial reporting risks and areas of the business that warrant particular audit attention?</li> </ul>

Attributes	Questions
	<ul style="list-style-type: none"> <li>• Did the audit committee discuss with the auditor whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this?</li> <li>• Does the audit committee, on occasion, meet with the auditors without management in attendance?</li> </ul>
Users of the financial statements	<ul style="list-style-type: none"> <li>• Does the annual report contain information about the activities of the audit committee?</li> </ul>
<b><i>Values, Attitude and Culture of the auditors</i></b>	
<p>The engagement team appears to recognize that the audit is performed in the interests of the entity's shareholders and the wider public interest. The engagement team exhibits:</p> <ul style="list-style-type: none"> <li>• Professional skepticism;</li> <li>• Objectivity and integrity; and</li> <li>• Professional competence and due care.</li> </ul>	<ul style="list-style-type: none"> <li>• Are the engagement partner and the rest of the team prepared to challenge management judgments?</li> </ul>
The engagement team is independent.	<ul style="list-style-type: none"> <li>• Does the engagement partner discuss independence issues with the audit committee?</li> <li>• Is the audit committee involved in approving non-audit services?</li> <li>• Has the engagement partner been "rotated" in accordance with ethical requirements?</li> </ul>
<b><i>Knowledge, Experience and Time of the auditors</i></b>	
Partners and staff understand the entity's business.	<ul style="list-style-type: none"> <li>• Do partners and senior staff demonstrate a good understanding of the entity's business?</li> <li>• Where necessary, is the engagement team supported by an industry specialist group within the firm?</li> <li>• Has a reasonable degree of continuity been achieved in the staffing of the engagement team from one year to the next?</li> </ul>
Partners and staff have the necessary skills and experience to make sound judgments.	<ul style="list-style-type: none"> <li>• When important audit judgments have been discussed with the audit committee do they appear to be: <ul style="list-style-type: none"> <li>○ Objective;</li> <li>○ Well researched; and</li> </ul> </li> </ul>

Attributes	Questions
	<ul style="list-style-type: none"> <li>○ Reasonable?</li> </ul>
The audit engagement partner is actively involved in the work performed and staff performing detailed “on-site” audit work are appropriately supervised and reviewed.	<ul style="list-style-type: none"> <li>• Is the engagement partner often seen on site working with the team?</li> </ul>
The audit engagement partner and other experienced members of the audit team are accessible to management and the audit committee.	<ul style="list-style-type: none"> <li>• Have the engagement partner and other senior members of the engagement team been readily accessible to management and the audit committee throughout the engagement?</li> </ul>
Partners and staff have sufficient time to undertake the audit in an effective manner.	<ul style="list-style-type: none"> <li>• Has the engagement team experienced undue time constraints during the course of the audit?</li> </ul>
<b>Audit Process of the auditors</b>	
There is effective engagement with internal auditors where applicable.	<ul style="list-style-type: none"> <li>• Does the degree of interaction between the external auditor and the internal audit function seem appropriate?</li> </ul>
The group audit is effectively managed.	<ul style="list-style-type: none"> <li>• Does the group auditor efficiently co-ordinate the work undertaken at components?</li> <li>• Does the group auditor effectively engage with component auditors?</li> <li>• Is a consistent methodology used for the audit of components?</li> </ul>
The engagement team works with management so as to achieve audit efficiency.	<ul style="list-style-type: none"> <li>• Is management notified of potential audit and financial reporting issues, including those arising from changes in standards and regulation on a timely basis?</li> <li>• Does there appear to be timely engagement with management on resolving issues identified during the audit?</li> <li>• Have the auditors met agreed timelines and reporting deadlines?</li> </ul>
<b>Outputs of the auditors</b>	<ul style="list-style-type: none"> <li>• Are reports to the audit committee clear, valuable and timely?</li> </ul>