

### Invitation to Comment: Responding to Public Interest Calls to Enhance Audit Quality

The IAASB's strategic objectives for 2015–2019 include ensuring that International Standards on Auditing (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. The [IAASB's Work Plan for 2015–2016](#) ("the Work Plan") committed to give priority to:

- Quality control;
- Group audits;
- Audits of financial institutions (including ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*); and
- Professional skepticism.

This Invitation to Comment (ITC) represents a combined approach to soliciting stakeholder input on these priority projects. The IAASB will also continue to monitor developments on related initiatives from others,<sup>1</sup> and, as needed, may supplement this ITC with more specific or targeted outreach to certain regulators and other stakeholders (e.g., outreach to banking regulators in relation to financial institutions).

The purpose of this ITC is to explore how the IAASB might best respond in the public interest to calls to enhance audit quality, particularly in the context of the above priority projects, and in light of:

- Inspection findings highlighted by regulators and audit inspection bodies, and
- Issues and practical challenges noted by audit firms, including small and medium practices, public sector audit institutions and others related to the performance of audits in accordance with ISAs.

This ITC also recognizes the input factors<sup>2</sup> set out in the IAASB's [Framework for Audit Quality](#) (the AQ Framework), and includes discussion about whether relevant aspects of the AQ Framework need to be more explicitly addressed in the IAASB's International Standards.

The forepart of this ITC is intended to provide a high-level overview of issues the IAASB believes are most relevant in responding to calls to enhance audit quality in areas related to the priority projects.

The more in-depth discussion in the *Exploring the IAASB's Suggested Enhancements in Relation to Specific Projects* section, (Part II) of this ITC, highlights areas where changes to the standards or other actions by the IAASB may be needed in the public interest.

This ITC also includes questions for stakeholders that are intended to solicit views on the areas highlighted and their relative importance and relevance, as well as views about steps the IAASB and others should take to have the most meaningful effects on audit quality over the longer term. Stakeholder views will be used in 2016 to inform the Board's future standard-setting proposals in relation to the projects on group audits and quality control, and other priority projects as appropriate.

<sup>1</sup> The activities of others, including national standard setters, accounting standard setters and regulators, that are relevant to the IAASB's priority projects, can be found in Appendix X [*to be inserted after September 2015 IAASB discussions*].

<sup>2</sup> Input factors in the AQ Framework include the values, ethics and attitudes of auditors, which in turn, are influenced by the culture prevailing within the audit firm; as well as the knowledge, skills, and experience of auditors and the time allocated for them to perform the audit.

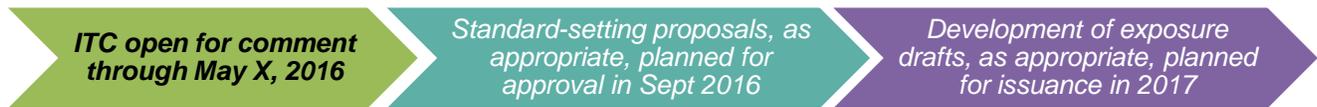
## Chairman’s Statement

As the global auditing standard setter, the IAASB has a public interest responsibility to take appropriate actions to promote high-quality audits. Our work over the past 10 years to enhance the ISAs has been focused on the goal of developing standards that are clear and sufficiently robust to support the performance of quality audits, and capable of consistent application worldwide. During this time, the world has seen the effects of a global financial crisis, and the business environment in which audits are conducted continues to change rapidly. The business models of audit firms have also evolved, including how networks, firms and engagement teams are structured and how audits are organized and managed.

We knew that the finalization of the clarified ISAs and 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*, did not represent the end of our work. This work was, however, an important step in our continuing quest to develop and maintain standards that provide the basis for high-quality, valuable, and relevant audits conducted worldwide. Shortly after the clarified ISAs became effective in 2009, the Board embarked on its first post-implementation review; which we refer to as our “ISA Implementation Monitoring” project. This project focused on obtaining input from a variety of different channels to learn about adoption and implementation issues related to the clarified ISAs. Our rigorous outreach program, in particular our strengthened collaboration with the International Forum of Independent Audit Regulators (IFIAR) and its Standards Coordination Working Group, and the International Organization of Securities Commissions (IOSCO), as well as ongoing dialogue with audit firms, national auditing standard setters (NSS) and others, continues to keep us apprised of areas where improvements to our standards may be needed, or where other actions to enhance auditor performance may be appropriate.

The IAASB’s [Strategy for 2015–2019](#) acknowledges the IAASB’s strong commitment to meeting the expectations of stakeholders regarding the application of the ISAs and ISQC 1. These standards serve a fundamental role in underpinning audit quality in both the private and public sectors.

The IAASB is therefore investing significant effort in 2015 and beyond to respond to some of the most significant implementation issues identified from its ISA Implementation Monitoring project and other outreach, particularly in relation to quality control, group audits, financial institutions and professional skepticism. This ITC marks the start of a public consultation, as the IAASB seeks to reach conclusions as to what actions are needed in the public interest in relation to these projects.



Our *Framework for Audit Quality* highlights important inputs to audit quality – with the ISAs being a critical input, but not the only one of importance. Accordingly, through this consultation the IAASB may identify actions in addition to standard setting that are needed to enhance auditor performance and audit quality (e.g., the development of non-authoritative guidance or the need for others to enhance auditor training programs). The IAASB may promote calls for action by others and facilitate dialogue about the need for additional actions that may complement the IAASB’s commitment to audit quality. As such, we welcome views from our stakeholders about where others (e.g., regulators and audit oversight bodies, audit committees, policymakers, and audit firms) can proactively take steps to meaningfully enhance audit quality worldwide.

## An Audit of Financial Statements

***The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements.***

- *International Standards on Auditing (ISA) 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, paragraph 3*

1. The audit of financial statements is an integral element of the financial reporting chain, as an audit and an auditor's report enhance the credibility of the underlying financial statements; a high-quality audit is therefore essential to financial stability. Investors have told the IAASB that the auditor's opinion is valued and that additional transparency about auditor's insights acquired during the audit is desired and welcome. The widespread and growing [international use of the ISAs](#)<sup>3</sup> underscores the importance of the IAASB continuing to focus its efforts on maintaining the quality and scalability of its standards. Calls for quality audits come from a broad range of users of financial statements – ranging from investors in the largest global capital markets, to banks and other users of small- and medium-sized entity (SME) financial statements – as well as from audit regulators and audit oversight bodies.
2. The suite of the clarified ISAs takes a principles-based approach that can be applied regardless of the underlying financial reporting framework applied by management in preparing the financial statements, the industry in which an entity operates, or its size.
3. The ISAs are designed to support the auditor in obtaining sufficient appropriate audit evidence to support the audit opinion. No two entities are exactly the same and therefore the audit work and judgments required will necessarily vary. What comprises “sufficient appropriate audit evidence” will therefore be a matter of professional judgment in the circumstances of the audit, reflecting the size, nature, and complexity of the entity; the industry and associated regulatory environment within which it operates; as well as the auditor's assessment of the risks that the financial statements prepared by management are materially misstated. Auditors use their experience and the values of integrity and objectivity, and professional skepticism, to make reasonable professional judgments that are supported by the facts and circumstances of the engagement.
4. When using the ISAs, in addition to addressing the relevant requirements in ISAs at the engagement level, audit firms are also required to establish and maintain systems of quality control, including addressing all the elements of such a system in accordance with ISQC 1.

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<sup>3</sup> Currently there are 106 jurisdictions using the clarified ISAs, or committed to using them, in the near future,

**Elements of a System of Quality Control**



**Enhancements to Audit Quality<sup>4</sup>**

***What Is a Quality Audit?***

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 Audit Quality (AQ) Framework*

<sup>4</sup> The term “audit quality” is frequently used in discussions among stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting. Audit quality is a complex subject and there is no single definition or analysis thereof that has achieved universal recognition. Recognizing the importance of audit quality and its relevance to all stakeholders in the financial reporting supply chain, the IAASB developed its AQ Framework that describes the input-, process- and output factors that contribute to audit quality at the engagement, audit firm and national levels, for financial statement audits. The AQ Framework also demonstrates the importance of appropriate interactions among stakeholders and the importance of various contextual factors.

5. The IAASB recognizes that the world is changing. The way that businesses are structured is continually evolving, in particular as they become more global. Advances in technology facilitate more integration, but can also support more decentralization, provide for greater strategic flexibility and, in many cases, achieve efficiencies and cost savings. In addition, law and regulation in certain jurisdictions may create tax incentives that drive how entities are domiciled and therefore how groups are structured. These evolving situations have affected how audits are carried out, in particular audits of multi-national entities, as audit firms recognize the need to tailor their approaches to facilitate effectiveness and efficiency in performing audits. Audit firms themselves are also contemplating their own structures and how best to organize engagement teams and conduct audit engagements, with a view towards achieving high-quality audits at reasonable cost. At the same time, audit firms of all sizes face resource challenges and continued pressure on audit fees as they adapt to the pace of change in legal and regulatory environments, including expectations of audit regulators.
  
6. Financial reporting frameworks are also evolving, becoming more complex and increasingly involving the use of significant management judgments as fair value measurements become more prevalent and more forward-looking information is demanded by investors. These trends pose challenges not only for auditors, but also for preparers and audit committee members responsible for preparing or overseeing the preparation of high-quality financial statements, including related disclosures.
  
7. Groups such as the International Forum of Independent Audit Regulators (IFIAR), established to promote collaboration in audit oversight regulatory activity and to focus on audit quality and related matters, continue to emphasize the need for actions to continuously improve audit quality. Publicly reported inspection findings consistently highlight areas where quality audits are not being performed. For example, [IFIAR's 2014 Summary of Inspection Findings](#) highlights persistent deficiencies in important aspects of audits, including with respect to audit firms' systems of quality control. An important part of the IAASB's consultation is therefore to seek to obtain input in the context of its priority projects, about respondents' understanding of the causal factors of audit deficiencies (i.e., perform "root cause analysis"), thereby identifying those issues that can be effectively addressed by the IAASB. Such input is therefore expected to inform the IAASB's efforts to explore whether changes to its International Standards are needed to enhance auditor performance, or whether there are actions that the IAASB or others can undertake that are likely to be more effective or that will complement the IAASB's standard setting actions.<sup>5</sup>

The findings of the IAASB's ISA Implementation Monitoring project, finalized in the 2013 publication [Clarified International Standards on Auditing—Findings from the Post-Implementation Review](#), indicated that improvement to aspects of some ISAs is necessary to achieve greater consistency and effectiveness in their application. The IAASB's current Work Plan focuses on responding to these findings in a number of priority areas.

<sup>5</sup> See Appendix X for Possible Actions by Others to Enhance Audit Quality [to be inserted after September 2015 IAASB discussions].

8. Audit firms have also identified areas for needed improvements within the ISAs, noting in some cases that it has been necessary to develop internal methodologies and guidance to bridge perceived gaps in or difficulties in applying the principles-based ISAs to circumstances that arise in practice today. Concerns continue to be expressed by the small and medium practices (SMP) community that more is needed to assist them in effectively applying the ISAs in a manner that both achieves audit quality and also recognizes the challenges that SMPs face.
9. The IAASB recognizes that its standards apply to a wide range of circumstances in diverse jurisdictions. Any changes to the standards therefore will need to be drafted with a view towards maintaining the relevance of the standards as the circumstances to which, and in which, they are applied continue to evolve. Changes will also be made bearing in mind the fundamental principles of an audit and overall objectives of the auditor<sup>6</sup> (i.e., including obtaining sufficient appropriate audit evidence on which to base the audit opinion).
10. Other topics on the IAASB's current Work Plan are also important to audit quality, such as its plans to consider the ISA Implementation Monitoring findings with respect to ISA 315 (Revised),<sup>7</sup> as well as the use of data analytics and the effects of technology on the audit. While the IAASB has commenced initial exploratory work related to these topics, they do not explicitly form part of this consultation.
11. In addition, ISQC 1<sup>8</sup> also applies more broadly to firms that conduct engagements other than audits of historical financial statements (including compilation engagements, agreed-upon procedures engagements, review engagements and other assurance engagements). This ITC focuses on ISQC 1 as it applies to audits of historical financial statements. In considering changes to the standard and how it is structured, consideration will however also be given to clarifying how ISQC 1 applies to these other types of engagements.

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<sup>6</sup> In conducting an audit of financial statements, the overall objectives of the auditor are: (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, and (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings ( ISA 200, paragraph 11).

<sup>7</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>8</sup> 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*

## Taking Steps to Strengthen Standards or Provide More Relevant Guidance to Enhance Audit Quality

### *In Relation to Quality Control*

12. The clarified ISAs and ISQC 1 serve a fundamental role in underpinning audit quality and users' confidence in the audit and financial reporting. The IAASB's deliberations to date have highlighted many aspects of a firm's system of quality control that are essential to ensuring quality audits are performed, and have noted that certain aspects could be more explicitly addressed in ISQC 1. The engagement partner responsible for each individual audit engagement plays an essential role relative to audit quality and users' confidence, given that such partner is the individual responsible for the quality of the engagement. It is therefore in the public interest that the roles and responsibilities of both the firm and the engagement partner are robust and clearly articulated within the IAASB's standards. Improving these foundational elements upon which audits are conducted will help to facilitate the ongoing effective implementation of the principles-based ISAs and ISQC 1, in particular as the environment changes and challenges continue to emerge.

*Key attributes in relation to creating a culture where audit quality is valued are:*

- ❖ *Governance arrangements are in place that establish the appropriate "tone at the top", and which aim to safeguard the firm's independence.*
- ❖ *Necessary personal characteristics are promoted through appraisal and reward systems supporting audit quality.*
- ❖ *Financial considerations do not drive actions and decisions that impair audit quality.*
- ❖ *The firm emphasizes the importance of providing partners and staff with continuing professional development opportunities and access to high-quality technical support.*
- ❖ *The firm promotes a culture of consultation on difficult issues.*
- ❖ *Robust systems exist for making client acceptance and continuance decisions.*

*- Paragraph 5 of the AQ Framework*

13. Set out below are the relevant issues related to **quality control** that the IAASB believes it should seek to address in the public interest in order to enhance audit quality.

### *Leadership Responsibilities for Quality within the Audit Firm*

14. While ISQC 1 addresses the concept of firm governance at a high level, it does not provide much detail or guidance as to what is expected with respect to governance, nor does it include well-understood and commonly used concepts and terminology such as "tone at the top"<sup>9</sup> and "leading by example."

15. Among other recommendations to strengthen the requirements for governance of audit firms described in paragraphs 63–72, the IAASB is also considering whether ISQC 1 should focus more

<sup>9</sup> "Tone at the top" is an often used term to convey leadership's attitudes and general ethical values. The concept incorporates leadership's commitment regarding openness, honesty, independence, integrity and ethical behavior and is the foundation of the culture of an audit firm.

broadly on accountability of firm leadership for sustaining and continuously improving audit quality. For example, the current approach of addressing responsibilities at both the firm level in ISQC 1 and at the engagement level in ISA 220<sup>10</sup> could be changed within those standards to establish clear accountability of firm leadership for matters related to audit quality, which may for example, involve the elements of empowerment, direction, reporting back, incentives and consequences (also see paragraph 32).

16. Given the important linkage between a firm's governance and the quality of audit engagements performed by the firm, the IAASB is particularly interested in understanding stakeholders' views as to what standard-setting actions it could take as it relates to firm governance

*The audit firm's culture has an important influence on the values, ethics and attitudes of audit partners and other members of the engagement team because the environment in which the engagement team works can materially affect the mindset of partners and staff, and consequently the way they discharge their responsibilities.*

*- Paragraph 4 of the AQ Framework*

17. Recognizing the wide diversity in types of audit firms and related governance processes, and differing law and regulation at a national or jurisdictional level, some aspects of governance (e.g., to require public reporting about audit firm governance and quality control systems (commonly referred to as transparency reporting)),<sup>11</sup> may not be appropriate or possible for the IAASB to address.

#### *Monitoring and Remediation*

*Quality control procedures will include monitoring and taking remedial action when needed... Monitoring audit quality within an audit firm is an important aspect of identifying emerging risks and opportunities, and ensuring that standards are being adhered to and that the partners and staff are performing appropriately... In addition to addressing any shortcomings that have been identified on individual audits, it is important that audit firms take appropriate actions to address systemic issues revealed by both internal and external monitoring activities and take appropriate action.*

*- Paragraphs 105, 106 and 109 of the AQ Framework*

18. Audit oversight bodies are placing increased demands on audit firms to take actions to understand the causal factors of inspection findings and to put policies and procedures in place to respond to internal and external inspection findings (inspection findings) as a means of improving audit quality. The IAASB agrees that monitoring and remediation is a critical component in a firm's system of quality control, and is considering whether enhanced requirements and application material in ISQC 1 may be needed to emphasize actions to be taken by an audit firm to respond to inspection findings. Strengthening the requirements related to the documentation of the remedial actions taken by audit firms could also contribute to enhanced audit quality (see also paragraphs 80–89). The

<sup>10</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

<sup>11</sup> Further discussion about transparency reporting can be found in paragraphs 150–155.

IAASB is particularly interested in understanding audit firms' current practices to investigate the causal factors of inspection findings and how that understanding is factored into remediation activities, which may include updates to audit firms' methodologies, training and other actions aimed at promoting audit quality.

### *Engagement Partner Definition and Responsibilities*

ISA 220 sets out the responsibility of the engagement partner for the:

- ❖ Direction, supervision and performance of the engagement in compliance with professional standards and applicable legal and regulatory requirements;
- ❖ Responsibility for reviews being performed in accordance with the firm's policies and procedures;
- ❖ Responsibility for ensuring that sufficient appropriate audit evidence has been obtained to support the auditor's report; and
- ❖ Appropriateness of the report is appropriate in the circumstances.

19. The audit engagement partner<sup>12</sup> is responsible for the audit engagement and therefore is directly responsible for its quality. In addition to taking responsibility for the audit engagement and its performance, the audit engagement partner has a critical role in ensuring that the engagement team embraces and exhibits the values, ethics and attitudes necessary to support a quality audit.
20. It is therefore essential to the public interest that the fundamental principles and expectations related to the engagement partner are sufficiently clear and well-articulated within the ISAs, in particular as the manner in which audits are conducted adapts to the changing environment in which the entities under audit operate. Questions and concerns from regulators and audit oversight bodies have arisen relating to how engagement partners are taking overall responsibility for audits and demonstrating appropriate direction and supervision throughout.
21. Concern has also been raised that the ISAs do not clearly set out the responsibilities of the engagement partner in circumstances when other auditors are involved in an engagement that is not a group audit (i.e., the other auditors are not component auditors as defined by ISA 600). Reference is made in paragraph 2 of ISA 600 to the ability to adapt ISA 600 to these situations but it has been observed that the lack of more specific requirements and guidance proves challenging in practice (see further discussion on involvement of other auditors in paragraphs 29–31)
22. For example, the IAASB has already recognized that challenges arise in the circumstances where the engagement partner is not located where the majority of the audit work is performed, and other auditors are involved in the audit. As noted in the August 2015 Staff Audit Practice Alert, [\*Responsibilities of the Engagement Partner in Circumstances When the Engagement Partner Is Not Located Where the Majority of the Audit Work is Performed\*](#), these issues arise in part because the nature of these and other multi-location audits make it more challenging for the engagement partner to discharge the required responsibilities for direction and review of the audit.

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<sup>12</sup> As it relates to the public sector environment, the terms "client," "engagement," "engagement partner," and "firm" should, where relevant, be read as referring to their public sector equivalents as defined in International Standard of Supreme Audit Institutions (ISSAI) 40, *Quality Control for Supreme Audit Institutions*, Section 7

It may also not be clear as to whether and how ISA 600<sup>13</sup> applies in some circumstances, i.e., in addition to the requirements of ISA 220 and other ISAs. Further consideration of relevant issues related to these circumstances can be found in paragraphs 106–121, 165–178, 200 and 204–206.

*Engagement Quality Control Reviews (EQCRs), Including Engagement Quality Control Reviewers*

23. As a complement to the requirements set forth for engagement partners, ISQC 1 and ISA 220 set out requirements for audits of financial statements of listed entities to have an EQCR conducted by an engagement quality control reviewer. EQCRs are intended to comprise objective evaluations of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. Given the public interest importance of the role of the engagement quality control review, regulators and audit oversight bodies have called for the IAASB to give priority attention to understanding whether these reviews are functioning as intended and whether the requirements and guidance in the IAASB's standards need to be clarified or strengthened, or potentially expanded beyond audits of listed entities, such as to audits of other entities that may be of significant public interest, for example because they have a large number and wide range of stakeholders; and considering the nature and entities with certain characteristics, including size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds) and other entities such as charities (see paragraphs 133–139).
24. While acknowledging the important role of an EQCR, the IAASB believes that an appropriate balance must be maintained between the responsibilities of the engagement partner and those of the engagement quality control reviewer, in light of the objectives of their respective roles (i.e., the engagement partner is responsible for the audit engagement and the auditors' report, and the engagement quality control reviewer's role is to provide an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report). Accordingly, the IAASB proposes considering changes to the standards to address the responsibilities of the EQCR holistically in conjunction with the consideration of any changes relating to the engagement partner's responsibilities (see paragraph 140).

*Exploring the Potential Effects That Audit Firms' Changing Business Models and Structures and Other Matters Have on Audit Quality*

*Firm's Structures, Including Audit Delivery Models*

25. In today's changing environment, audit firms are structuring themselves in many and varied ways, adding new levels of complexity to matters related to both the audit firm's and the engagement partner's responsibilities in support of a quality audit, and potentially affecting the way that engagement teams are structured and how audit engagements are performed.
26. Some audit firms may operate through a network of firms, sharing common methodologies and quality control and monitoring policies and procedures. Concerns have been raised that some audit firms may be inappropriately relying on the network's system of quality control (including monitoring policies and procedures in addressing responsibilities under ISQC 1) (see paragraphs 73–79). At the engagement level, issues have also arisen about whether and how engagement teams (or group engagement teams) can rely on the common systems of quality control when using work

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<sup>13</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

performed by other auditors (or component auditors) from the same firm or network of firms (see paragraphs 167, 175, 189–190, 196 and 206).

27. In conducting audits, some audit firms are developing models of service delivery that are different to the traditional engagement team structures (referred to in this ITC as audit delivery models (ADMs)). These responses are reactions to changes in the global business environment, technology developments that better facilitate the functioning of virtual engagement teams and, in some cases, to changes in how entities being audited are organizing themselves. Examples of ADMs include:
- Elements of the firm's system of quality control may be focused in a centralized location (e.g., independence monitoring).
  - Certain standard audit procedures for all or many of the firm's audit engagements may be performed by dedicated central resources (e.g., centralized functions to manage confirmation processes).
  - Centralized resources may be available to perform audit procedures at the request of individual engagement teams.

In some cases, these centralized resources may be physically located in a foreign jurisdiction or in a location other than where the majority of the engagement team is located.

28. The manner in which ADMs are structured, how they operate (including where the auditors are located), and the approaches to the oversight of the work performed can vary significantly across audit firms. Considerations to address the concerns raised by regulators and audit oversight bodies about the effects of these structures on audit quality, including how a firm's system of quality control is to be applied, and how the work is being directed, performed, supervised and reviewed can be found in paragraphs 141–149.

#### Involvement of Other Auditors

29. Group audits are addressed by ISA 600, which contains requirements and guidance dealing with the involvement of component auditors. In some cases audits may involve other auditors who are not component auditors (i.e., other auditors that do not meet the definition of component auditors). Their involvement is often a function of how an entity is structured, or the circumstances of a particular audit, but can also be driven by how a firm assembles the engagement team (including potentially through the use of one or more ADMs as discussed above). The IAASB's August 2015 [Staff Audit Practice Alert](#) addresses situations where the engagement partner is not located where the majority of the audit work is being performed and highlights a number of matters relevant to the involvement of other auditors. Paragraph 2 of ISA 600 notes that ISA 600 may be adapted as necessary when an audit is not a group audit, but it involves other auditors; however the ISAs do not provide any additional clarity as to the circumstances when this paragraph would be relevant or how ISA 600 can or should be adapted in order to assist the engagement partner in addressing the requirements of ISA 220.

#### IAASB Considerations

30. The circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the ISAs (including situations when the definitions of group audit, component and component, auditors as set forth in ISA 600 do not apply to the particular engagement).

Accordingly, the IAASB believes that it is important to first focus on the core principles established by ISA 220 and other ISAs when ADMs exist or when other auditors are used on the engagement, and in particular in relation to direction, supervision and review of their work.

31. The IAASB will also give further consideration to matters such as:
- How audit firms' systems of quality control may need to take into account the implications of using ADMs, and the need for appropriate policies and procedures to safeguard against inappropriate use of ADMs or ineffective oversight of work performed by auditors in an ADM.
  - Considering the professional competence and capabilities of the other auditors, and the appropriateness of the work being performed using ADMs, including whether those individuals are to be considered part of the engagement team or whether they are more akin to component auditors.
  - Whether there are implications for auditor performance and auditor reporting in such circumstances, such as the possibility of highlighting the involvement of other auditors or making reference to auditor reports issued by those auditors.

#### *Other Areas Relevant to Quality Control*

##### Use of a Quality Management Approach to Restructure ISQC 1 and ISA 220

32. As part of the discussions about recommendations for possible actions, the IAASB is also seeking views about the possibility of restructuring ISQC 1.<sup>14</sup> The IAASB could:
- Make amendments to extant ISQC 1 and ISA 220 as outlined in this ITC while retaining the current structure (hereafter referred to as a quality control approach (QCA)); or
  - Restructure ISQC 1 (and ISA 220 as appropriate) using a more holistic approach to quality control to more proactively focus audit firms on achieving quality objectives through the integration of business processes, including governance systems, risk and compliance management systems and systems of internal control (hereafter referred to as a quality management approach (QMA)) (see paragraphs 156–164).<sup>31</sup>

#### Other Matters

33. Further discussion of potential actions that could be taken with respect to other aspects of quality control for audit engagements are addressed in more detail in the quality control section of this ITC, for example strengthening or clarifying requirements or guidance relating to engagement partner performance and rewards systems (see paragraphs 90–100), policies and procedures for human resources (see paragraphs 101–105), and engagement partner competencies (see paragraphs 122–132).

#### ***In Relation to Group Audits***

34. Many audits today are audits of group financial statements and therefore involve participation of component auditors who perform work on financial information related to components of the group. The IAASB's ISA Implementation Monitoring project, as well as recent inspection findings from

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<sup>14</sup> Any restructuring of ISQC 1 would likely result in changes to ISA 220.

audit oversight bodies, have highlighted that there are issues with, and inconsistencies in, the application of ISA 600 to group audit engagements.

35. There are new and continuing challenges as group structures become more complex and continue to evolve, and auditors structure their audit engagements to respond to such challenges. Situations where challenges arise includes where, for example:
- Access by the group engagement team to the relevant financial information of components is restricted, such as when the component is a non-controlled entity, (e.g., when the entity is accounted for using the equity method of accounting) (see paragraphs 166–168).
  - The engagement partner is not located where the majority of the audit work is performed (see paragraphs 109–111 and 169).
  - The group engagement team has structured the audit engagement team to use innovative ADMs and other evolving audit practices that are not well addressed throughout the ISAs, including, for example, where:
    - There is increased use by entities of shared service centers (SSC), which may perform financial reporting or accounting functions for some or all components within a group. The group engagement team may use component auditors to perform procedures at the SSC, however, questions arise such as whether such SSC meets the definition of a component (in some cases, no separate financial information is prepared for the SSC) or whether auditors at the SSC meet the definition of component auditors.
    - Auditors of the group’s components have to perform audits of statutory financial statements when such financial statements are prepared based, in part, on information processed at the SSC and audited by another auditor or the group engagement team (further discussion about the challenges when using another auditor can also be found in paragraphs 29–31 above).

(Also see paragraphs 141–149)

36. The IAASB intends to consider whether clarified or strengthened requirements, or additional practical guidance, may be needed to enhance the quality of group audits. In considering changes to its standards, the IAASB needs to take into account that group structures are unique, and that ISA 600 needs to continue to be principles-based and capable of being applied as such structures continue to evolve, and it needs to allow for the auditor to structure the audit engagement to respond to such challenges.
37. The IAASB has also had preliminary discussions about the possibility of amending ISA 600 to provide for the ability of the group engagement team, in limited circumstances and subject to appropriate requirements, to use an auditor’s report of another auditor as audit evidence for the financial information of a

*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 is also necessary for the exercise of professional skepticism and the ability to make appropriate audit judgments.*

*- Paragraph 45 of the AQ Framework*

component, including the potential to indicate in the auditor's report that the auditor's opinion is based in part on the report of the other auditor.<sup>15</sup>

38. The overarching issues relating to group audits are explored further below, with more detail on the specific issues set out in the Group Audits section of this ITC.

#### *Applying the ISAs to Group Audits*

39. Underlying all audits, including group audits, are the requirements of ISA 220 relating to quality control at the engagement level. ISA 600 deals with the *additional* responsibilities of the auditor when auditing group financial statements. ISA 600 focuses on special considerations of the auditor in applying the suite of ISAs in a group audit situation and providing specific assistance to the group engagement partner in meeting the requirements in ISA 220 where component auditors perform work on the financial information of components.
40. ISA 600 indicates that the requirements of ISA 220 are to be applied in a group audit engagement, regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component.<sup>16</sup> However, outreach with both audit firms and audit oversight bodies has suggested that auditors may not have a consistent view as to how ISA 600 relates to ISA 220 and other ISAs because the interrelationship between ISA 600 and the other ISAs is not addressed in a sufficiently clear manner in ISA 600. For example, the linkage to the requirements related to identifying and assessing the risks of material misstatement and developing appropriate responses in accordance with ISAs 315 (Revised) and 330<sup>17</sup> is not explicit in ISA 600. The IAASB therefore intends to consider whether clearer linkage could be made in ISA 600 to key requirements in other ISAs as a means of enhancing auditor performance and improving the effectiveness of the implementation of the ISAs in a group audit. Specific areas where such gaps have been identified are further explained in paragraphs 175, 178, 215–217, 246–247, and 255.

#### *Using Component Auditors*

*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 engagement teams other than the group engagement team. If effective interaction between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion. Clear and timely communication of the group engagement team's requirements forms the basis of effective two-way communication between the group engagement team and the component auditor,*

*Paragraph 89 of the AQ Framework*

<sup>15</sup> The IAASB is aware that in some jurisdictions, including the United States, the standards of the US Public Company Accounting Oversight Board (PCAOB) and the American Institute of CPAs, provide for this ability.

<sup>16</sup> ISA 600, paragraph 5

<sup>17</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

41. The audit procedures performed by component auditors, for the purposes of a group audit, are integral to the performance of the group audit, and form part of the audit evidence to support the group audit opinion. There are a wide range of audit procedures that may be requested from component auditors, ranging from the audit of specified balances to audits of the financial information of components using component materiality. In some cases, component auditors also perform audits of standalone financial statements of components in accordance with local law and regulation (e.g., requirements for audited financial statements for statutory purposes) or for other purposes, and the work of component auditors can be designed to achieve both objectives. Challenges exist for both the group engagement team and the component auditor in relation to working together and addressing the requirements of the ISAs, especially in global multi-jurisdictional audits. These challenges may arise from a variety of factors, including differing:
- Cultures and languages.
  - Law and regulation (including those that may impact the ability to access to information at components or to component auditors and their working papers, as well as relevant ethical and independence requirements)
  - Financial reporting and jurisdictional auditing requirements.
42. The IAASB is considering how best to address these challenges, including whether and what changes to ISA 600 might be necessary (see further discussion in paragraphs 165–178 and 187–206 of this ITC). Notably, it has been pointed out that ISA 600 is directed towards the responsibilities of the group engagement partner and team, and more may be needed in the ISAs to direct and support component auditors in performing their work. Changes to the requirements for component auditors may impact SMPs in particular, as in many instances their role in group audits comprises serving as component auditors.

#### *Other Areas Relevant to Group Audits*

43. Among other issues discussed, further consideration will also be given to ongoing challenges being faced by auditors in relation to access to the financial information of the component, the component's management or the auditors of the component (these issues may be due to a variety of reasons, including law and regulation in some jurisdictions). Various aspects of the audit may be impacted by the inability to obtain sufficient appropriate audit evidence because the necessary information is not available to the group engagement team, and is further discussed in paragraphs 166–168 and 175.
44. The IAASB will also consider the requirements and guidance addressing communication between the group engagement team and the component auditors, with a view to emphasizing that appropriate communication would help address aspects of various issues discussed in this consultation. See further discussions about communications between the group engagement team and the component auditors in paragraphs 179–186 and 255.

#### **In Relation to Financial Institutions, Including Auditing Accounting Estimates**

45. The global financial crisis emphasized the importance of strong financial systems and the need for a robust regulatory infrastructure to support financial stability. The IAASB has responded to this call and commenced work on a project to consider audit issues relevant or specific to the audits of banks and other financial institutions, in light of the importance of those entities to global capital

markets and of users' confidence in their ongoing effective operation. In particular, as a matter of priority, the IAASB is considering the impact of IFRS 9<sup>18</sup> on audits conducted in accordance with ISAs, including whether changes to the ISAs or additional implementation guidance may be needed. The IAASB is also considering issuing guidance addressing the relationship between auditors and regulators, in response to work on this topic by the Basel Committee on Banking Supervision and to respond to calls from stakeholders that an updated version of IAPS 1004<sup>19</sup> would be useful.

46. In addition to calls to address the implications of IFRS 9, the IAASB acknowledges the need to prioritize the exploration of certain issues related to auditing accounting estimates (including in particular fair value measurements) and related considerations that have specific relevance to financial institutions, including impairment and loan loss provisioning, and using the work of experts such as actuaries and others. However, the IAASB recognizes that many of these issues have broader implications beyond audits of financial institutions and, therefore, as part of this consultation, the IAASB is seeking to explore broader matters relating to ISA 540<sup>20</sup> [which will be set out in detail in this ITC following the IAASB's discussions at its September 2015 meeting].
47. In addition to issues specific to audits of financial institutions, other issues relating to ISA 540 more broadly have also been identified, including from audit inspections. Also, the auditing of fair values and accounting estimates, including the appropriate application of professional skepticism, continue to be highlighted as areas of concern by regulators and audit oversight bodies and other key stakeholders. These stakeholders are calling for more robust requirements around the auditor's considerations of accounting estimates, for example, how auditors obtain sufficient appropriate audit evidence, evaluate management's assumptions, and look for indications of management bias. Further consideration is needed in response to issues highlighted in the IAASB's ISA Implementation Monitoring project, including appropriate consideration of identifying those accounting estimates with a high degree of estimation uncertainty as significant risks, and the implications of the use of third-party pricing sources.
48. Notwithstanding that International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*, was published in December 2011 with the objective of providing practical assistance in auditing financial instruments, the IAASB has the view that further consideration of the matters identified in the ISA Implementation monitoring project is warranted. More detailed information about the issues can be found in paragraphs X-X [to be inserted after September 2015 IAASB discussions].

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<sup>18</sup> International Financial Reporting Standard (IFRS) 9, *Financial Instruments*. IFRS 9 will be effective for annual periods beginning on or after 1 January 2018.

<sup>19</sup> International Audit Practice Statement (IAPS) 1004, *The Relationship between Banking Supervisors and Banks' External Auditors*, was jointly developed with the Basel Committee for Banking Supervision. IAPS 1004 was withdrawn in December 2011 when the IAASB changed the status and authority of the IAPSs.

<sup>20</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

*Using the Work of Experts*

49. Questions pertaining to the engagement partner and engagement team’s competence may arise in certain circumstances, such as audits of financial institutions or in extractive industries, or one in which fair value measurements are prevalent. In such circumstances, the consideration of the need to involve team members with specialized skills or knowledge, or an auditor’s internal or external expert, or undertake consultations within the firm becomes more important to achieve a quality audit. In some cases, audit firms are structuring themselves in a manner that brings the necessary expertise “in house” to support complex engagements, such as audits of financial institutions; however, this may not be feasible for all audit firms. Using an “in house” expert does not release the engagement team from its responsibilities to evaluate the adequacy of the auditor’s expert’s work.
50. As an example, stakeholders may have views regarding a potential need for greater specificity in ISA 540 relating to the use of an auditor’s internal or external expert. Other related issues that were also identified in the IAASB’s ISA Implementation Monitoring project include:
- Distinguishing between the auditor’s expert and management’s expert, and the related work effort thereon.<sup>21</sup>
  - Understanding the competence and capability of the expert in relation to the subject matter.
  - The extent of the work effort of the auditor on the work of the expert in relation to how the expert has developed their assumptions, the appropriateness of any models used, and whether the data used in the models is appropriate.

*[These issues, together with the IAASB’s recommendations thereon, will be set out in more detail in this ITC after the September 2015 IAASB discussions.]*

**Strengthening the Application of Professional Skepticism in an Audit of Financial Statements**

“A factor underlying many audit deficiencies is insufficient exercise of professional skepticism during performance of the audit. IFIAR believes that enhancing professional skepticism of practitioners contributes significantly to quality financial statement audits and should be a high priority for audit firms, given the recurrence of audit deficiencies.” – *IFIAR 2014 Summary of Inspection Findings*

51. In February 2012, an IAASB Staff Publication, [\*Staff Questions and Answers—Professional Skepticism in an Audit of Financial Statements\*](#), was issued to highlight considerations in the ISAs and ISQC 1 that are relevant to the proper understanding and application of professional skepticism during an audit of financial statements. However, the topic continues to be highlighted by regulators and audit inspection bodies, and others<sup>22</sup> as an area where improvement is required.

<sup>21</sup> The PCAOB is also working on a [project](#) addressing the auditor’s use of the work of “specialists” that may be of relevance to the IAASB’s work in this area.

<sup>22</sup> In 2013, a study commissioned by the Standards Working Group of the Global Public Policy Committee (GPPC) noted that that various definitions of, and perspectives on, professional skepticism exist and, as a result, there is a lack of common understanding or practical guidance on what professional skepticism is and how it can be demonstrated and documented.

52. Professional judgment and professional skepticism, appropriately documented,<sup>23</sup> are essential elements of a foundation that supports a quality audit. The ISAs require the auditor to exercise professional judgment and professional skepticism throughout the planning and performance of the audit.<sup>24</sup>

*Professional judgment is “the application of relevant training, knowledge and experience, within the context provided by accounting, auditing and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.”*

*ISA 200, paragraph 13(k)*

53. Reasonable judgments are achieved when the auditor has developed the necessary competence through training, knowledge and experience, and are made in light of the facts and circumstances. Professional judgment permeates the audit, and is needed throughout the audit process, from acceptance or continuance of an audit engagement through to the evaluation of the financial statements.

54. Professional skepticism is necessary to the critical assessment of audit evidence.<sup>25</sup> The ISAs explicitly require auditors to exercise professional skepticism throughout the audit – i.e., during engagement acceptance; as part of identifying and assessing risks of material misstatement; in designing the nature, timing and extent of audit procedures; and in forming an opinion on whether the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework.

*Professional skepticism is “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.”*

*ISA 200, paragraph 13(l)*

55. The topic of professional skepticism is also multi-faceted, as it relates to:

- Independence of mind and integrity, with linkages to firm culture, governance and incentives.
- Objectivity, as it addresses cognitive biases.
- Due care, for example where auditor reliance is placed on inquiry or corroboration, as compared to obtaining and evaluating conflicting evidence.
- Skills and experience, so training and education, as well as exposure, are necessary to cultivate an individual’s ability to appropriately exercise professional skepticism.

56. Professional skepticism is an important component of many, if not all, of the IAASB’s individual projects. For example, the IAASB has already noted that its work in relation to ISA 540 provides an opportunity to stress the importance of professional skepticism and professional judgment, as accounting estimates that have been identified as having high estimation uncertainty involve

<sup>23</sup> ISA 230, paragraph 8(c)

<sup>24</sup> ISA 200, paragraph 7

<sup>25</sup> ISA 200, paragraph A20

significant management judgment and the possibility for unintentional or intentional management bias. Similarly, the Board's planned efforts in relation to ISA 315 (Revised) may also identify areas where further emphasis could be useful on the need for professional skepticism in developing the auditor's risk assessment and determining appropriate responses to identified risks.

57. Though most prominently dealt with in the ISAs, professional skepticism is also addressed in the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code)<sup>26</sup> and the International Accounting Education Standards Board (IAESB) standards.<sup>27</sup> Because of this, a joint Working Group has been formed with representatives from these three independent standard-setting boards (SSBs) to start the exploratory work and make recommendations to each Board whether there is standard-setting or related work that can be undertaken.
58. From an ISA perspective, feedback from a June 2015 panel session with the IAASB has already put forth some useful areas for the Working Group to explore in formulating views on next steps, which include questions such as:
- Can more be said about factors that influence professional skepticism, including individual biases and the auditor/entity relationship (sometimes referred to as the “payor model”)?
  - How can the IAASB's quality control standards further emphasize the need for a strong “tone at the top”?
  - Does the construct of the requirements in the ISAs promote a “corroboration” mentality, as opposed to a more neutral or challenging mindset?
  - Are the requirements in the ISAs sufficiently robust in terms of evidence-gathering in areas of significant management judgment?
59. The IAASB also intends to further consider relevant academic research on the topic of professional skepticism to assist it in determining what actions may be needed by the IAASB and others to promote greater application of professional skepticism. The IAASB may also consider further actions relating to the IAASB Staff Publication to enhance its visibility. The IAASB is particularly interested in feedback from respondents as to what actions it could take, potentially in coordination with others, to enhance the application of professional skepticism in audits.

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<sup>26</sup> The IESBA Code explicitly mentions the term professional skepticism in a number of places including in the definition of “independence” – both independence of mind, and independence in appearance. There is also a perceived connection between professional skepticism and the fundamental principle of objectivity and integrity, though there is not an explicit reference.

<sup>27</sup> International Education Standards (IES) 4, *Initial Professional Development – Professional Values, Ethics, and Attitudes*, prescribes learning outcomes that aspiring professional accountants should achieve in developing professional skepticism and professional judgment. IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*, prescribes the learning outcomes for professional skepticism and professional judgment that engagement partners are expected to develop and maintain through continuing professional development. Both standards emphasize that effective development of professional skepticism needs to include learning methods such as mentoring, reflective activity, and practical experience within the context of a work environment.

## Questions for Respondents

60. The IAASB is seeking views on what actions it may need to undertake to enhance audit quality in the public interest in relation to the topics outlined in this paper and welcomes views in this regard. For this purpose, a number of high-level questions have been presented below to assist stakeholders in responding to this ITC. While the more detailed questions included in Part II of this ITC may be more relevant to respondents representing audit firms, regulators and audit oversight bodies, national auditing standard setters, public sector organizations and IFAC member bodies and other professional organizations,<sup>28</sup> all stakeholders are welcome to respond to those questions they consider relevant, and are encouraged to do so.
61. Feedback from this ITC is intended to enable the Board to identify and evaluate relevant alternative actions that might be taken and inform the development of standard-setting project proposals, which are expected to be put forth to the IAASB and the IAASB Consultative Advisory Group (CAG) in September 2016.

### Overall Questions

1. What do you believe is most important for the IAASB to consider to enhance audit quality in the public interest, specifically in the context of the topics of quality control, group audits, financial institutions and professional skepticism? Where you believe actions other than those outlined in this ITC need to be prioritized, it would be helpful to understand what those actions are, as well as your supporting rationale.
2. What steps do you think are most necessary or will be most impactful in enhancing audit firms' systems of quality control and why?
3. What are your primary concerns relating to how group audits are conducted in accordance with the ISAs? What are the most important or impactful steps the IAASB could take to enhance quality audits in circumstances when component auditors, including network and non-network firms, are used in a group audit?
4. Do you believe that the IAASB should further consider how other auditors are dealt with in the ISAs (i.e., other auditors that don't meet the definition of component auditors)?
5. Do you have views on whether and how the IAASB should enhance the requirements and guidance within the ISAs to deal with evolving and ever-increasing complexity in business structures (including for example to better address increasing use by entities of SSC or situations where components within group entities are non-controlled)?
6. Do you believe more is needed within the ISAs to support the requirements for the auditor to obtain sufficient appropriate audit evidence (for example, with respect to fair value accounting estimates)? If so, what specific areas need to be strengthened and why?
7. What do you believe would be the most meaningful action(s) for the IAASB to undertake to strengthen the application of professional skepticism in audits? What actions may be needed by others in this regard?

<sup>28</sup> Please see "Guide for Respondents: XXX" [this will be the reference to the guides that will be developed for certain categories of stakeholders to navigate through the ITC as relevant to them]

*[There will also be a specific question on ISA 540 / financial institutions – this will be developed after the September 2015 IAASB discussions]*

62. Part II of this paper includes further details on a number of areas explored in the forepart, as well as more specific reference to the requirements and guidance in the current suite of ISAs, and possible actions that the IAASB may take to address the issues. The possible actions set out in this ITC relate predominantly to standard-setting activities of the IAASB, specifically whether the improvements or enhancements should be in the requirements, application material or both. However, respondents may have the view that alternative actions should rather be considered—the IAASB is particularly interested in these views from respondents. Examples of some alternative actions, either by the IAASB or others, include:
- Development of non-authoritative guidance by the IAASB (such as an International Auditing Practice Note (IAPN)).
  - Development of non-authoritative Staff publications (such as a Staff Questions and Answers).
  - Development of relevant guidance on particular topics by others (for example the Forum of Firms (FoF)).
  - Development of training or educational materials for auditors (for example, by the IFAC Small and Medium Practices (SMP) Committee or others).

In describing the alternatives that the IAASB should consider, respondents are requested to indicate specific alternative actions that would be appropriate as well as providing views as to whom they believe should be responsible for the actions.

## Part II: Exploring the IAASB's Suggested Enhancements in Relation to Specific Projects

*The discussion that follows sets out, in more detail than described in the forepart, the IAASB's understanding of the most significant issues that have been identified to date and considered by the IAASB relating to the its projects on:*

- *Quality control,*
- *Group audits and*
- *Special audit considerations relevant to financial institutions. [to be inserted after September 2015 IAASB discussions]*

*The issues discussed below were identified through the IAASB's ISA Implementation Monitoring project, feedback from regulators and audit oversight bodies, SMP's,<sup>29</sup> other outreach activities (including meetings of the FoF, National Auditing Standards Setters (NSS) and the CAG), and Working Group and IAASB discussions.*

*The discussion of each issue includes:*

- *A brief description of how the existing ISAs currently address or are otherwise relevant to the matters under consideration;*
- *The IAASB's preliminary views about possible actions to address the issue identified, in light of the need for changes to the standards from the perspective of the public interest and with a view to actions that would enhance the quality of audits performed in accordance with the ISAs; and*
- *Where relevant, specific considerations relevant to SMPs or public sector perspectives.*

### QUALITY CONTROL

**The feedback received by the IAASB in developing its [Work Plan for 2015–2016](#) indicated that there are issues and concerns in the following areas related to quality control:<sup>30</sup>**

***In relation to Engagement Quality Control Reviews (EQCR)—Concerns about the selection of engagement quality control reviewers (in particular, in light of previous inspection findings and competency to carry out such reviews), independence of the reviewer from the engagement team, the professional skepticism exercised by the reviewer; and the other matters relating to the objective, extent and timing, and documentation of the EQCR.***

***In relation to the IAASB's development of the Framework for Audit Quality and other outreach—Consideration of whether aspects of the Framework may need to be addressed either within the requirements or guidance in ISQC 1 and ISA 220 or, as appropriate, by the International Ethics***

<sup>29</sup> As part of the information gathering activities on the Quality Control project, an SMP survey was undertaken in early 2015 to better understand the issues experienced by SMPs in implementing and complying with the requirements of ISQC 1 and ISA 220 thereby informing the considerations reflected in the quality control discussions in this ITC.

<sup>30</sup> Input included the [findings](#) from the IAASB's ISA Implementation Monitoring project, a stakeholder survey on work plan priorities, consultation on the proposed Work Plan for 2015–2016, and input from outreach with key stakeholders.

Standards Board for Accountants' *Code of Ethics for Professional Accountants (IESBA Code)*,<sup>31</sup> for example:

- Engagement performance (matters relating to consultations, technical reviews of financial statements, engagement acceptance, appointment of engagement team members, independence and ethics, changing resource models (e.g., audit firm use of shared service centers);
- Human resources (technical competence / capabilities and expertise of the engagement team, including the engagement partner, recruitment and training, remuneration based on audit quality);
- Internal monitoring reviews, including scope and extent;
- Using the work of a specialist and auditor's expert, and the differences between the two;
- Clarification of definitions, such as "professionals", and further guidance on the applicability to public sector audits;
- Governance structures of firms and networks.

*In relation to remediation*—Whether there is a need within ISQC 1, or elsewhere in the ISAs, for the IAASB to acknowledge the importance of a firm's system of quality control addressing root cause analysis of significant audit deficiencies that have been identified by external inspections. Regulators suggested that greater consistency in practice by firms to respond to inspection findings in respect of individual audits may be seen as a means to improving audit quality.

*In relation to proportionality of ISQC 1 for small and medium practices (SMPs) and applicability to reviews, other assurance and related services engagements*— Concerns have been raised that ISQC 1 cannot be proportionately applied by SMPs performing audits, and SMPs and others have also suggested that it could be made more clear as to how ISQC 1 can be applied to reviews, other assurance, and related services engagements.

The discussion that follows explores the issues identified in the IAASB's Work Plan for 2015–2016, refined and expanded as necessary based on the IAASB's deliberations and other outreach. The IAASB believes that issues set forth below represent those matters where priority attention may be needed to take action to respond to public interest calls to enhance audit quality. The IAASB is particularly interested in further understanding stakeholders' views about the issues affecting quality control for an audit, the relative priority of the issues and the possible actions that may be taken (including input on the IAASB's preliminary views about those actions). The issues relating to quality control for an audit that are discussed below are organized as follows:

- Leadership responsibilities for quality within the audit firm (See paragraphs 63–72);
- Quality control policies and procedures throughout the audit firm, including when operating through a network of firms (See paragraphs 73–79);

<sup>31</sup> The IAASB will continue to coordinate and collaborate with the IESBA on topics of mutual interest.

- Monitoring and remediation (See paragraphs 80–89);
- Engagement partner performance and rewards systems (See paragraphs 90–100);
- Human resources (See paragraphs 101–105);
- Engagement partner definition and responsibilities (See paragraphs 106–121);
- Engagement partner competencies (See paragraphs 122–132);
- Engagement quality control reviews and engagement quality control reviewers (See paragraphs 133–140);
- Exploring the potential effects that audit firm’s changing business models and structures have on audit quality (See paragraphs 141–149);
- Transparency Reporting (See paragraphs 150–155); and
- Exploring a Quality Management Approach to Updating ISQC 1 and ISA 220 (See paragraphs 156–164).

The IAASB is considering two approaches to updating ISQC 1 and ISA 220, as described in paragraph 32 ((i.e. a QCA versus a QMA-)). Under a QCA, any updates to ISQC 1 and ISA 220, such as additional requirements or application material or clarifications of existing requirements and application material considered necessary as discussed in paragraphs 63–155 of this ITC, would be made to those standards, while retaining the current structure of ISQC 1 and ISA 220.

Using a QMA (further discussed in paragraphs 156–164) would involve a more holistic approach in revising ISQC 1<sup>13</sup>, placing focus on achieving quality objectives through the integration of business processes, including corporate governance systems, risk and compliance management systems and systems of internal control.

## Leadership Responsibilities for Quality within the Audit Firm

### ISSUES

63. Governance of an audit firm includes the establishment of policies and procedures designed to support the performance of quality audits. Leadership of the audit firm is responsible for monitoring compliance with the established policies and procedures and instilling a culture of accountability for audit quality throughout the audit firm. Effective audit firm leadership, which is an important part of addressing the public interest aspects of an appropriate system of quality control, should encompass:
- the allocation of responsibilities;
  - the mechanism by which conflicting stakeholder interests are addressed;
  - the procedures to provide for appropriate supervision, control and monitoring of quality within an organization; and
  - generating a culture of openness that encourages collaboration and consultation.
64. While ISQC 1 addresses the concept of audit firm governance at a high level, it does not provide much detail or guidance as to what is expected with respect to governance, nor does it include well-understood and commonly used terminology such as “tone at the top” and “leading by example.”

ISQC 1 does not include guidance related to the importance of leadership in sustaining and continuously improving audit quality through effective governance at the audit firm level.

65. An audit firm's leadership has a vital role in promoting a culture that stresses the importance of the role of the audit in the public interest and therefore, the importance of audit quality. ISQC 1 addresses various responsibilities of audit firm leadership; however, the standard does not explicitly address the concept of accountability<sup>32</sup> within firm leadership, which has been identified by audit oversight bodies as a possible missing component within ISQC 1.
66. In comparing the requirements and application material included in ISQC 1 to various other governance codes and quality frameworks,<sup>33</sup> the IAASB identified gaps between ISQC 1 and those codes and frameworks. Specifically, when compared to those codes, ISQC 1 could have more emphasis on safeguarding, monitoring and acting in the public interest.

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

67. ISQC 1 addresses governance on leadership responsibilities for quality within the audit firm, requiring that an audit firm shall establish policies and procedures that promote an appropriate internal culture,<sup>34</sup> recognizing that audit quality is essential in performing engagements.
68. ISQC 1 also requires that those responsible for the audit firm's system of quality control have the appropriate experience and ability, and the necessary authority to perform those duties.<sup>35</sup>

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

69. Leadership responsibilities could be clarified in ISQC 1 through additional requirements or application material or clarifications of existing requirements and application material to more explicitly incorporate commonly used and familiar terminology (e.g., tone at the top and leading by example). Further emphasis could be given in ISQC 1 to the importance of audit firm leadership setting an appropriate culture for the audit firm and for taking responsibility and being accountable for extending that culture throughout the audit firm. This point may be particularly relevant when considering the increasing diversity in how audit firms organize themselves and in how engagement teams are structured.
70. In addition to addressing leadership responsibilities, the IAASB is also considering whether ISQC 1 should clearly establish accountability of firm leadership for matters related to audit quality, which

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<sup>32</sup> Although accountability is often used interchangeably with responsibility, responsibility is slightly narrower in scope than accountability. Responsibility refers to the individual who is in charge of, or owns, the task, whereas accountability refers to the individual who has to answer for the outcome of any given task.

<sup>33</sup> Codes and frameworks reviewed include: [The Audit Firm Governance Code](#) (Institute of Chartered Accountants in England and Wales and UK Financial Reporting Committee); [Oversight and transparency. A code for audit firms holding a PIE licence](#) (Nederlandse Beroepsorganisatie van Accountants); [European Commission Directive 2006/43/EC](#) of the European Parliament and Council of 17 May 2006 and [Directive 2014/56/EU](#) of the European Parliament and of the Council of 16 April 2014; The Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2013 Internal Control Framework; COSO Enterprise Risk Management (ERM) Framework; US Center for Audit Quality (CAQ) [Approach to Audit Quality Indicators](#); and [ISO 9001\(2008\)](#). The IAASB acknowledges that there may be other codes and frameworks that may be relevant and welcomes feedback from respondents as to others that should be considered.

<sup>34</sup> ISQC 1, paragraph 18

<sup>35</sup> ISQC 1, paragraphs 18–19 and A4–A6

may, for example, involve the elements of empowerment, direction, reporting back, incentives and consequences.

71. In response to concerns in relation to audit firms' independence that were brought to the attention of the IESBA, it may be necessary to strengthen ISQC 1 through additional requirements for an audit firm to identify appropriate personnel within audit firm leadership to be responsible for independence matters.
72. Finally, the concept of public interest, in the context of firm leadership's responsibility for the firm's system of quality control, could be explicitly incorporated into ISQC 1. This could be incorporated into the introduction to ISQC 1 or into the application material associated with requirements relating to leadership responsibilities.

### Questions

8. With respect to leadership responsibility for quality within the audit firm:

(a) Do you believe the possible suggested changes to ISQC 1 to:

- Enhance the prominence of leadership responsibility for quality within the audit firm, including leadership accountability for extending quality throughout the audit firm;
- Assign appropriate personnel or individual within the audit firm the responsibility for independence matters; and
- Add the concept of public interest into the introduction in ISQC 1 or applicable application material

are appropriate responses to calls for audit firms to be acting in the public interest? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

(b) Are there other issues related to leadership responsibility within the firm that have not been considered in paragraphs 63–66? If so, please explain.

### Quality Control Policies and Procedures Throughout the Audit Firm, including when Operating through a Network of Firms

#### ISSUES

*Some audit firms operate internationally through a network of firms. Network firms often share common methodologies and quality control and monitoring policies and procedures. Some networks also share guidance in relation to values, ethics, and attitudes, and have programs to enhance the knowledge and experience of partners and staff.*

*- Paragraph 107 of Appendix 2 of the AQ Framework*

73. The IAASB acknowledges that audit firms choose to organize themselves within many different types of arrangements. ISQC 1 makes reference to the fact that some audit firms operate through a network of firms. Audit firms that operate through a network of firms often share common

methodologies, and quality control and monitoring policies and procedures. The following factors are often observed in these arrangements:

- Audit firms within the network are not owned or controlled by the network entity for various reasons, including jurisdictional law and regulation and risk and litigation management purposes.
  - The extent of operational and decision-making power at the network level is limited. Compliance at the individual audit firm level with shared common methodologies, and quality control and monitoring policies and procedures, can be influenced through economic and other measures, but often cannot be centrally controlled.
74. Some audit firms that operate through a network of firms may seek to rely on aspects of the network's system of quality control, including monitoring policies and procedures, in addressing the audit firm's responsibilities under ISQC 1. However, ISQC 1 does not apply at the level of the network.
75. Regulators and audit oversight bodies have also:
- Highlighted that ISQC 1 does not extend to the monitoring procedures that may, or may not be, performed at the network level; and
  - Expressed concerns about overreliance on network level policies and procedures without an appropriate basis for doing so, as well as concerns that networks are not adequately considering the results of external inspection findings of individual network firms and their implications to the network as a whole.

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

76. ISQC 1 acknowledges that some audit firms operate as part of a network and may implement some of their monitoring procedures on a network basis. ISQC 1 contains requirements<sup>36</sup> for the audit firm to comply with when the audit firm, operating as part of a network, seeks to rely on the network's system of quality control, including monitoring policies and procedures.

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

77. The IAASB is considering whether to provide additional requirements or application material, or clarify existing requirements and application material, in ISQC 1 to more explicitly address the extent to which audit firms can rely on shared quality control and monitoring policies and procedures in designing policies and procedures to comply with ISQC 1 at the audit firm level.
78. However, establishing requirements in ISQC 1 relating to how audit firms are structured, including how audit firms may choose to operate through a network of firms, may be difficult or even inappropriate, as involvement in operational matters is outside of the IAASB's mandate. Such requirements would also likely go beyond jurisdictional law and regulation related to legal forms of ownership and how audit firms choose to organize themselves in the context of such law and regulation.
79. Notwithstanding this, there may be a need for the IAASB to consider whether those audit firms that operate as part of a network should be required to consider the outcome, as allowed by law and

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<sup>36</sup> ISQC 1, paragraph 54

regulation, of inspections that take place across the network. This may include the audit firm's consideration of the inspection findings and the potential impact on the audit firm's own system of quality control, including monitoring policies and procedures, designed to comply with ISQC 1.

### Questions

9. Other than those issues identified in paragraphs 73–75, are there other issues related to quality control policies and procedures throughout the audit firm and networks of firms that have not been considered above? If so, please explain.
10. Do you agree with the possible actions recommended in paragraphs 77–79? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

### Monitoring and Remediation

#### ISSUES

80. An important aspect of an effective quality control system are policies and procedures providing for regular assessment of the adequacy and effectiveness of that system, including a mechanism by which the system is evaluated and modified, as appropriate, when deficiencies are identified. While ISQC 1 contains requirements related to monitoring of an audit firm's system of quality control, the ISA Implementation Monitoring project and feedback from stakeholders, particularly audit oversight bodies, has highlighted areas where ISQC 1 could be improved. For example, audit oversight bodies have increased demands on audit firms to take actions to understand the causal factors of inspection findings (i.e., perform "root cause analysis") and respond to inspection findings related to individual engagements as a means of improving audit quality.
81. ISQC 1 does not contain explicit requirements for audit firms in respect of policies and procedures to address and respond to the results of inspections performed by external inspectors, such as:
  - The communication of findings from external inspections related to both individual engagements and the audit firm.
  - How those findings may impact other engagements not selected for inspection within the audit firm.
  - Documentation requirements regarding the consideration of findings from inspections, including evaluation and resolution thereof.
  - Guidance on the implementation of systems or policies and procedures that focus on continual improvement, including the performance of a root cause analysis.
82. ISQC 1 provides for an engagement quality control review (EQCR) of some audits (see further discussion in paragraphs 133–140). However, many audit firms perform other types of reviews at different stages of an audit that are also focused on achieving quality. Examples of these types of reviews include "pre-issuance" and "post-issuance" reviews. Such reviews have the objective of identifying and correcting potential engagement deficiencies but do not take the place of the EQCR. ISQC 1 does not explicitly contemplate the use of these or other external reviews in the monitoring system or as a source of identifying situations where remedial action might be necessary.

SMP PERSPECTIVE

83. Monitoring, including compliance with the requirements set out in ISQC 1, has been identified by SMPs as one of the most difficult aspects of a quality control system to implement. These difficulties stem largely from resource constraints in general, funding the cost of compliance, and the requirement for a person external to the engagement to perform the internal inspection.<sup>37</sup>

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

84. Included within ISQC 1 are requirements that provide for a monitoring process such that at least one engagement for each engagement partner is evaluated on a cyclical basis, subsequent to the completion of that engagement,<sup>38</sup> and that any identified deficiencies are evaluated, communicated and remediated.<sup>39</sup> These requirements and related application material currently only pertain to internal inspections.
85. Although ISQC 1 does provide requirements in respect of complaints and allegations where the work performed by the audit firm fails to comply with professional standards and applicable legal and regulatory requirements and where there is non-compliance with the audit firm's system of quality control, the link to remediation of external inspection findings through this requirement and related application material<sup>40</sup> is not explicit.

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

86. Strengthened requirements and new application material within ISQC 1 could lead to improved audit quality with firms achieving greater consistency in practice to respond to inspection findings of individual engagements. Such requirements or application material could address:
- An analysis of any external findings and appropriate responses thereto, in the same way that internal findings are considered;
  - Consideration of whether such findings would have implications for other engagements as well as the quality control system, including appropriate remediation;
  - Consideration of performance of “pre-issuance” reviews and “post-issuance” reviews and the results thereof; and
  - Addressing the role of external reviews in the internal monitoring system.
87. ISQC 1 could require obtaining an understanding of the causal factors of audit deficiencies related to inspection findings. It is important that audit firms design policies and procedures or update existing policies and procedures based on information gathered regarding the causal factors of audit deficiencies. Such actions taken by the audit firm would be going beyond remediation of the identified deficiency to obtaining an understanding of why the deficiency may have occurred and the measures that should be taken to prevent the circumstances creating that deficiency from occurring on future engagements.

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<sup>37</sup> ISQC 1, paragraph 48 (c)

<sup>38</sup> ISQC 1, paragraphs 48 and A64–A68

<sup>39</sup> ISQC 1, paragraphs 49–54 and A69

<sup>40</sup> ISQC 1, paragraphs 55–56 and A70–A72

88. Additional requirements or application material or clarifications of existing requirements and application material could be added to ISQC 1 to more explicitly articulate existing requirements and application material to monitor the effectiveness and appropriateness of the remedial actions, including the documentation of the resulting actions taken by the audit firm, as an effective way to demonstrate its commitment to audit quality.
89. Taking these various suggested improvements into account, the IAASB believes that there may be merit in ISQC 1 incorporating more explicitly the need for continual improvement of audit quality into the requirements for an effective system of quality control. An approach to accomplish this is further described in paragraphs 156–164, and would include adding requirements or application material to ISQC 1 addressing:
- The remediation of deficiencies;
  - Obtaining an understanding of the causal factors of audit deficiencies and updating of policies and procedures based on that analysis; and
  - Monitoring the effectiveness of those updates.

### Questions

11. Other than those issues identified in paragraphs 80–83, are there other issues related to monitoring and remediation that have not been considered above? If so, please explain.
12. Do you agree with the possible actions recommended in paragraphs 86–89? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

## Engagement Partner Performance and Rewards Systems

### ISSUES

90. The engagement partner performs a pivotal role in an audit and is responsible for the overall quality on each audit engagement to which the partner is assigned.<sup>41</sup> In the context of audit quality, some have suggested that it may be appropriate to provide that an element of a partner's remuneration should be variable and include incentives, such as profit-sharing based on achieving audit quality. Conversely, such a variable remuneration policy could also include sanctions when audit quality is not achieved.
91. ISQC 1 does not include requirements or application material in respect of:
- Human resource policies governing fixed and variable remuneration for partners or remuneration based on the provision or cross selling of services additional to those contracted for; or
  - A continuity plan, encompassing loss of a key partner, loss of an office or the introduction of sanctions affecting a key partner or the audit firm.

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<sup>41</sup> ISA 220, paragraph 8

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

92. ISQC 1 includes the requirement to establish policies and procedures that address compensation, including incentive systems and the assignment of responsibilities so that commercial considerations do not override the quality of the work performed.<sup>42</sup>
93. ISQC 1 also includes compensation as personnel issues relevant to the audit firm's policies and procedures related to human resources.<sup>43</sup>
94. The IESBA Code includes compensation safeguards against a member of the audit team being compensated for selling non-assurance services to that audit client.<sup>44</sup> In addition, some jurisdictions have various rules and regulations regarding this topic.

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

95. Similar to some governance frameworks, ISQC 1 could require that audit firms, as part of their human resource policies and procedures, have a policy in place governing remuneration of partners and other key staff.
96. ISQC 1 could also seek to address a better linkage between compensation and audit quality, for example by describing factors that may address how inspection findings (or lack thereof) relate to audit quality, acknowledging that audit quality is one of many factors that should be considered as part of a remuneration structure.
97. Remuneration of partners and other key staff could include incentives to address audit quality, such as profit-sharing based on achieving audit quality or sanctions when audit quality is not achieved, and the results of internal and external inspection of engagements including the severity of any findings therefrom.
98. However, the IAASB does not believe ISQC 1 should be used as a vehicle to mandate the structure of the engagement partner's remuneration, specifically with respect to compensation that may be withheld and paid out in the longer term based on the results of pre-determined criteria in the intervening period.
99. To achieve greater consistency with the spirit of the requirements in the IESBA Code,<sup>45</sup> ISQC 1 could also include new application material relating to the provision of non-assurance services to audit clients and safeguards needed with respect to compensation.
100. Continuity planning requirements would also be an appropriate addition to ISQC 1. This would include new requirements or application material addressing:
  - The loss of a key audit partner;
  - The loss of a network office; and
  - The imposition of sanctions affecting a key partner, office or firm within a network.

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<sup>42</sup> ISQC 1, paragraph A5

<sup>43</sup> ISQC 1, paragraph A24

<sup>44</sup> IESBA Code, paragraphs 290.225 and 290.226

<sup>45</sup> IESBA Code, paragraphs 290.32

## Questions

13. Other than those issues identified in paragraphs 90–91, are there other issues related to engagement partner performance and rewards systems that have not been considered above? If so, please explain.
14. Do you agree with the possible actions recommended in paragraphs 95–100? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

## Human Resources

### ISSUES

101. The knowledge, skills and competence of an audit firm's employees and the manner in which those employees are assigned to an engagement are essential to achieving audit quality. To facilitate this, an audit firm should develop and maintain an appropriate structure for managing people within its organization that supports the audit firm's commitment to attracting, developing, motivating, retaining and rewarding personnel in line with the audit firm's objectives.
102. However, financial considerations may undermine an audit firm's commitment and ability to do so. It is therefore important that audit firms are not unduly influenced by the need to meet target financial metrics, such that the audit firm's policies do not allow for appropriate investment in training and education of personnel or that result in insufficient partner hours allocated to an engagement.

### SMP PERSPECTIVE

103. SMPs have cited challenges in their ability to attract and retain the appropriate talent, while noting that this cannot be resolved through updates to auditing or quality control standards. A recent IAASB SMP Survey has also highlighted difficulties with the performance of staff reviews, with a view expressed that formal documentation of staff reviews may not be necessary in every case, such as when the engagement partner gives continual feedback to staff.

### EXISTING REQUIREMENTS AND APPLICATION MATERIAL

104. ISQC 1 includes requirements and application material around personnel issues relevant to an audit firm's human resources policies and procedures.<sup>46</sup> For example, ISQC 1 notes the personnel issues of career development and promotion as relevant to an audit firm's human resources policies and procedures, but does not provide detail as to what is envisaged.

### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

105. Clarification to the application material in ISQC 1 that financial considerations should not undermine audit quality objectives may be helpful. Additional application material to support the requirements addressing career development and promotion could highlight that part of career development and promotion is providing timely and informative performance appraisals and evaluations; however how such evaluations are performed may be based on the facts and circumstances of the audit firm.

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<sup>46</sup> ISQC 1, paragraphs 29–31 and A24–A26

**Question**

15. Do you agree with the possible actions recommended in paragraph 105? If not, please indicate why and whether there are additional actions you would recommend?

**Engagement Partner Definition and Responsibilities**

ISSUES

106. The audit engagement partner<sup>47</sup> is responsible for the audit engagement and therefore is directly responsible for the quality of the audit. In addition, the audit engagement partner has a critical role in leading and directing the values, ethics and attitudes exhibited by the engagement team that are necessary to support audit quality.
107. It is therefore essential to the public interest that the fundamental principles and expectations related to the engagement partner are sufficiently clear and well-articulated within the ISAs, in particular as the manner in which audits are conducted adapts to the changing environment in which the entities being audited operate (see paragraphs 25–30 ). Concerns from regulators and audit oversight bodies have arisen relating to how engagement partners are taking overall responsibility for audits and demonstrating appropriate direction and supervision throughout.
108. Achieving the right balance of responsibilities between the engagement partner and others that participate in the audit engagement as part of the engagement team is a key aspect of audit quality.
109. The practical application of direction and supervision to an engagement can be very different depending on the size and the complexity of that engagement. Examples of engagements that may be more challenging for the engagement partner to appropriately direct and supervise include:
- The audit of a large-listed entity, as compared to that of an audit of a small-private entity. This scenario may be further complicated in the event the conduct of the audit involves service delivery models that are different to the traditional engagement team structures (see further discussion in paragraphs 141–149 of this ITC).
  - An audit in which the engagement partner is not located where the majority of the audit work is performed, and other auditors are involved in the audit.
110. Neither ISA 220 nor the AQ Framework provides discussion on how direction is to be applied or what constitutes “active involvement” in an engagement. For example, direction of an engagement would likely require the engagement partner to be involved at all stages of the audit, i.e., planning, execution and completion. However, the areas described in ISA 220 paragraph A13 are primarily those areas associated with planning an audit engagement.
111. Understanding what comprises appropriate direction and supervision of an engagement (and thus compliance with the requirements of ISA 220) can be challenging in practice, in particular the determination as to when and how the engagement partner should be involved and the specific aspects of that involvement.

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<sup>47</sup> In the public sector environment, the terms “client,” “engagement,” “engagement partner,” and “firm” should, where relevant, be read as referring to their public sector equivalents as defined in International Standard of Supreme Audit Institutions (ISSAI) 40, Quality Control for Supreme Audit Institutions, Section 7

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

112. In defining the engagement partner, ISQC 1<sup>48</sup> and ISA 220<sup>49</sup> establish the overall responsibility of the engagement partner for the performance of the audit engagement and the issuance of the resulting auditor's report on that engagement.
113. ISA 220 also includes the responsibility of the audit engagement partner for the direction, supervision and performance of the engagement in compliance with professional standards and applicable legal and regulatory requirements;<sup>50</sup> the responsibility for reviews being performed in accordance with the audit firm's policies and procedures;<sup>51</sup> the responsibility for being satisfied that sufficient appropriate audit evidence has been obtained to support the auditor's report;<sup>52</sup> and that that report is appropriate in the circumstances.<sup>53</sup>
114. To facilitate compliance with these requirements, ISA 220 provides guidance in paragraph A13 on what direction of the engagement team involves, including in instances where a member of the engagement team has expertise in a specialized area; and guidance in the area of supervision in paragraph A15.
115. The ISAs include responsibilities that are specific to the engagement partner. Although the majority of these responsibilities are incorporated into ISQC 1 and ISA 220, there are many others that can be found in other ISAs including: ISA 230;<sup>54</sup> ISA 240;<sup>55</sup> ISA 300,<sup>56</sup> ISA 315 (Revised); ISA 600; and ISA 620.<sup>57</sup> This approach to communicating the engagement partner requirements makes the practical application of the ISAs more difficult for engagement partners to determine if they have fulfilled all their responsibilities in accordance with the ISAs.
116. ISQC 1 also includes application material highlighting whether the audit firm is able to complete the engagement within the reporting deadline as a consideration of whether the audit firm has the appropriate resources to accept an engagement.<sup>58</sup> However, ISA 220 does not address the need for the engagement partner to be satisfied that sufficient time is available to the engagement team to be able to obtain sufficient appropriate audit evidence before the report is issued.

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

117. The AQ Framework notes active involvement of the engagement partner in the risk assessment, planning, supervision and review of the work performed as a key attribute to audit quality. The AQ Framework also notes an additional key attribute that influences audit quality is that the staff

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<sup>48</sup> ISQC 1, paragraph 12(c)

<sup>49</sup> ISA 220, paragraph 7(a)

<sup>50</sup> ISA 220, paragraph 15(a)

<sup>51</sup> ISA 220, paragraph 16

<sup>52</sup> ISA 220, paragraph 17

<sup>53</sup> ISA 220, paragraph 15(b)

<sup>54</sup> ISA 230, *Audit Documentation*

<sup>55</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>56</sup> ISA 300, *Planning an Audit of Financial Statements*

<sup>57</sup> ISA 620, *Using the Work of an Auditor's Expert*

<sup>58</sup> ISQC 1, paragraph A18

performing detailed “on-site” audit work has sufficient experience, its work is appropriately directed, supervised and reviewed, and there is a reasonable degree of staff continuity. Consideration could be given to including these concepts, to the degree feasible, either as requirements or application material within ISQC 1 and ISA 220.

118. Notwithstanding the development of internal methodologies by audit firms, ISA 220 could include application material that clarifies what is meant by performance, direction, supervision and review of the audit engagement, through additional requirements or application material that discusses the responsibilities of the engagement partner, including that the engagement partner needs to spend an appropriate amount of time reviewing the significant areas to be able to be satisfied that sufficient appropriate audit evidence has been obtained.
119. An appendix could be added to ISA 220, or non-authoritative guidance could be developed, that indicates where the responsibilities of the engagement partner, both requirements and application material, are located within the ISAs.
120. Additional application material could be provided in ISA 220 concerning the engagement partner’s considerations of the sufficiency of the engagement team members’ experience and the sufficiency of time available to perform the engagement.
121. Similar to the recommendation in paragraph 72 ISA 220 could incorporate reference to consideration of the public interest in a similar manner to ISQC 1.

#### Question

16. Do you agree with the possible actions recommended in paragraphs 117–121 to address related to engagement partner definition and responsibilities? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

### Engagement Partner Competencies

#### ISSUES

122. In order to properly fulfill engagement partners’ responsibilities in accordance with the ISAs, it is essential that engagement partners have the necessary skills and competencies in place. The IAESB recently issued IES 8 (Revised).<sup>59</sup> This standard focuses on the professional competence requirement for engagement partners who have responsibility for audits of financial statements. The standard is organized by areas of competence, including: Technical Competence; Professional Skills and Professional Values, Ethics and Attitudes. The considerations in these areas provide useful guidance, through the learning outcomes, as to the characteristics necessary for an engagement partner in fulfilling the responsibilities under the ISAs.
123. Although not all areas of IES 8 may be relevant, the IAASB could consider whether inclusion of the competencies in IES 8 (Revised) in the areas of Interpersonal and Communication Skills, Professional Skills and Professional Values, Ethics and Attitudes in IAASB standards is appropriate.

<sup>59</sup> International Education Standard (IES) 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements* (Revised)

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

124. IES 8 (Revised) notes that competence in Interpersonal and Communication Skills includes effective and appropriate communication with the engagement team, management and those charged with governance of the entity.<sup>60</sup>
125. Paragraph A13 of ISA 220 notes that discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team. However, the concept of “more experienced team members” can be open to interpretation as this is not defined in ISA 220.
126. In the area of Professional Skills, and specifically personal competencies, IES 8 (Revised) includes the promotion of and undertaking lifelong learning, acting as a role model to the engagement team and acting in a mentoring or coaching capacity to the engagement team.<sup>61</sup>
127. Also within Professional Skills, IES 8 (Revised) notes the evaluation of whether the engagement team, including the auditor’s experts, collectively has the appropriate objectivity and competence to perform the audit, and the management of audit engagements by providing leadership and project management of engagement teams.<sup>62</sup> ISA 220 addresses the engagement partner’s responsibility to be satisfied that the engagement team has appropriate competence and capabilities.<sup>63</sup>
128. ISQC 1 includes that competence can be developed through coaching by more experienced staff, for example, other members of the engagement team.<sup>64</sup>
129. ISA 220 currently requires that the engagement partner remain alert for non-compliance with relevant ethical requirements by members of the engagement team,<sup>65</sup> and subsequently explains that in paragraph A4 that the IESBA Code includes objectivity as one of its fundamental principles.
130. IES 8 (Revised) in the competence area of Professional Values, Ethics and Attitudes, also highlights a commitment to the public interest, and more specifically, the promotion of audit quality in all activities with a focus on protecting the public interest.<sup>66</sup>

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

131. The IAASB could undertake a more detailed review of the relationship between IES 8 and the standards (ISQC 1 and ISA 220) to determine whether greater attention can be given to the requirements in IES 8 by providing additional requirements or application material or clarification to existing requirements and application material, such as:
  - Update application material in ISA 220 to explain “more experienced team members,” and to have the engagement partner responsible for setting the appropriate tone for engagement

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<sup>60</sup> IES 8 (Revised), Professional Skills (j) Interpersonal and communication

<sup>61</sup> IES 8 (Revised), Professional Skills (k) Personal

<sup>62</sup> IES 8 (Revised), Professional Skills (l) Organizational

<sup>63</sup> ISA 220, paragraph 14

<sup>64</sup> ISQC 1, paragraph A25

<sup>65</sup> ISA 220, paragraph 9

<sup>66</sup> IES 8 (Revised), Professional Values, Ethics and Attitudes (m) Commitment to the Public Interest

team discussions such that all engagement team members feel comfortable raising questions.

- Update the application material in ISQC 1 or ISA 220 concerning the engagement partner responsibilities to include the concepts of being a role model and of mentoring.
- Update the requirement and application material in ISA 220, to make the engagement partner's responsibilities for leadership and project management including the assessment of the competence and objectivity of the engagement team more explicit.

132. The IAASB may also need to consider whether amendments to ISA 260<sup>67</sup> should be made to require, when applicable, that the engagement partner's communications with those charged with governance of the entity include the results of the EQCR that was performed.

### Question

17. Do you agree with the possible actions recommended in paragraphs 131–132 to address related to engagement partner competencies? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

## Engagement Quality Control Reviews and Engagement Quality Control Reviewers

### ISSUES

133. Through the ISA Implementation Monitoring project, regulators and audit oversight bodies expressed concerns with respect to the following areas:

- The selection of engagements for which an engagement quality control reviewer should be appointed. ISQC 1 requires the appointment of an engagement quality control reviewer for listed entities and the establishment of criteria to determine when other engagements should be subject to an EQCR.<sup>68</sup>
- The selection of the engagement quality control reviewer, including the qualifications and the objectivity of the individual selected to perform the EQCR and consideration of the reviewer's own inspection results.
- The timing of the performance of the EQCR, specifically with respect to when the engagement quality control reviewer becomes involved in the engagement quality control review and the time allocated to the engagement quality control reviewer for the performance of that review.
- The depth and the focus of the review, specifically highlighting a perception that in some cases the engagement quality control reviewer paid insufficient attention to the areas of significant risk or significant judgments made by the engagement partner and the engagement team.
- The robustness of the documentation of the review, including the documents reviewed, the issues raised as part of the review and the disposition of those issues.

<sup>67</sup> ISA 260, *Communication with Those Charged with Governance*

<sup>68</sup> ISQC 1, paragraph 19

134. Since ISA 220 and ISQC 1 were finalized, the PCAOB has issued AS 7.<sup>69</sup> A review of AS 7 has highlighted potential areas for improvement in the IAASB's standards in relation to:

- An objective of the performance of an EQCR.
- A requirement for an engagement quality control reviewer to have sufficient integrity and independence to perform the review.
- A requirement for a "cooling off" period for an engagement quality control reviewer that had previously been involved in the engagement.
- A requirement that focuses the engagement quality control reviewer to review specific areas of the engagement, such as areas of significant risk or significant judgment.
- The concept of highlighting instances where the engagement quality control reviewer found significant or material deficiencies in the work performed by the engagement team.

135. Application material in ISQC 1 explains that an engagement quality control reviewer does not otherwise participate in the engagement during the period of review. However, there is insufficient clarity in respect of what the period of review and participation means in this context.

#### SMP PERSPECTIVE

136. SMPs have also identified difficulties in complying with the existing requirements in ISQC 1 and ISA 220, due to the availability of resources, including that:

- The engagement quality control reviewer, in many cases, may be the most appropriately qualified person with whom to consult on significant issues arising from the engagement, which may diminish the reviewer's ability to perform an objective evaluation resulting from a reduction in the:
  - Objectivity of the engagement quality control reviewer; and
  - Value of the consultation if a person other than the engagement quality control reviewer performs the consultation
- Many SMPs need to use third-party resources as engagement quality control reviewers, because suitably qualified reviewers within the audit firm may not exist.
- Challenges have arisen related to not having sufficient time to adequately perform and document the review, including review and sign off meetings between the engagement team and the engagement quality control reviewer.

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

137. ISQC 1 includes requirements and application material for an audit firm to develop policies and procedures over the selection of engagements that should be subject to an EQCR and the timing of

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<sup>69</sup> PCAOB Auditing Standard No. 7 (AS 7), *Engagement Quality Review*

that review.<sup>70</sup> ISQC 1 also includes requirements and application material for determining the eligibility of personnel to perform the role of the engagement quality control reviewer.<sup>71</sup>

138. ISQC 1<sup>72</sup> and ISA 220<sup>73</sup> include requirements and application material discussing the engagement partner's responsibilities and the engagement quality control reviewer's responsibilities, including documentation requirements,<sup>74</sup> with respect to the performance of the EQCR.

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

139. The IAASB believes that strengthening the requirements and application material in ISQC 1 and ISA 220 related to EQCRs may be useful to enhance audit quality. Actions that may be undertaken include:

- Elevating the application material in ISQC 1 and ISA 220 concerning criteria for selecting those engagements subject to EQCR to requirements. This change could result in the IAASB potentially expanding the engagements that would be subject to an EQCR beyond audits of listed entities, such as to audits of other entities of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and entities with certain characteristics, including size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. In addition, new requirements or clarification of existing requirements could be added to focus on the selection of engagements for review based on identified risks of the engagements, such that engagements with higher audit risk would be more likely to be selected. Further, additional application material may also be beneficial to explain the connection between EQCRs and risk mitigation, and the relevance of the review to audit firms of all sizes and for all types of audits (e.g., in group audits).
- Elevating the application material in ISQC 1 concerning criteria to maintain objectivity of the engagement quality control reviewer<sup>75</sup> to requirements.
- Developing a new requirement in ISA 220 to document the timing and the substance of the EQCR procedures performed and significant or substantive discussions of the engagement partner and the engagement quality control reviewer.
- Adding application material to ISA 220 that provides for the use of subject matter experts or other qualified individuals to assist an engagement quality control reviewer, where appropriate. Where an EQCR is not performed, subject matter experts or other qualified individuals could be used as part of a pre-issuance review.

140. The IAASB also believes that the role of the engagement quality control reviewer in relation to the engagement partner could be clarified in ISQC 1 and ISA 220 to address concerns over the

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<sup>70</sup> ISQC 1, paragraphs 35–36 and A41–A43

<sup>71</sup> ISQC 1, paragraphs 39–41 and A47–A51

<sup>72</sup> ISQC 1, paragraphs 37–38 and A44–A46

<sup>73</sup> ISA 220, paragraphs 19–21 and A23–A31

<sup>74</sup> ISQC 1, paragraph 42 and ISA 220, paragraph 25

<sup>75</sup> ISQC 1, paragraph A49

balance of the respective responsibilities and make sure that updates to the role of the engagement quality control reviewer do not result in the requirements and responsibilities of the engagement quality control reviewer exceeding those of the engagement partner.

### Questions

18. Do you agree with the possible actions recommended in paragraphs 139–140? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why. Specifically, do you agree with:
- (a) Expanding requirements to which engagements the performance of an EQCR would be required, as described in paragraph 139? If not, please explain.

## Exploring the Potential Effects that Audit Firm’s Changing Business Models and Structures Have on Audit Quality

### ISSUE

141. In delivering audits, firms continue to develop models of service delivery. Examples of ADM's include where elements of the audit firm's system of quality control are focused in a centralized location (e.g., independence monitoring); centralized resources are dedicated to performing certain standard procedures for all or many of the audit firm's engagements (e.g., a centralized function to manage confirmation processes); or using centralized resources to perform audit procedures (e.g., procedures to audit the fair values of certain financial instruments) at the request of individual engagement teams. In some cases, the centralized resources may be physically located in a foreign jurisdiction. The way that ADMs are structured, the way that they operate (including where the auditors are located), and the approaches to the oversight of the procedures performed can vary significantly across audit firms.
142. The continued development of ADMs are a response by audit firms to:
- Changes in the global business environment;
  - Technology developments that better facilitate the functioning of virtual engagement teams;
  - Changes in how the audit firm's clients are organizing themselves;
  - The need to focus on, and improve audit quality;
  - Resource constraint issues; and
  - A need to realize engagement efficiencies.
143. Audit oversight bodies have expressed concern over the more recent developments in ADMs. Specifically, concerns have been raised in relation to:
- The sufficiency of the extension of an audit firm's leadership and oversight at centralized locations or over other centralized resources, particularly those that are in remote locations, as part of its internal systems of quality control.
  - The sufficiency of audit firms' established policies and procedures to govern the work that is performed at the centralized locations or by other centralized resources, and whether

sufficient documentation exists to demonstrate how the audit team assessed these in relation to the audit being performed.

- The competency of the personnel performing the procedures in relation to the complexity of the procedures being performed and the implications of the remoteness of the personnel from the engagement team it is supporting, including the inability to interact with management of the entity in completing specific tasks.
- The sufficiency of supervision of persons performing procedures at these centralized locations or other centralized resources, including the sufficiency of the review of the procedures performed, may not be as rigorous as the supervision and review of the engagement team they are supporting.
- Whether the procedures performed at these centralized locations or by other centralized resources, including evidence of review, is appropriately documented.

144. Neither ISQC 1 nor the ISAs contain explicit requirements or application material related to ADMs. However, it is understood that audit firms are applying ISQC 1 and ISA 220 in situations involving ADMs and continue to develop their own internal methodologies in respect of the types of work that may be performed at centralized locations or by other centralized resources, and guidelines as to how that work should be performed.<sup>76</sup>

145. Audit firms have indicated, where appropriate, that their internal methodologies require at least the same policies and procedures in respect of supervision of procedures performed at the centralized locations or by other centralized resources as that of the engagement team and, in some instances, noted the requirement of incremental quality control procedures in this area.

146. Examples of the types of policies and procedures developed could include:

- Minimum education and experience requirements for personnel at the centralized location or other centralized resources;
- Obtaining confirmation by personnel at the centralized location or other centralized resources that they meet those educational and experience requirements;
- Limiting the work to be performed by the personnel at the centralized locations or other centralized resources to only pre-determined specific procedures; and
- Providing detailed instructions as to the performance of those procedures.

#### REFERENCES TO EXISTING GUIDANCE AND APPLICATION MATERIAL

147. Neither ISQC 1 nor the ISAs explicitly acknowledge the use of ADMs, nor do they contain explicit requirements or application material in respect of their use nor do they address the potential additional challenges that ADMs may create.

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<sup>76</sup> Similar to circumstances discussed in IAASB Staff Audit Practice Alert, *Responsibilities of the Engagement Partner in Circumstances when the Engagement Partner is not located where the Majority of the Audit Work is Performed*, ISQC 1 and ISA 220 apply in these circumstances.

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

148. Given the evolving use of ADMs in practice, the IAASB believes it would be useful for the ISQC 1 and the ISAs to acknowledge the use of ADMs and emphasize the need for appropriate policies and procedures to be part of the audit firm's quality control system, specifically in instances where centralized locations or centralized resources are utilized in conducting audits. It may also be helpful to clarify how these centralized locations or other centralized resources are viewed in the context of the definition of engagement team set out in the ISAs.
149. Specifically, updates to ISQC 1 and ISA 220 could be developed to provide additional requirements or application material or clarifications of existing requirements and application material to more explicitly address supervision and review of procedures performed at a centralized location or by other centralized resources. These could include consideration of:
- The risk of material misstatement associated with the account or balance on which the procedure is being performed, such that appropriate safeguards are put into place to assess:
    - the level of complexity of the procedure and
    - the level of judgment required to perform the procedurein relation to the competencies and experience of the personnel at the centralized location or other centralized resources tasked with performing the procedure.
  - The nature and extent of documentation required by both those performing the procedure at the centralized location or by other centralized resources and those directing and supervising the performance of the procedure.
  - Whether the procedure is capable of being performed at a location that is remote from the engagement team and the client and, in particular, not require face to face interaction with the client to properly complete the procedure.
  - Whether performance of the procedure is capable of being directed and supervised remotely.
  - Whether the performance of the procedure at a remote location would result in a breach of client confidentiality, or any legal or cross-border restrictions.
  - Whether communications with management or those charged with governance noting the use of personnel at a centralized location or other centralized resources in executing the audit is appropriate.
  - Whether policies and procedures to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation are appropriately designed in the context of procedures performed at a centralized location or by other centralized resources.

## Questions

19. Other than those issues identified in paragraphs 141–146, are there other issues related to the potential effects firm’s changing business models and structures have on audit quality that have not been considered above? If so, please explain.
20. Do you agree with the possible actions recommended in paragraphs 148–149? If not, please indicate which actions are not appropriate or other actions that might be needed, and describe why.

## Transparency Reporting

*...A number of countries have introduced requirements for audit firms to provide transparency reports that provide information about audit firm governance and quality control systems.<sup>1</sup> Making such information publicly available may assist those users of audited financial statements who have no proximity to the audit process to understand the characteristics of individual audit firms, and the drivers of audit quality in those firms. Where key stakeholders cannot evaluate audit quality directly this information may assist entities in selecting a new audit firm.*

*Transparency reports also provide an opportunity for audit firms to distinguish themselves by highlighting particular aspects of their policies and approach to audits 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 the firm’s commitments.*

*- Paragraphs 37–38 of the AQ Framework*

## ISSUE

150. Audit firms have recently been publishing transparency reports in accordance with law and regulation or for other reasons. While the AQ Framework discusses the uses and benefits of transparency reports, ISQC 1 does not include requirements or application material relating to transparency reports.

## REFERENCES TO EXISTING GUIDANCE AND APPLICATION MATERIAL

151. Neither ISQC 1 nor the ISAs include requirements or application material relating to transparency reports.

## POSSIBLE ACTIONS TO ADDRESS THE ISSUES

152. The IAASB believes that, as an international standard setter requiring transparency reporting as an element of a firm’s system of quality control would be beyond its mandate, in large part because:
  - Transparency reporting would likely typically address more than how an audit firm has complied with ISQC 1 and the ISAs; and

- Setting meaningful requirements for transparency reporting would likely not be feasible on a global basis, in light of the effects of laws or regulations on audit firms on a national or jurisdictional level.
153. Changes to the ISQC 1 for transparency reporting may impact SMPs in particular, as in many instances they are unlikely to be issuing transparency reports. .
154. Even in the absence of specific requirements in law and regulation, audit firms are choosing to issue transparency reports. The IAASB believes transparency reporting is an area where practice will continue to evolve therefore does not believe it would be appropriate, at this time, to incorporate in ISQC 1, transparency reporting by firms, as this could inhibit innovation in this area and possibly result in less useful information being provided to stakeholders.
155. To the extent that audit firms in certain jurisdictions are required by law and regulation to publish transparency reports, or choose to do so on a voluntary basis, adding application material within ISQC 1 may be helpful to provide audit firms with guidance on policies and procedures that may be needed in order to capture information in the transparency report that is most relevant.

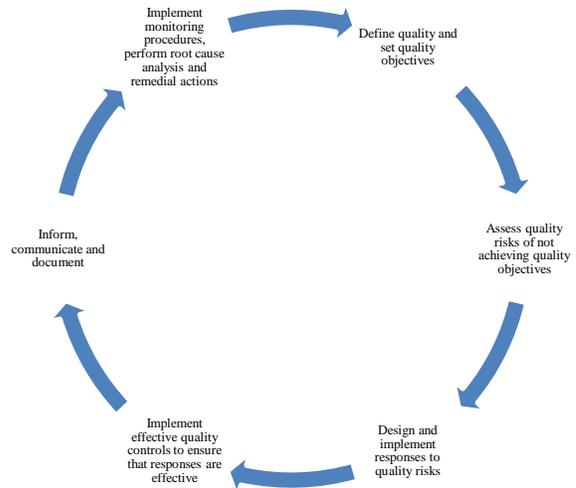
### Questions

21. Do you agree with the suggestion in paragraph 155 that ISQC 1 should contain application material to assist with suggestions of policies and procedures that should be in place for audit firms who publish a transparency report?
22. Do you agree with the views expressed in paragraphs 152–154? If not, please indicate why.

### Exploring a Quality Management Approach to Updating ISQC 1 and ISA 220

156. As noted previously, in addition to the IAASB's consideration of updating ISQC 1 and ISA 220 utilizing a QCA, the IAASB has considered the possibility of adopting a QMA to quality control, and redrafting ISQC 1 and ISA 220 on this basis.
157. A QCA retains the current structure of ISQC 1 and ISA 220, updating those standards with additional requirements or application material, or clarifications of existing requirements and application material, to be made as described in the previous paragraphs relating to quality control. A QMA would take a broader approach, placing focus on achieving quality objectives through the integration of business processes, including corporate governance systems, risk and compliance management systems and systems of internal control.
158. Under a QMA, audit firms would be required to engage in setting quality objectives and performing quality risk assessments as a foundation for setting policies and procedures as quality risk responses. As a result, the audit firm's system of quality control could be more responsive to identified quality risks, as policies and procedures are more closely connected to, and correlated with, the quality objectives.
159. While maintaining minimum requirements, including those in ISQC 1 that proved to be effective and appropriate, a QMA would allow for flexibility in the application of policies and procedures based on the nature and extent of a firm's current and future activities and the related quality risk of the firm.

160. Policies and procedures, including factors to consider, could be developed to determine the level of risk that provides for more stringent policies and procedures where the firm’s activities are determined to be of higher risk when compared to situations where the firm’s activities are determined to be lower risk in nature. Such policies and procedures, however, would still be designed to provide reasonable assurance that the system of quality control operates effectively.



161. Because a QMA requires risk assessment, it places more emphasis on policies and procedures that are preventative in nature, such as those around leadership and engagement performance, than those that are detective in nature such as those around quality reviews and inspections. It would also achieve consistency with the risk assessment and response approach taken in other types of assurance standards, including the ISAs.

162. The IAASB believes that a QMA will have a greater effect on audit quality than retaining the current approach in ISQC 1. This outcome is because the revisions would be aimed at establishing a system of quality management that focuses on continuous improvement to firms’ policies and procedures, providing for better remediation planning and accountability within the design of the system.

163. Although there are many internal control and risk management frameworks and standards on quality management, the IAASB believes it may be useful to model its QMA around the Enterprise Risk Management—Integrated Framework (2004) issued by COSO (COSO ERM Framework).<sup>77</sup> This framework is a three-dimensional model that can easily be adapted to address some of the current challenges.

164. A multi-dimensional model can be responsive to evolving environments, providing firms with the flexibility to adapt more efficiently and more effectively to changes in regulatory requirements or other developments in the environment in which firms operate. It can also be applied in a similar way at various levels within a quality control system, such as the network level, the firm level and the engagement level.



<sup>77</sup> The COSO Enterprise Risk Management (ERM) Framework is in the process of being updated and the IAASB will follow these developments and consider resulting implications in the context of a QMA to quality control.

### Question

23. Which approach is preferable, a QCA or a QMA? Please explain the rationale for your preference. If neither is preferred, please provide additional suggestions or alternative approaches the IAASB could take with respect to quality control.

### Overall Questions

The following apply to all the issues and possible actions set out in relation to quality control:

24. Are there any other standard-setting actions that would be appropriate to address the issues identified in this section of the ITC? If yes, please provide details about the specific actions and describe why they would be appropriate.
25. Are there any other specific actions, including by others, that could address the issues that have been set out in this section of the ITC? If yes, please provide details and describe why the actions would be appropriate.

## GROUP AUDITS

The feedback received by the IAASB in developing its *Work Plan for 2015–2016* indicated that there are issues and concerns in the following areas related to group audits:<sup>78</sup>

*In relation to the application of ISA 600 in particular circumstances—Matters relating to:*

- “Letterbox audits”, i.e., whether ISA 600 applies in the situation where the group parent entity is registered in one jurisdiction, which is where the group auditor is based, but the group’s operations, accounting records and management are located in a different jurisdiction.
- The practical implications of applying ISA 600 in certain circumstances, such as when access to the relevant information is restricted (in particular when a significant component is an equity investment or joint venture), and in “funds of funds” structures.
- Whether and, if so, how ISA 600 applies in situations where shared service centers are used.

*In relation to auditor performance in accordance with ISA 600—Concern has been expressed about:*

- The extent of the group auditor’s involvement in the work of the component auditor (the amount and scope of work needed by the group auditor in relation to the component including the audit evidence needed, access to the workpapers of the component auditor, and clarification of various aspects relating to “significant components”);

<sup>78</sup> Input included the [findings](#) from the IAASB’s ISA Implementation Monitoring project, a stakeholder survey on work plan priorities, consultation on the proposed Work Plan for 2015–2016, and input from outreach with key stakeholders.

- **Communication between the group auditor and the component auditor;**
- **Application of the concept of component materiality;**
- **Identifying a component in complex situations; and**
- **Work effort of the component auditor.**

**Issues arising in the Quality Control and Professional Skepticism initiatives may also be relevant to this work.**

The discussion that follows explores the issues identified in the IAASB's Work Plan for 2015–2016, refined and expanded as necessary based on the IAASB's deliberations and other outreach. The IAASB believes that issues set forth below represent those matters where priority attention may be needed to take action to respond to public interest calls to enhance audit quality. The IAASB is particularly interested in further understanding stakeholders' views about the issues affecting group audits, the relative priority of the issues and the possible actions that may be taken (including input on the IAASB's preliminary views about those actions). The issues relating to group audits that are discussed below are organized as follows:

- Acceptance and continuance of the group audit engagement, including issues relating to:
  - Understanding the group, its components, and their respective environments, when making the decision to accept or continue with the group audit engagement, and
  - Access, including:
    - Access to component management or component financial information.
    - Access to component auditors.

(See paragraphs 165–178).
- Communications between the group engagement team and component auditors (see paragraphs 179–186).
- Using the work of the component auditors (see paragraphs 187–206).
- Identifying and assessing the risks of material misstatement in a group audit (including issues relating to component materiality) (see paragraphs 207–226).
- Responding to identified risks of material misstatement in a group audit (including issues relating to the group engagement team's involvement in the consolidation process) (see paragraphs 227–248).
- Review and evaluation of the work of component auditors by the group engagement team (see paragraphs 249–258).
- Other issues related to group audits (see paragraph 259)

## Acceptance and Continuance of the Group Audit Engagement

### ISSUES

165. When the group engagement partner makes a decision to accept a new group audit engagement, or continue with an existing engagement, in addition to the relevant requirements of ISA 210<sup>79</sup> and ISA 220, the group engagement partner is required to determine whether sufficient appropriate audit evidence can reasonably be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team is required to have sufficient understanding about:
- The group, its components, and their respective environments to be able to determine whether and how sufficient appropriate audit evidence will be obtained. This understanding includes the determination that they would be able to obtain sufficient appropriate audit evidence, including for the components, to report on the financial statements in accordance with their findings.
  - The competence and capabilities of the component auditors (this is discussed further in paragraphs 187–196 below).
166. It has been noted that there are situations where auditors give inadequate consideration to certain matters that may be relevant to the decision about whether to accept or continue a group audit engagement. In particular, some audit oversight bodies and others are concerned that group engagement partners, before accepting a new group audit engagement or making a decision to continue an existing engagement, do not obtain a sufficient understanding about:
- The ability to access the information that may be required for the group audit, including access to the components (e.g., access to financial information of the component or to component management). Group management may not have the ability to control management of the component so that it cooperates with the group engagement team (e.g., when investments are accounted for in accordance with the equity method or when there are other non-controlled entities that are consolidated or included in the group financial statements)
  - The ability to have effective involvement in the work of the component auditors (e.g., including the ability to communicate with the component auditors at all stages of the audit, and as considered necessary, have access to their working papers).
  - The impact on the group audit of “environmental” issues relating to the entity (e.g., different cultures or customs between components of the group), or to component auditors (e.g., differential fee structures which may create incentive for more or less involvement of component auditors).
  - The impact on the group audit of differing law and regulation relating to the entity (e.g., where components prepare financial information using financial reporting standards that are different from the group financial reporting standards) and the auditor (e.g., differing relevant ethical requirements (including independence requirements)).

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<sup>79</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

- Complex group structures, including an understanding of the business rationale for the legal and operational structure of the group and its components.

Inadequate consideration of the matters above may result in the group engagement partner not having sufficient understanding of the group, its components, and their environments to make the determination as to whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion.<sup>80</sup>

167. Concern has also been expressed about the specificity of the requirements in ISA 600 relating to the evaluation by the group engagement partner of the ability of the group engagement team to obtain the necessary audit evidence when there will be significant involvement of component auditors performing work related to the financial information of components. In particular, concern has been expressed about:
- The lack of specificity in the requirements in ISA 600 to address situations where access by the group engagement team to the component auditors and their working papers may be difficult, or in some cases precluded. Challenges may arise because:
    - Of restrictive law or regulation, such as those around confidentiality;
    - Information requested by the group engagement team may not be readily available or typically shared outside the component auditor's firm (such as information about the results of internal or external quality reviews that the group engagement team may inquire about as part of the assessment the competence of the component auditors); or
    - Access issues relating to situations where significant components are non-controlled entities (see also paragraph 166)
  - The ability of the group engagement team to be sufficiently involved in the work performed by component auditors being adversely affected by the inability to effectively communicate via electronic means, including as a result of the use of differing audit performance technologies by the group engagement team and the component auditors.
168. Situations may arise when the group engagement team does not or will not have appropriate access to the working papers of the component auditors, or the financial information of the component or to component management, such that it will not be possible to be able to obtain sufficient appropriate audit evidence to support the group audit opinion. Some audit oversight bodies therefore have the view that the ability to have access to what the group engagement team needs to be able to support the audit opinion should have stronger emphasis in the engagement acceptance process, such that the issues would be highlighted earlier in the process and in some cases, engagements would not be accepted.
169. In addition, some regulators and audit oversight bodies have expressed concern that in circumstances where the engagement partner is not located where the majority of the audit work is performed, it is not always apparent that the engagement partner has been sufficiently involved in the process to accept or continue the engagement.

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<sup>80</sup> As is required by ISA 600, paragraph 12

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

170. ISQC 1 requires that firms establish policies and procedures for the acceptance and continuance of engagements, such that the firm will only undertake work where the firm is:
- Competent to perform the engagement and has the capabilities, including the time and resources;
  - Can comply with the relevant ethical requirements; and
  - Has considered the integrity of the client.<sup>81</sup>
171. In addition, when accepting or continuing a group audit engagement ISA 600 requires the group engagement partner to determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of components on which to base the audit opinion, as well as be involved, to the extent necessary, in the work of the component auditors.<sup>82</sup> The application material also provides various matters to consider regarding understanding the component auditors when accepting a new, or continuing with an existing, group audit engagement.<sup>83</sup>
172. Situations where there is restricted access have been contemplated in the application material in paragraphs A14-A19 of ISA 600 as guidance for the requirement in paragraph 13 relating to the acceptance and continuance of the audit engagement where the group engagement partner concludes that restricted access will impact the ability to obtain sufficient appropriate audit evidence to support the audit opinion. This application material covers both situations where the restrictions are imposed because of circumstance and where the component auditors refuse to provide access to relevant audit documentation sought by the group engagement team.
173. ISA 210 requires that the auditor establishes that preconditions exist for an audit, including the acknowledgement and understanding from management in the terms of the engagement that they would provide the auditor with all access to information that is relevant for the audit.<sup>84</sup>
174. The requirements in ISA 600 include that the group engagement partner, in the case of a new engagement, should not accept a new engagement where there will be a scope limitation that would result in a disclaimer (if the restrictions are imposed by group management), or, if possible under law or regulation, should resign from an engagement if it is concluded that it will not be possible to obtain sufficient appropriate audit evidence.<sup>85</sup>

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

175. Clarifying or enhancing the existing requirements that form the basis for the decision by the group engagement partner to either accept or continue an engagement, and considering specific requirements that would address the documentation of the basis for the decision, would be helpful in addressing the issues raised. Possible actions include the following:

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<sup>81</sup> ISQC 1, paragraph 26

<sup>82</sup> ISA 600, paragraph 12

<sup>83</sup> ISA 600, paragraphs A10–A12 set out examples of matters to understand before accepting or continuing a group audit engagement.

<sup>84</sup> ISA 210, paragraph 6(b)(iii)

<sup>85</sup> ISA 600, paragraph 13

- Strengthening the standard to help auditors identify (when deciding whether to accept or continue an engagement) those situations where (1) there is no reasonable way of obtaining sufficient appropriate audit evidence and clarifying what to do in such situations (i.e., not accept or continue the engagement, or if law or regulation precludes declining an engagement, making it clear to all involved that the result will be a disclaimer of opinion); or (2) there is, or is likely to be, added complexity in obtaining sufficient appropriate audit evidence. Amendments to ISA 600 could also include providing additional application material for matters to be considered in obtaining an understanding of the group, its components and their environments as well as the component auditors so as to be able to make the decision to accept or continue the engagement on the most informed basis possible (see current requirements described in paragraphs A10–A12 of ISA 600), in particular to address the concerns set out in paragraph 166 above. Strengthening the requirements and clarifying that an appropriate understanding is required before deciding to accept or continue a group audit engagement could:
  - Better assist group engagement partners in determining when not to accept or continue an engagement .
  - Result in earlier identification of issues affecting the ability to obtain sufficient appropriate audit evidence.
  - Enhance auditor performance through focusing on obtaining information that will be relevant to the rest of the audit at an earlier stage.

The nature and extent of the required understanding would need to be explored (especially as it relates to new engagements), taking into account that this understanding takes place prior to the audit firm being engaged (i.e., natural limitations to the nature and extent of the understanding will therefore exist, including that the auditor will not be able to leverage knowledge from prior engagements).

- Strengthening the link in ISA 600 to the requirements in ISQC 1 that address the firm’s acceptance and continuance policies and procedures, and the requirements in ISA 220 that address the engagement partner’s responsibilities, e.g., to emphasize the need to consider the competence and capabilities of the component auditors when considering the competence and capabilities of the engagement team.<sup>86</sup>
- Providing more application material with more specific considerations related to situations where the component auditors have policies and procedures that are not common with those of the group engagement team, including for example, to highlight the need to consider whether and how such situations affect the group engagement team’s ability to be adequately involved in the work of the component auditors (see discussion about the quality control aspects relating to networks of firms in paragraphs 73–79).

176. The existing requirement in paragraph 12 of ISA 600 could be clarified such that the group engagement partner would be more explicitly required to assess, as part of the determination whether to accept a new, or continue an existing, group audit engagement, whether the group

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<sup>86</sup> ISA 220, paragraph A8 provides examples of matters to be considered in the acceptance and continuance of client relationships, including that the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.

engagement team would have sufficient involvement in the work on the components. Alternatively, the requirement could be reworked to place greater emphasis on the need for an explicit conclusion as part of the acceptance or continuance decision, that the group engagement partner and group engagement team can serve in those capacities and fulfil their responsibilities relative to the engagement overall. Such conclusion could be based on an assessment of the work that the group engagement partner and group engagement team will perform directly, as well as on the determination of their ability to be sufficiently involved in the work of component auditors. Guidance could be provided to emphasize the significance of the judgments involved in making this determination, including, for example, pointing out that the more component auditors will be involved in performing work on greater proportions of the group's financial information, the more important it will become for the group engagement partner to make a sufficiently robust assessment.

177. Additional clarity could be provided in the standard about the different circumstances that may lead to access issues. More guidance may provide auditors with the ability to better address some of the identified or known issues, for example, enhanced application material for the specific circumstances and some examples about how some of the issues may be overcome. The examples could draw from current practices that group engagement teams or component auditors have used to overcome access issues. However, it is acknowledged that some of the issues are because of situations that revisions or clarifications to the standards will not resolve.
178. ISA 600 could more clearly emphasize that the agreed terms of the engagement are expected to include that group management agree to the pre-conditions for the group audit, including agreeing to provide the auditor with all access to information relevant for the group audit (i.e., consistent with ISA 210). For example, application material may be added to explain what "access to information" means in the context of a group audit and the importance of considering what is relevant in the context of the group, its components and their environments. In particular, application guidance might highlight the importance of considering the effects of complex structures or non-controlled components or where law or regulation may restrict access to a component's information. Furthermore, revisions to the standard could also help clarify that access to relevant information is a necessary consideration in the acceptance or continuation process.

### Questions

26. Are there any other issues related to the acceptance / continuation of group audit engagements that have not been considered above? If yes, please describe the issues and if possible, the ways that auditors currently address these issues in practice.
27. Are access issues prevalent in your jurisdiction? If so, please describe the kinds of issues that exist.
28. Do you agree with the possible actions recommended in:
  - o Paragraph 175–178 related to enhancing the acceptance process
  - o Are there other actions that you think are appropriate? If yes, please describe the actions and explain why they would be appropriate.

If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

## Communications between the Group Engagement Team and Component Auditors

### ISSUES

179. Appropriate communications between the group engagement team and the component auditors are an important element of a group audit, and in many ways, the foundation to the group engagement team's ability to be sufficiently involved in the work of component auditors. Communications between the group engagement team and the component auditors can take a variety of forms, including, but not limited to:
- Team meetings (in-person or virtual), discussions and e-mail correspondence.
  - Group instructions provided by the group engagement team to component auditors.
  - Clearance memoranda or similar documents presenting component auditor's findings provided by component auditors to the group engagement team.
180. Concerns have been expressed that the communication requirements in ISA 600, including those in paragraphs 40 and 41, are not specific enough to result in sufficient and appropriate communication between component auditors and the group engagement team during the various stages of the audit. Specific issues noted include:
- Inadequate communication between the group engagement team and the component auditors during the audit, in particular as it relates to the communications related to the findings of the component auditor. Some stakeholders are looking for more of a 'feedback loop' in the required communications, such that there is more interactive communication required between the group engagement team and component auditor as the group engagement team plans, reviews and assesses the work performed by the component auditor.<sup>87</sup> Another observation is that the ISA is not specific in addressing the importance of the necessary communications taking place on a timely basis.
  - Group instructions provided by the group engagement team to component auditors may not be clear or appropriate. For example, the same group audit instructions may be sent to all component auditors' regardless of their significance or individual facts and circumstances. This issue is particularly relevant for SMPs that receive group instructions designed for significant components and, in many cases, they may be performing work on the financial information of components that are not significant (and for which tailored instructions would therefore be more appropriate).

### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

181. One of the objectives of an auditor of group financial statements (i.e., the group engagement team) is to communicate clearly with the component auditors about the scope and timing of their work on financial information related to the component and their findings thereon.<sup>88</sup> ISA 600 sets out requirements about the necessary communications to achieve this objective, including the work to be performed, the use to be made of that work, and the form and content of the component

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<sup>87</sup> Further discussion about the group engagement's team's response to the findings of the component auditor is discussed in paragraphs 249–258

<sup>88</sup> ISA 600, paragraph 8(b)(i)

auditor's communications with the group engagement team.<sup>89</sup> ISA 600 also sets out matters that the group engagement team should request the component auditor to communicate with regard to the group audit.<sup>90</sup>

182. These communication requirements were designed to allow for flexibility based on the many variations in the way group audits are carried out and are purposely not prescriptive. Application material was also specifically included to explain that communications may not necessarily be in writing but are still required to be on a timely basis.

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

183. The requirements regarding communications with the component auditors could be strengthened, including placing more emphasis on the need for sufficient and appropriate two-way communication during the audit. Additional emphasis or clarity may help the group engagement team to better understand when communication with the component auditor may be necessary and what might be sufficient and appropriate in the circumstances, as well as providing a better understanding that the instructions provided to the component auditors have been fully understood and complied with. Revisions to the standard may also improve the group engagement team's involvement in the component auditors' work (including understanding of the component auditors' findings), thereby improving the evaluation of the sufficiency and appropriateness of the audit evidence obtained for purposes of the group audit opinion.
184. The supporting application material could also be enhanced by explaining more precisely what the requirement are intended to achieve, and could include examples of different kinds of communications that may be appropriate in the circumstances. For example, ISA 600 requires timely communication between the group engagement team and the component auditors, however it doesn't then explain what is meant by timely. ISA 260 guidance in respect of the timing of communications could be used as a basis to provide such an explanation in ISA 600. In addition, further application material could also be considered to emphasize the importance of documenting (in accordance with the requirements of ISA 230) significant communications between the group engagement team and component auditors and not just focus on the inclusion of the required written communications.
185. In developing new application material to support the requirements, consideration will also be given to addressing:
- Communication of instances of non-compliance or suspected non-compliance with law and regulation (NOCLAR) among the group engagement team and between the group engagement team and component auditors.<sup>91</sup>
  - Requirements relating to communication of key audit matters (KAM) by the group auditor. For example, it may be appropriate for ISA 600 to include additional application guidance to assist group engagement teams and component auditors in having effective communications

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<sup>89</sup> ISA 600, paragraph 40

<sup>90</sup> ISA 600, paragraph 41

<sup>91</sup> As part of its deliberations relating to its NOCLAR project, the IAASB highlighted that such communications needed to be considered in light of the proposed changes to the IESBA Code (see the [Explanatory Memorandum](#) in the IAASB's Exposure Draft, *Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations*)

so as to ultimately support the identification, where applicable, by the group engagement team of matters that might be considered KAM in the context of the group audit.

186. At the same time, as previously noted consideration will also be given to enhancing the ISAs to direct and support component auditors (see paragraphs 41–42). Encouraging appropriate two-way communication during the group audit could also form part of these considerations.

### Questions

29. Do you agree with the possible actions recommended in paragraphs 183–185 to strengthen the required communications (and documentation thereof) between the group engagement team and the component auditors?

If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

## Using the Work of the Component Auditors

### ISSUES RELATING TO UNDERSTANDING THE INDEPENDENCE, COMPETENCE AND CAPABILITIES OF THE COMPONENT AUDITORS

187. Concern has been expressed about whether and how group engagement teams demonstrate the necessary understanding of the component auditor, and the consequential impact as to how the group engagement team determines the nature, timing and extent of its involvement in the work of the component auditors.
188. As noted in paragraph 34–35, there are new and continuing challenges in group audits as group structures become more complex and continue to evolve. Some of these challenges manifest themselves when the group engagement team commences its work to understand the component auditors (including their competence), in particular where the component auditors are situated in a jurisdiction that:
- Does not have similar legal and regulatory requirements as those that are applicable to the jurisdiction where the group engagement team is located,
  - Has different:
    - (Or no) oversight regimes.
    - Independence and ethical requirements.
    - Languages or cultures.
    - Licensing or accreditation requirements.

The group engagement team may have difficulty obtaining or understanding relevant information in order to properly understand component auditors, including assessing their competence. For example, there may be privacy law or regulation in the jurisdiction of the component auditor that preclude information being shared, or the risk management policies of the firm of the component auditor may not allow sharing of certain information.

189. Uncertainties also exist about the appropriate extent of reliance the group engagement team can place upon firm quality control policies and procedures (e.g., internal quality inspections or

independence monitoring) where the component auditors have the same quality control policies and procedures as the group engagement team. These questions arise in situations when group engagement teams and component auditors are part of the same firm, but also when they are from different firms that are part of the same international network of firms (see further discussion on this in the quality control section in paragraphs 73–79). In such circumstances, there would likely be a presumption that the group engagement team would have some confidence in the independence, and competence and capabilities of the component auditor, thereby resulting in less need to obtain additional information to make their assessment of the component auditors' competence and capabilities.

190. However, in cases where the component auditor does not have common quality control monitoring and procedures as the group engagement team, additional information and understanding about the component auditors' competence and capabilities is likely to be needed. Some regulators and audit oversight bodies have the view that, in some cases, over-reliance is being placed on component auditors with the same policies and procedures as the group engagement team, without due consideration of the need to obtain and assess additional information to understand their independence, and competence and capabilities (such as information to address the other factors mentioned in paragraph A33 of ISA 600).

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

191. The introduction to ISA 600 notes that the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities.<sup>92</sup>
192. ISA 600 also requires the group engagement team to obtain an understanding of matters relevant to:
- Ethics and independence<sup>93</sup> of the component auditors.
  - The component auditors' professional competence.
  - The involvement in the work of the component auditors.
  - The regulatory environment in which the component auditors operates.<sup>94</sup>
193. ISA 220 sets out matters that may be considered when assessing whether the appropriate competence and capabilities that are expected in the engagement team as a whole<sup>95</sup> (and given the interaction between ISA 220 and ISA 600,<sup>96</sup> this would extend to component auditors). ISA 600 also provides further guidance for group audit situations relevant to determining the nature, timing

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<sup>92</sup> ISA 600, paragraph 4

<sup>93</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, includes a new requirement for auditors to identify the jurisdiction of origin of the relevant ethical requirements to increase transparency relating to the particular audit engagement.

<sup>94</sup> ISA 600, paragraph 19

<sup>95</sup> ISA 220, paragraph A11

<sup>96</sup> 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 (ISA 600, paragraph 5).

and extent of the group engagement team's procedures to obtain an understanding of the component auditors and are affected by factors such as the previous experience with, or knowledge of, the component auditor, and the degree to which the group engagement team and component auditor are subject to common policies and procedures.<sup>97</sup> ISA 600 also contains guidance about ethical requirements that are relevant to a group audit,<sup>98</sup> and the professional competence of the component auditors.<sup>99</sup>

194. ISA 600 precludes being able to use the work of component auditors that do not meet the independence requirements relevant to the group audit, or in situations where the group engagement team has serious concerns about matters related to competence and capabilities. Paragraphs A39–A41 provide additional guidance about the application of the group engagement team's understanding of a component auditor, including providing examples about how to address less than serious concerns about competency.

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

195. The application guidance included in paragraph A33 of ISA 600 about the factors that are relevant to the group engagement team's procedures to understand the competence of the component auditor could be made more prominent (including potentially through more focus or specificity being included in the requirements). Enhanced application material could also be developed to, for example, include more specific examples that address some of the practical challenges that have been identified related to understanding the component auditors' independence, and competence and capabilities. These actions may strengthen the group engagement team's assessment of the component auditor and help them more appropriately determine the necessary level of involvement in the work of the component auditors, including as it relates to component auditors in foreign jurisdictions. For example, additional application material could be developed to demonstrate the impact on the assessment of the competence of the component auditors if there are different or no national or jurisdictional licensing requirements.
196. Additionally, the application material could be enhanced to more clearly address how group engagement teams can consider the existence of common policies and procedures in assessing the competence of component auditors and in determining the necessary levels of involvement in their work. Specifically, application material could be developed on how to understand and evaluate quality control monitoring results or the results of external quality reviews for component auditors, including the impact when the group engagement team and the component auditors are subject to common quality control monitoring mechanisms, and when there are not.

#### ISSUES RELATING TO THE GROUP ENGAGEMENT TEAM'S INVOLVEMENT IN THE WORK OF THE COMPONENT AUDITORS

197. The group engagement team's involvement in the work of the component auditors depends on a number of interrelated factors, some of which have been discussed in this ITC, such as the competence and capability of the component auditor, the expected communications between the

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<sup>97</sup> ISA 600, paragraphs A33 and A34

<sup>98</sup> ISA 600, paragraph A37

<sup>99</sup> ISA 600, paragraph A38

group engagement team and the component auditors, the determination of significant components and the determination of the necessary work relating to non-significant components .

198. The ISAs require that the engagement partner take responsibility for the direction and supervision of the group audit engagement, and suggest that there will be involvement by the group engagement team in the audit work of the component auditors during the audit. The appropriate nature, timing and extent of the involvement will however vary according to the circumstances of each group audit engagement (e.g., including the significance of the components, the significance of the risks of material misstatement related to the components and the results of the understanding of the component auditors).
199. Some audit oversight authorities have raised concerns that involvement of the group engagement team's involvement in the work of the component auditors is not always demonstrated. For example, it has been noted in inspection reports by some audit oversight bodies that the extent to which the group engagement team specifies or communicates identified risks of material misstatement to component auditors varies.
200. In addition, certain audit inspection reports have noted that the judgments around the nature, timing and extent of the group engagement team's involvement in the work done by component auditors, and the reasons therefore, may not be demonstrated in all instances (including documentation thereof), particularly in instances where the engagement partner is not located where the majority of the audit work is performed.

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

201. ISA 600 requires the group engagement team to determine the type of work to be performed on the financial information of the components (by themselves, as well as the component auditors), as well as the nature, timing and extent of their involvement in the work of the component auditors.<sup>100</sup> For significant components, there is a requirement for the group engagement team to be involved in the component auditor's risk assessment process.<sup>101</sup> Guidance setting out the factors<sup>102</sup> that may affect the group engagement team's involvement in the work of the component auditor, as well as examples of forms of involvement,<sup>103</sup> are included in the application material in ISA 600.
202. The group engagement team is required to document the type of work to be performed on the financial information of the components,<sup>104</sup> as well as the nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components, including where applicable, the group engagement team's review of relevant parts of the component auditor's audit documentation and conclusions thereon.<sup>105</sup>
203. As previously noted, the group engagement partner is responsible for the group audit engagement. Where component auditors will perform work on the financial information of components, as part of

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<sup>100</sup> ISA 600, paragraph 24

<sup>101</sup> ISA 600, paragraph 30

<sup>102</sup> ISA 600, paragraph A54; see also the connection between A54 (c) and A33.

<sup>103</sup> ISA 600, paragraph A55

<sup>104</sup> ISA 600, paragraph 50(a)

<sup>105</sup> ISA 600, paragraph 50(b)

the acceptance and continuance of the engagement, the group engagement partner is required to evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence.<sup>106</sup>

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

204. Strengthening ISA 600 to provide more clarity as to how the group engagement team determines the necessary nature, timing and extent of the involvement in the work of the component auditors, including why such involvement is appropriate in light of all relevant considerations, may improve auditor performance and assist auditors in better demonstrating whether and how the group engagement team's involvement is sufficient and appropriate in the circumstances. Due to widely varying group structures and varying types of component auditors, the appropriate nature, timing and extent of appropriate involvement of the group engagement team in the work of component auditors for every case cannot be described in ISA 600, for example:

- In some cases it may be appropriate to undertake site visits to meet with the component auditors and review their working papers to effectively evaluate their findings.
- In other circumstances, preparing group instructions and sending them to a component auditor, obtaining a memorandum from the component auditor that describes in sufficient detail the work performed based on the instructions, and the resulting findings, may be sufficient for the group engagement team's purposes.

In either case, it may be appropriate for selected working papers prepared by component auditors to be shared with the group engagement team

205. ISA 600 could be further strengthened, either through clarification or additions to the requirements or application material, as follows:

- Emphasizing the need for greater focus by the group engagement team on the significant judgments<sup>107</sup> that need to be made about the nature, timing and extent of the involvement of the group engagement team in work performed by the component auditors, and importantly the need for appropriate documentation thereof.
- Clarifying the interrelationships between paragraphs 24, 30, A33, A47 and A54, of ISA 600 to assist auditors in better applying professional judgment in determining the nature, timing and extent of their involvement in the work of the component auditors.
- More explicitly explaining the interactions between the group engagement team and the component auditors in varying circumstances (e.g., in different group structures or in jurisdictions where restrictions on access exist).

206. In addition, providing further examples in the application material to address situations where the component auditors may have the same policies and procedures as the group engagement team, or may be from the same jurisdiction as the group engagement team, may also help distinguish the varying involvement of the group engagement team that may be appropriate. For example, such circumstances may result in the nature, timing and extent of involvement by the group engagement

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<sup>106</sup> ISA 600, paragraph 12

<sup>107</sup> ISA 230, paragraphs 8(c) and A8 sets out the documentation requirements for the significant professional judgments of the auditor in reaching their conclusions

team in the work of the component auditors being different than in those situations in which the component auditors do not have the same policies and procedures or are from a different jurisdiction (e.g., the nature and extent of the group engagement team's involvement in the work performed by the component auditor in these latter circumstances may need to be greater, including for example more detailed instructions and more frequent communications as the audit progresses).

#### Question

30. Do you agree with the possible actions recommended in paragraphs 204–206 to enhance the group engagement team's involvement in the work of the component auditors?

If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

### Identifying and Assessing the Risks of Material Misstatement in a Group Audit (Including Issues Relating to the Group Engagement Team's Involvement in the Consolidation Process)

#### ISSUES RELATING TO THE GROUP ENGAGEMENT TEAM'S UNDERSTANDING OF THE COMPONENTS AND IDENTIFYING SIGNIFICANT RISKS FOR THE GROUP

207. The group engagement team is required to obtain an understanding of the entity and its environment (including its internal control) to identify and assess the risks of material misstatement in the group audit.<sup>108</sup> This understanding builds upon the understanding that has been obtained when deciding to accept (or continue) a group audit engagement (and as discussed in paragraphs 165–178).

208. It has been suggested that more clarity is needed about certain aspects of the understanding needed by the group engagement team about the group, and its environment, to be able to appropriately identify the significant risks of material misstatement for the group engagement. For example, some stakeholders have the view that the understanding of the components and their respective environments that is obtained by the group engagement team is, in some cases, not sufficient to be able to direct the group audit towards the areas of risk that may exist in the group. Challenges identified include being able to appropriately understand and respond to the impact of:

- Issues in multi-jurisdictional audits related to diverse markets and differing cultures.
- Circumstances where the group structures are such that the engagement partner may be located in the jurisdiction of registration or listing, with the majority of the audit work being performed in another jurisdiction where general and financial management are located, and where the business activities and related processing of transactions take place.
- Overly complex or unusual group structures.
- Evolving group structures that are becoming more complex, making the identification of components, and how to audit them, more difficult. For example, many entities are increasingly operating in integrated structures, such as situations where the transactions for

<sup>108</sup> ISA 600, paragraph 17

the group are processed centrally (e.g., through a SSC). It has been noted that it is not clear how ISA 600 applies (or if it applies) to these situations. In some circumstances the SSC may be treated as a separately identifiable component. In other circumstances a SSC may not be considered a separate component based on applying the definition of component as stated in ISA 600.

209. Related to the identification of significant risks, concern has also been expressed that:

- (a) Risks identified at the component level by the component auditors are sometimes not appropriately considered at the group level, i.e., as to whether they are group-wide risks or whether such risks also exist at some of the other components.
- (b) In situations where group-wide significant risks have been identified that relate to all components, including non-significant components where no procedures are planned to be performed, it may be confusing as to where or to which component the work on the significant risk is to be directed in order to fully address the risk.
- (c) There is confusion about the interaction of 'significant risks' and 'significant components'<sup>109</sup>, and it has been noted that there are challenges in dealing with how the identification of significant risks at a component impacts the determination as to whether a component is a significant component. Significant components are identified either based on financial metrics or whether components are likely to include significant risks (determined in accordance with ISA 315 (Revised)). As identification and assessment of significant risks is also linked to the identification of significant components, providing further clarification as to how significant risks that are pervasive to the group (and therefore exist at all components) impact the determination as to whether a component is significant would be beneficial.

210. Lastly, in identifying a 'significant component,' it has been noted that some uncertainty exists as to what it means to be "of individual financial significance."<sup>110</sup>

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

211. Although certain aspects of the required understanding of the entity and its environment are not specifically covered in ISA 600 (e.g., relevant industry, regulatory, and other external factors including the applicable financial reporting framework), the requirement in paragraph 17(a) (as well as related application material in paragraphs A23–A29) as well as the overarching requirement in paragraphs 11(a) and A26 of ISA 315 (Revised) would adequately, in the view of the IAASB, require auditors of group financial statements to obtain the necessary understanding of the entity and its environment in order to perform their risk assessments in relation to the group audit, including the identification and assessment of risks at both the group as well as the significant component level.

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<sup>109</sup> A 'significant component' is described as being of individual financial significance to the group, or that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement in the group financial statements (ISA 600, paragraph 9(m))

<sup>110</sup> ISA 600, paragraph A5 provides guidance on identifying components of individual significance, including applying percentages to chosen benchmarks.

212. The requirements for identifying significant risks in an audit engagement are contained in paragraphs 27–29 of ISA 315 (Revised), with related application material in paragraphs A32–A136. Although there are no specific requirements or guidance in ISA 600 for identifying significant risks, the group engagement team would refer to ISA 315 (Revised) for relevant guidance.
213. ISA 330 requires that if the auditor has identified a risk as significant, substantive procedures that are specific to that risk be performed.<sup>111</sup>
214. Significant components are identified to help the group engagement partner and group engagement team determine the type of work to be performed on the financial information of components. The definition of a significant component in ISA 600 and the requirement to determine significant components drives the types of audit procedures to be performed<sup>112</sup>. The requirements are supplemented by application material about appropriate procedures in different circumstances.<sup>113</sup>

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

215. The IAASB recognizes that improvements are needed to ISA 600 to more explicitly reference the principles in ISA 315 (Revised) (related to identifying and assessing risks of material misstatement) and in ISA 330 (related to responding to assessed risks), so as to better support their application in group audit engagements. In particular, the IAASB recognizes the need to acknowledge the existence of evolving environments and increasingly complex group structures, and to the extent possible, eliminate constraints that may exist or arise in relation to overly prescriptive definitions.
216. In addition to making the links in ISA 600 to the principles in ISA 315 (Revised) and ISA 330 more explicit, additional examples for relevant aspects that may arise from a group audit may be provided (e.g., to address the examples where issues have arisen in paragraph 208 above). These changes may help reinforce that the understanding of the group and its components builds upon the requirements in ISA 315 (Revised) and ISA 330, and may help the group engagement team in better considering all aspects of where risks may exist in a group audit.
217. The standard could be enhanced (either through clarification or additions to the requirements or application material) to emphasize that significant risks identified by component auditors for a specific component should also be considered at the group level to determine whether the risks identified may apply more broadly to some or all of the other components (i.e., where the component auditors at other components may not necessarily have identified the same risk, but the facts and circumstances would appear to be similar) or for the group overall.
218. As identification and assessment of significant risks is also linked to the identification of significant components, providing further clarification as to how significant risks that are pervasive to the group (and therefore exist at all components) impact the determination as to whether a component is to be considered significant would be beneficial.
219. Additional application material to further clarify the meaning of the phrase "of financial significance to the group" may also help address some of the challenges in identifying significant components.

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<sup>111</sup> ISA 330, paragraph 21

<sup>112</sup> ISA 600, paragraphs 26–27

<sup>113</sup> ISA 600, paragraphs A48–A49

**ISSUES RELATING TO COMPONENT MATERIALITY AND OTHER ASPECTS OF MATERIALITY RELEVANT TO GROUP AUDITS**

220. It has been noted that there is confusion and significant variation in practice as it relates to the understanding of the concepts of component performance materiality and component materiality, and their purpose, as well as the manner in which they are determined. It has been noted that the concept of aggregation risk is also not well understood.
221. Many of the issues related to component materiality are intrinsically linked to the requirements and guidance in ISA 320,<sup>114</sup> and therefore cannot be addressed in the narrow context of a project that is addressing ISA 600. In its recently completed Disclosures project, the IAASB has acknowledged that work currently being undertaken by the International Accounting Standards Board (IASB) may give rise to further implications to the ISAs relating to materiality. The IAASB will continue to monitor the IASB's developments, and in conjunction with its planned consultation on the Work Plan for 2017–2018, determine the need for a more holistic review of ISA 320.<sup>115</sup> The IAASB will also continue to monitor relevant research on the topic (see Appendix X for relevant research on materiality)[*to be inserted after September 2015 discussions*]. Therefore any actions as part of the group audits project are not expected to pre-judge the outcomes of those efforts.

**REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL**

222. ISA 600 requires the group engagement team to determine:
- Materiality for the group financial statements as a whole when establishing the overall group audit strategy.
  - Specific materiality for classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.
  - Component materiality for those components where component auditors will perform an audit or review for purposes of the group audit.<sup>116</sup>
223. In addition, the group engagement team is required to evaluate the appropriateness of performance materiality determined at the component level (which may be accomplished by the group engagement team either establishing component performance materiality, or evaluating component performance materiality determined by the component auditor).<sup>117</sup>
224. If a component has been or will be audited on a standalone basis (e.g., for statutory or regulatory purposes) and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team is required to determine that the materiality used in the audit of the component financial statements as a whole, and the related performance materiality for the component, would comply with the requirements of ISA 600.<sup>118</sup>

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<sup>114</sup> ISA 320, *Materiality in Planning and Performing an Audit*

<sup>115</sup> As ISA 320 is revised, changes to ISA 450, *Evaluation of Misstatements Identified during the Audit*, will also likely be required.

<sup>116</sup> ISA 600, paragraphs 21 and A42–A45

<sup>117</sup> ISA 600, paragraph 22 and A46

<sup>118</sup> ISA 600, paragraph 23

225. ISA 600 requires that component materiality be set at a level lower than materiality for the financial statements as a whole.<sup>119</sup>

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

226. The IAASB is open to the possibility of developing more topic-specific guidance in this area. However, any actions taken should not infringe on the basic principles in ISA 320 until a more holistic review of that standard has been undertaken as explained above. Examples of topic-specific guidance could include:

- More guidance about the concepts of component materiality and component performance materiality and their relevance in a group audit, including how they are expected to be used;
- Further consideration of matters that are specifically relevant to component materiality in the context of group audits particularly in relation to the concept of aggregation risk; and
- How materiality is to be applied in situations when procedures other than audits of financial information of components are being performed (e.g., when auditing one or more account balances, classes of transactions or disclosures or when performing specified audit procedures in terms of paragraphs 27(b) and (c) of ISA 600).

**Questions**

31. Do you agree with the possible actions recommended in:

- Paragraph 215–216 to enhance the group engagement team's understanding of the component and consequential identification of significant risks? Are there any other matters that should be considered when assessing and responding to significant risks in a group audit?
- Paragraph 217 to strengthen the requirements and application material related to significant risks that have been identified at the component level?
- Paragraph 218 to clarify the identification of significant components?
- Paragraph 219 to clarify what “of financial significance to the group” means.

If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

32. Do you agree with the possible actions recommended in paragraph 226 to clarify the different aspects of materiality in a group audit? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

**Responding to Identified Risks of Material Misstatement in a Group Audit**

**ISSUES RELATING TO AUDIT PROCEDURES PERFORMED ON THE COMPONENT'S FINANCIAL INFORMATION**

227. ISA 600 focuses on the responsibilities of the group engagement team as opposed to the responsibilities of the component auditor (who may have separate responsibilities relating to

<sup>119</sup> ISA 600, paragraph 21 (c) and A43

standalone reporting requirements in their own jurisdiction, at the component level). The forepart of the ITC further discusses the possibility of the development of separate requirements and related application material dealing with responsibilities of the component auditor (see paragraphs 41–42).

228. Challenges have been noted with respect to the nature, timing and extent of procedures being performed on the component's financial information. The group engagement team or component auditor perform one or more of the following on individual non-significant components:
- An audit of the financial information of the component using component materiality.
  - An audit of one or more account balances, classes of transactions or disclosures.
  - A review of the financial information of the component using component materiality.
  - Specified procedures.<sup>120</sup>
229. Questions have arisen as to the meaning of “an audit of financial information of the component using component materiality”; in particular whether it means (and therefore requires) applying all the ISAs, or whether it means only applying those ISAs or those requirements in specific ISAs that are relevant in the circumstances.
230. The circumstances under which a component auditor performs its work may result in different considerations about how such work is planned and performed. Some examples of scenarios that affect the performance of work at the component level include the following:
- The materiality for the component for purposes of the group audit will likely be higher than the materiality that is required to be used when a component auditor is issuing an auditor's report on the component's standalone financial statements. Challenges may arise when planning and performing the work for both purposes, especially when the timing is not aligned (i.e., work done to support the group audit is sometimes required to be completed sooner to support earlier group reporting deadlines.)
  - Certain audit procedures may be performed centrally by the group engagement team for purposes of the group audit, and consequently, it may not be necessary for further audit procedures to be performed on the related financial information of the component. For example, the identification and assessment of risks, and planning and performance of procedures related to litigation and claims might be performed by the group engagement team on a group-wide basis, even though the component financial information may include related accounts and disclosures.
  - When the only reporting on the component's financial information is to the group auditor<sup>121</sup> (e.g., through a clearance memorandum), in addition to not applying the ISA reporting standards, the component auditor may also not address other requirements of other ISAs when these procedures are done centrally for the group as a whole (e.g., may not obtain written representations from component management or may not obtain separate communications from legal counsel). This situation applies to significant as well as non-significant components.

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<sup>120</sup> ISA 600, paragraph 29

<sup>121</sup> For example, under ISA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* or ISA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

231. Further challenges have been noted in instances where some balances are audited centrally (e.g., at a SSC) or in the aggregate by the group engagement team (or potentially one of the component auditors or another auditor involved in the engagement). The work performed on group-level balances may also be important to a component auditor's conclusions when an auditor's report on the separate financial statements of the component are issued (e.g., for statutory or other purposes). In such instances, there is a need for relevant information to be communicated to the component auditor by the group engagement team (or a component auditor or other auditor who has performed the work).

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

232. ISA 600 includes requirements and guidance for determining the type of work to be performed on significant and non-significant components.<sup>122</sup> However, ISA 600 does not deal explicitly with some of the practical challenges set out in paragraphs 227–231 above.

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

233. Making the distinction between work performed for the purposes of the group audit and work performed to support a stand-alone opinion at the component level more clear, and providing more application material on relevant considerations for the component auditor in the different circumstances, may help clarify the work to be performed on the components, including for significant and non-significant components. For example, possible actions that may be helpful could include additional clarity in the requirements and application material to:
- Clarify what an “audit of financial information of the component using component materiality” means in the specific circumstances (e.g., it could be clarified that an audit of the financial information of a component for the purposes of the group audit, where there is no statutory or other requirement for an audit, may not necessarily mean applying *all* requirements in *all* ISAs in *all* circumstances).
  - Provide additional guidance to distinguish audit procedures that would be necessary when standalone auditor's reports are also required at the component level.
  - More clearly distinguish between the types of procedures that could be performed and in which circumstances they might be appropriate, e.g., through providing examples of “specified audit procedures” in specific circumstances and distinguishing them from “an audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement.”
234. Additional application material about the implications in situations where balances are audited centrally would also help clarify the procedures to be performed at the components (including in situations when the work is supporting standalone component auditor's reports in addition to the report on the group financial statements). For example, goodwill impairment may be audited centrally, and further application material could be provided for component auditors about their considerations relating to goodwill amounts that have been allocated to the component (including any charges for goodwill impairment) and the necessary procedures (if any) at the component level.

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<sup>122</sup> ISA 600, paragraphs 26–31 and A47–A53

**ISSUES RELATING TO SITUATIONS WHERE THERE ARE ONLY NON-SIGNIFICANT COMPONENTS, OR A LARGE NUMBER OF NON-SIGNIFICANT COMPONENTS**

235. In responding to assessed risks, ISA 600 requires the group engagement team to determine the type of work to be performed on the financial information of components. In setting forth requirements for the necessary work effort, the standard distinguishes between components that are significant<sup>123</sup> and those that are not significant (i.e., “non-significant”).<sup>124</sup>
236. Paragraph 29 of ISA 600 requires consideration of additional work if the group engagement team does not consider that sufficient appropriate audit evidence will be obtained without performing work at non-significant components. The standard does not specifically require that in making the determination as to what work is necessary, the group engagement team should consider whether risks of material misstatement remain that are not addressed by work performed on significant components and at the group level. Determining the approach and work necessary is particularly challenging when there are a large number of components, none of which are significant individually but which in aggregate represent one or more risks of material misstatement. As a result, audit regulators have expressed concerns that in some cases, the work being performed on ‘residual balances’ (i.e., those pertaining to components that are not significant and not otherwise selected for testing) is inadequate and not supported by a robust assessment of whether risks of material misstatement have been properly addressed.

REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

237. ISA 600 sets out requirements and guidance for procedures that may be relevant for group engagement teams or component auditors to perform in respect to components that are not significant components<sup>125</sup>. In addition to analytical procedures performed at the group level, procedures may include selecting non-significant components and performing audits of financial information or of select account balances, performing reviews of financial information or specified procedures. The application guidance includes factors to consider when selecting components and indicates that the selection of components is often varied on a cyclical basis.<sup>126</sup>

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

238. Strengthening the requirements (with related application material) to address the auditor’s considerations about the work to be performed on non-significant components, in addition to the work to be performed on significant components, may reinforce the need for, and assist group engagement teams in appropriately considering the sufficiency of audit evidence in totality for the group audit.
239. Furthermore, while paragraph A53 of ISA 600 addresses the situation where a group may be comprised of components that are not significant components, there is limited guidance on how the group engagement team should determine which components would require procedures and how to determine when a sufficient number of components have been selected for the performance of such procedures. Additionally, as it is not clear as to when the various procedures described in

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<sup>123</sup> ISA 600, paragraphs 26–27

<sup>124</sup> ISA 600, paragraphs 28–29

<sup>125</sup> ISA 600, paragraphs 28–29

<sup>126</sup> ISA 600, paragraph A51

paragraph 29 would be appropriate, additional guidance would be helpful in guiding auditors in making informed decisions. In particular, it may be appropriate to provide application guidance to clarify how review procedures provide audit evidence and whether there is a difference between the “specified audit procedures” described in paragraph 27 (c) and the “specified procedures” referred to in paragraph 29.

#### **ISSUES RELATING TO THE GROUP ENGAGEMENT TEAM’S INVOLVEMENT IN THE CONSOLIDATION PROCESS**

240. Group structures may necessitate consolidation processes at levels below those of the overall group (i.e., sub-consolidations). As part of obtaining its understanding of the entity, the group engagement team would need to determine whether consolidations of financial information take place at the sub-consolidation level. It has also been noted that various issues could arise when these sub-consolidations are audited by component auditors, and the group engagement team is not sufficiently involved, because the component auditors may not have the full context of the group-wide risks. Issues arising could include:
- Insufficient information for the group engagement team to understand the consolidation entries processed in the sub-consolidation, some of which may be material to the group.
  - Failure by the component auditor to appropriately consider the accounting for or processing of group-wide journal entries necessary for the sub-consolidation process (e.g., as a result of differing accounting policies used by the components and at the consolidated level).
  - Ineffective controls over the consolidation process that are not considered by the group engagement team.
241. Many factors may affect the necessary level of involvement of the group engagement team in sub-consolidations, including with respect to understanding the controls over the consolidation process at the sub-consolidation level(s). These factors may also affect the group engagement team’s assessed risks of material misstatement in the consolidation process. It has been suggested that additional perspectives are sought about whether more application material could be included in the standard about consideration of internal control relevant to the audit and the entity’s financial reporting process used to prepare the consolidated financial statements through making the link to relevant requirements and application material in ISA 315 (Revised).

#### **REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL**

242. As part of the required understanding of the group, its components and their environments, the group engagement team is required to obtain an understanding of the consolidation process,<sup>127</sup> with a further requirement that this includes an understanding of the instructions issued by group management to components. The group engagement team is also required to test the operating effectiveness of controls as appropriate and perform substantive procedures on the consolidation process to respond to the assessed risks of misstatement of the group financial statements arising from the consolidation process.<sup>128</sup>

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<sup>127</sup> ISA 600, paragraph 17(b)

<sup>128</sup> ISA 600, paragraphs 32–33

243. The standard also requires the group engagement team to:
- Evaluate the appropriateness, completeness and accuracy of the consolidation adjustments.<sup>129</sup>
  - Evaluate whether appropriate consolidation adjustments have been made to the components for differences in accounting policies.<sup>130</sup>
  - Determine that the correct component information has been consolidated.<sup>131</sup>
  - Make appropriate adjustments for components that have different financial reporting periods.<sup>132</sup>
244. Notwithstanding that the requirements on the consolidation process are robust, it has been noted that there is no specific guidance in ISA 600 on the group engagement team's expected involvement in any sub-consolidation processes.

POSSIBLE ACTIONS TO ADDRESS THE ISSUES

245. The IAASB is of the preliminary view that ISA 600 includes appropriate requirements and application material addressing the required understanding and evaluation of the consolidation process at the overall group level.
246. However, to address the challenges in this area, new application material could link, or build on, the requirements and application material in ISA 220 in respect of the engagement partner's responsibilities for the direction, supervision, performance and review of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements. Such new application material could also include recognition that component auditors would likely not have the "full picture" of the group that the group engagement team has, and therefore may not be in a position to properly evaluate the completeness and accuracy of all consolidation adjustments at the sub-consolidation level.
247. In addition, the link to ISA 315 (Revised) could also be made clearer. In particular, ISA 600 could be enhanced by more explicitly linking to the relevant requirements and application material in ISA 315 (Revised), (which requires the auditor to obtain an understanding of internal control relevant to the audit and the financial reporting process used to prepare the entity's financial statements),<sup>133</sup> and adding more application material to ISA 600 to explain how this might apply in the context of a group audit, specifically when sub-consolidations exist.
248. Additionally some aspects of the examples of matters to consider when understanding the consolidation process currently contained in Appendix 2 of ISA 600 could be considered for elevation in status to application material or to requirements.

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<sup>129</sup> ISA 600, paragraph 34

<sup>130</sup> ISA 600, paragraph 35

<sup>131</sup> ISA 600, paragraph 36

<sup>132</sup> ISA 600, paragraph 37

<sup>133</sup> ISA 315 (Revised), paragraph 18

### Questions

33. Do you agree with the possible actions recommended in paragraphs 233–234 to distinguish the different types of audit work at the components in varying circumstances? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.
34. Do you agree with the possible actions recommended in paragraphs 238–239 to strengthen the requirements and application material relating to the work to be performed on non-significant components, as well as situations where the components are all non-significant components? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.
35. Do you agree with the possible actions recommended in paragraphs 245–248 in relation to the engagement team’s involvement in the consolidation process? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

## Review and Evaluation of the Work of Component Auditors by the Group Engagement Team

### ISSUES RELATING TO EVALUATING THE COMMUNICATIONS FROM THE COMPONENT AUDITOR AND THE ADEQUACY OF THEIR WORK

249. ISA 600 allows flexibility as to the necessary level of involvement in the work of the component auditors by the group engagement team, including as it relates to the review of component auditors’ audit documentation. The group engagement team determines how to evaluate the component auditor’s communications and the adequacy of their work based on an assessment of the circumstances of the engagement, and with respect to each component and its respective component auditors.<sup>134</sup>
250. As discussed in paragraph 197–198 the level and manner of the group engagement team’s involvement in the work of the component auditors will vary based on the circumstances of the group engagement. The nature and extent of documentation on the group audit file relating to the evaluation by the group engagement team of the component auditor’s findings also varies significantly, and may, for example, as it relates to reviewing the work of component auditors, range from including documentation of a review by the group engagement team of selected working papers prepared by the component auditors, to including copies of the working papers of the component auditor in the group audit file.
251. Concerns have been raised that the flexibility in ISA 600 regarding the nature, timing and extent of necessary involvement in the work of the component auditors, including the review of component auditors’ audit documentation, has led to inadequate demonstration by the group engagement team that an appropriate evaluation of the component auditors’ findings has been undertaken. It has been noted in particular that the requirement in paragraph 42(b) relating to reviews of component auditor’s audit documentation and the related application guidance in paragraph A61 are not sufficiently detailed to provide appropriate direction to group engagement teams in this regard. In

<sup>134</sup> ISA 600, paragraphs 42(a) and (b), 43 and A61

addition, it has been suggested that issues may sometimes arise because the review of the component auditors' documentation (including working papers and conclusions) by the group engagement team is not sufficiently documented in the group audit documentation. Therefore, challenges exist related to the group engagement team being able to adequately support the significant judgments made in relation to this review.

#### REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL

252. ISA 600 requires the group engagement team evaluate the component auditor's communication of the matters referred to in paragraph 41 and in particular to discuss significant matters arising from the component auditor's communications, as appropriate, and to determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.<sup>135</sup>
253. In addition, as part of the required evaluation of the sufficiency and appropriateness of the audit evidence obtained, the application material notes that the component auditor may also review the component auditor's audit documentation that is relevant to the group audit, the extent of which may vary depending on the circumstances.<sup>136</sup>

#### POSSIBLE ACTIONS TO ADDRESS THE ISSUES

254. The requirement in paragraph 42(b) in ISA 600 and the related application material regarding the work effort of the group engagement team in relation to the component auditor's findings and reviewing the component auditor's working papers may be clarified provide additional support and guidance to the group engagement team and therefore result in better demonstration of the judgments made by the group engagement team as to the appropriateness of their involvement. For example, to encourage the group engagement team to review the work of the component auditor to fully understand the extent and quality of the procedures performed by the component auditors, the requirements and related application guidance could potentially be revised to provide more clarity on when reviews would be appropriate and about the procedures that the group engagement team would perform in the review. However, care will be needed to ensure that, all other things being equal, the extent of the review required by the group engagement team does not exceed that which would be undertaken in a non-group audit situation. In addition, further consideration will be given in the quality control project to the involvement and review by the engagement quality control reviewer (see further discussion in paragraphs 133–140).
255. Further consideration could also be given to strengthening the documentation requirements regarding the group engagement team's evaluation of the component auditors' communication, including the nature of any review of documentation that was performed by the group engagement team, specifically linking to the requirements in ISA 230.<sup>137</sup> These matters need to be considered in light of the fact that the work of the component auditors is likely already reviewed by the engagement partner responsible for the work at the component, and that, all other things being equal, this review should not exceed the nature and extent of review by an engagement partner of another partner's work in a non-group situation.

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<sup>135</sup> ISA 600, paragraphs 42 (a) and (b)

<sup>136</sup> ISA 600, paragraph A61

<sup>137</sup> ISA 230, paragraph 8

**ISSUES RELATING TO THE EVALUATION OF THE WORK OF THE COMPONENT AUDITORS ON THE GROUP AUDIT ENGAGEMENT**

256. In evaluating whether sufficient appropriate evidence has been obtained, the group engagement team considers the findings of the component auditors that have been communicated. In some cases, the group audit documentation may not explicitly demonstrate the group engagement team's judgements, as appropriate, in relation to the findings of the component auditors. For example, some audit oversight bodies and regulators have noted that there is insufficient consideration of the effect on the group audit of the component auditor's findings, including the evaluation of whether sufficient appropriate audit evidence has been obtained.

**REFERENCES TO EXISTING REQUIREMENTS AND APPLICATION MATERIAL**

257. The group engagement team is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enabling reasonable conclusions on which to base the auditor's opinion to be drawn.<sup>138</sup> The group engagement team is required to evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.<sup>139</sup> The group engagement team's evaluation of the adequacy of the component auditor's work will help conclude whether sufficient, appropriate audit evidence to support the group audit opinion has been obtained.

**POSSIBLE ACTIONS TO ADDRESS THE ISSUES**

258. Strengthening the documentation requirement for the group engagement team about their significant judgments in relation to the findings of the component auditors may help address some of the concerns about the demonstration of the group engagement team's evaluation of the sufficiency and appropriateness of audit evidence for the group as a whole. For example, requiring the group engagement team to document that they have considered whether a component auditor finding for one component gives rise to increased risk where similar circumstances exist in other components.

**Questions**

36. Do you agree with the possible actions recommended in paragraph 254–255 to strengthen the requirements relating to the involvement in the work of the component auditors, including review of the component auditor's documentation by the group engagement team? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.
37. Do you agree that strengthening the documentation requirements as noted in paragraph 258 will help demonstrate the group engagement team's considerations regarding the findings of the component auditor? If not, please indicate which actions are not appropriate and describe why. Please also describe any additional actions that you think would be appropriate.

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<sup>138</sup> ISA 200, paragraph 17

<sup>139</sup> ISA 600, paragraph 44

## Other Issues Relating to Group Audits

### DISCLOSURES IN GROUP FINANCIAL STATEMENTS

259. In the recently completed Disclosures project, it was identified that the ISAs needed to specifically address the group engagement team's considerations of the impact of component financial statement information on the disclosures in the group financial statements (i.e., that ISA 600 needed to be strengthened in that regard). As the project proposal for addressing issues identified in group audits is developed, consideration will be specifically given to developing application material for consideration about group financial statement disclosures in all aspects of ISA 600 (i.e., in a similar approach to how ISAs were made across aspects of the ISAs in the Disclosures project).

#### Overall Questions

The following apply to all the issues and possible actions set out in relation to group audits:

38. Are there any other standard-setting actions that would be appropriate to address the issues identified in this section of the ITC? If yes, please provide details about the specific actions and describe why they would be appropriate.
39. Are there any other specific actions, including by others, that could address the issues that have been set out in this section of the ITC? If yes, please provide details and describe why the actions would be appropriate.