

**International Auditing and  
Assurance Standards Board®**

**Supplement to the  
Handbook of International  
Quality Control, Auditing,  
Review, Other Assurance,  
and Related Services  
Pronouncements**

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**SUPPLEMENT TO THE HANDBOOK OF INTERNATIONAL  
QUALITY CONTROL, AUDITING, REVIEW, OTHER  
ASSURANCE, AND RELATED SERVICES  
PRONOUNCEMENTS**

**PART III**

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## **A FRAMEWORK FOR AUDIT QUALITY: KEY ELEMENTS THAT CREATE AN ENVIRONMENT FOR AUDIT QUALITY**

### **The IAASB's Vision for the Framework of Audit Quality**

The objectives of the Framework for Audit Quality include:

- Raising awareness of the key elements of audit quality.
- Encouraging key stakeholders to explore ways to improve audit quality.
- Facilitating greater dialogue between key stakeholders on the topic.

The IAASB expects that the Framework will generate discussion, and positive actions to achieve a continuous improvement to audit quality.

Auditors are required to comply with relevant auditing standards and standards of quality control within audit firms, as well as ethics and other regulatory requirements. The Framework is not a substitute for such standards, nor does it establish additional standards or provide requirements for the performance of audit engagements.

## Foreword

Financial information should be relevant, timely and reliable to meet the needs of users. National laws and regulations, as well as an entity's stakeholders, often require an external audit of some elements of the financial information to give users confidence that the information can be trusted. For an external audit to fulfill its objective the users of audited financial statements must have confidence that the auditor has worked to a suitable standard and that "a quality audit" has been performed.

The term "audit quality" is frequently used in debates 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, as outlined in Appendix 1, there is no definition or analysis of it that has achieved universal recognition.

For this reason, the International Auditing and Assurance Standards Board (IAASB) has developed a Framework for Audit Quality (the 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 Framework also demonstrates the importance of appropriate interactions among stakeholders and the importance of various contextual factors.

The IAASB believes that such a Framework is in the public interest as it will:

- Encourage national audit firms, international networks of audit firms, and professional accountancy organizations to reflect on how to improve audit quality and better communicate information about audit quality;
- Raise the level of awareness and understanding among stakeholders of the important elements of audit quality;
- Enable stakeholders to recognize those factors that may deserve priority attention to enhance audit quality. For example, the Framework could be used to inform those charged with governance about audit quality and encourage them to consider their roles in enhancing it;
- Assist standard setting, both internationally and at a national level. For example, the IAASB will use the Framework when it revises International Standard on Quality Control (ISQC) 1<sup>1</sup> and the International Standards on Auditing (ISAs). It may also assist the International Ethics Standards Board for Accountants (IESBA) and International Accounting Education Standards Board (IAESB) in considering improvements to their authoritative pronouncements;

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<sup>1</sup> International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

- Facilitate dialogue and closer working relationships between the IAASB and key stakeholders as well as among these key stakeholders themselves;
- Stimulate academic research on the topic; and
- Assist students of auditing to more fully understand the fundamentals of the profession they are aspiring to join.

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## Overview

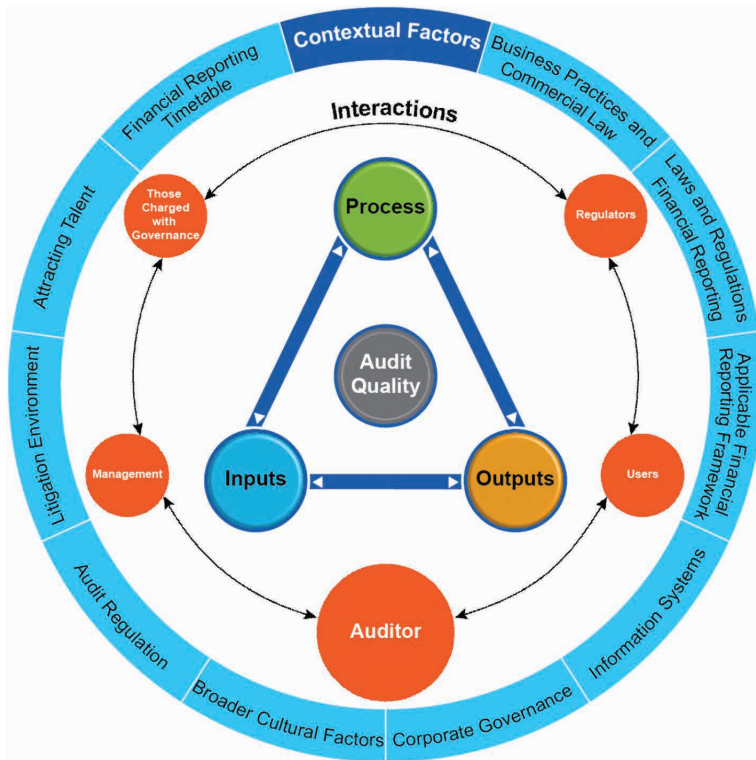
1. The term **audit quality** encompasses the key elements that create an environment which maximizes the likelihood that quality audits are performed on a consistent basis.
2. The objective of an audit of financial statements is for the auditor to form an opinion on the financial statements based on 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.
3. The responsibility for performing quality audits of financial statements rests with auditors. However, audit quality is best achieved in an environment where there is support from, and appropriate interactions among, participants in the financial reporting supply chain.
4. The Framework is aimed at raising awareness of the key elements of audit quality, thereby encouraging auditors, audit firms and other stakeholders to challenge themselves about whether there is more they can do to increase audit quality in their particular environments.
5. The Framework applies to audits of all entities regardless of their size, nature, and complexity. It also applies to all audit firms regardless of size, including audit firms that are part of a network or association. However, the attributes of audit quality described in this Framework vary in importance and affect audit quality in different ways.
6. Auditors are required to comply with relevant auditing standards and standards of quality control for audit firms, as well as ethics and other regulatory requirements. In particular, ISQC 1<sup>2</sup> addresses a firm's responsibilities for its system of quality control for audits. The Framework is not a substitute for such standards, nor does it establish additional standards or provide procedural requirements for the performance of audit engagements.

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<sup>2</sup> ISQC 1 requires audit firms to establish and maintain a system of quality control to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and that reports issued by the firm or engagement partners are appropriate in the circumstances.

7. While the quality of an individual audit will be influenced by the inputs, processes, outputs and interactions described in this Framework, the Framework for Audit Quality, by itself, is not sufficient for the purpose of evaluating the quality of an individual audit. This is because detailed consideration will need to be given to matters such as the nature, timing and extent of audit evidence obtained in response to the risks of material misstatement in a particular entity, the appropriateness of the relevant audit judgments made, and compliance with relevant standards.
8. The Framework distinguishes the following elements:
  - (a) Inputs
  - (b) Process
  - (c) Outputs
  - (d) Key Interactions within the Financial Reporting Supply Chain
  - (e) Contextual Factors

The Framework can be depicted as follows:



## Inputs

9. Inputs are grouped into the following input factors:
  - (a) The values, ethics and attitudes of auditors, which in turn, are influenced by the culture prevailing within the audit firm; and
  - (b) The knowledge, skills, and experience of auditors and the time allocated for them to perform the audit.
10. Within these input factors, quality attributes are further organized between those that apply directly at:
  - (a) The audit engagement level;
  - (b) The level of an audit firm, and therefore indirectly to all audits undertaken by that audit firm; and
  - (c) The national (or jurisdictional) level and therefore indirectly to all audit firms operating in that country and the audits they undertake.
11. Appendix 2 describes, in more detail, the quality attributes of input factors for the engagement, firm, and national levels.
12. The inputs to audit quality will be influenced by the context in which an audit is performed, the interactions with key stakeholders and the outputs. For example, laws and regulations (context) may require specific reports (output) that influence the skills (input) utilized.

## Process

13. The rigor of the audit process and quality control procedures impact audit quality. Appendix 2 describes in more detail the quality attributes of this process factor for engagement, firm and national levels.

## Outputs

14. Outputs include reports and information that are formally prepared and presented by one party to another, as well as outputs that arise from the auditing process that are generally not visible to those outside the audited organization. For example, these may include improvements to the entity's financial reporting practices and internal control over financial reporting, that may result from auditor findings.
15. The outputs from the audit are often determined by the context, including legislative requirements. While some stakeholders can influence the nature of the outputs, others have less influence. Indeed, for some stakeholders, such as investors in listed companies, the auditor's report is the primary output.

### **Key Interactions within the Financial Reporting Supply Chain**

16. While each separate stakeholder in the financial reporting supply chain plays an important role in supporting high-quality financial reporting, the way in which the stakeholders interact can have a particular impact on audit quality. These interactions, including both formal and informal communications, will be influenced by the context in which the audit is performed and allow a dynamic relationship to exist between inputs and outputs. For example, discussions between the auditor and the audit committee of a listed company at the planning stage can influence the use of specialist skills (input) and the form and content of the auditor's report to those charged with governance (output). In contrast, for privately owned businesses, there may be close proximity to the owners during the course of the audit. In these circumstances, there may be frequent informal communications, which contribute to audit quality.

### **Contextual Factors**

17. There are a number of environmental – or contextual – factors, such as laws and regulations and corporate governance, which have the potential to impact the nature and quality of financial reporting and, directly or indirectly, audit quality. Where appropriate, auditors respond to these factors when determining how best to obtain sufficient appropriate audit evidence.

## 1. Input Factors

1. Quality audits involve auditors:
  - Exhibiting appropriate values, ethics and attitudes; and
  - Being sufficiently knowledgeable, skilled, and experienced and having sufficient time allocated to them to perform the audit work.
2. Key attributes that influence audit quality are described below. These attributes apply at the audit engagement level, at the audit firm level, and at a national (or jurisdictional)<sup>3</sup> level. Each attribute and level is described in separate sections.

### 1.1 Values, Ethics and Attitudes – Engagement Level (Ref.: Para. 2-16 Appendix 2)

3. The audit engagement partner<sup>4</sup> is responsible for an audit engagement and therefore is directly responsible for the quality of the audit. In addition to taking responsibility for the performance of the audit, the audit, the audit engagement partner has a critical role in ensuring that the engagement team exhibits the values, ethics and attitudes necessary to support a quality audit.

Key attributes are:

- The engagement team recognizes: that the audit is performed in the wider public interest; and the importance of complying with ethical requirements.<sup>5</sup>
- The engagement team exhibits objectivity and integrity.
- The engagement team is independent.
- The engagement team exhibits professional competence and due care.
- The engagement team exhibits professional skepticism.

### 1.2 Values, Ethics and Attitudes – Firm Level (Ref.: Para. 17-32 Appendix 2)

4. 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

<sup>3</sup> A jurisdiction can be larger or smaller than a country. In some areas of the world some aspects of audit regulation span a number of countries. In some countries aspects of audit regulation are undertaken by smaller units such as states or provinces.

<sup>4</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

<sup>5</sup> The *Code of Ethics for Professional Accountants* issued by the International Ethics Standards Board for Accountants (IESBA Code) identifies five fundamental principles of professional ethics for professional accountants: integrity; objectivity; professional competence and due care; confidentiality; and professional behavior.

mindset of partners and staff, and consequently the way they discharge their responsibilities. While the audit is designed to protect the public interest, audit firms are often commercial entities. Each firm's culture will be an important factor in determining how its partners and staff function in the public interest and at the same time achieve the firm's commercial goals.

5. 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.

1.3 **Values, Ethics and Attitudes – National Level** (Ref.: Para. 33-40 Appendix 2)

6. National audit regulatory activities have an important influence on the culture within firms and the values, ethics and attitudes of audit partners and other members of the engagement team. Key attributes are:
- Ethics requirements are promulgated that make clear both the underlying ethics principles and the specific requirements that apply.
  - Regulators, national standards setters and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied.
  - Information relevant to client acceptance decisions is shared between audit firms.

1.4 **Knowledge, Skills, Experience and Time – Engagement Level** (Ref.: Para. 41-58 Appendix 2)

7. The audit engagement partner is responsible for being satisfied that the engagement team collectively has the appropriate competences and that the team has sufficient time to be able to obtain sufficient appropriate audit evidence before issuing the audit opinion.

8. Key attributes are:
- Partners and staff have the necessary competences
  - Partners and staff understand the entity’s business.
  - Partners and staff make reasonable judgments.
  - The audit engagement partner is actively involved in risk assessment, planning, supervising, and reviewing the work performed.
  - Staff 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.
  - Partners and staff have sufficient time to undertake the audit in an effective manner.
  - The audit engagement partner and other experienced members of the engagement team are accessible to management and those charged with governance.
- 1.5 **Knowledge, Skills, Experience and Time – Firm Level** (Ref.: Para. 59-70 Appendix 2)
9. The audit firm’s policies and procedures will impact the required knowledge and experience of audit engagement partners and other members of the engagement team, and the time available for them to undertake the necessary audit work. Key attributes are:
- Partners and staff have sufficient time to deal with difficult issues as they arise.
  - Engagement teams are properly structured.
  - Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.
  - Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.
- 1.6 **Knowledge, Skills, Experience and Time – National Level** (Ref.: Para. 71-80 Appendix 2)
10. National activities can impact the competences of auditors. Key attributes are:
- Robust arrangements exist for licensing audit firms/individual auditors.
  - Education requirements are clearly defined and training is adequately resourced and effective.

- Arrangements exist for updating auditors on current issues and for providing training to them in new accounting, auditing or regulatory requirements.
- The auditing profession is well-positioned to attract and retain individuals with appropriate qualities.

## 2. **Process Factors**

11. Quality audits involve auditors applying a rigorous audit process and quality control procedures that comply with laws, regulations and applicable standards.

### 2.1 **Audit Process and Quality Control Procedures – Engagement Level** (Ref.: Para. 81-93 Appendix 2)

12. Audits need to be performed in accordance with auditing standards and are subject to the audit firm's quality control procedures, which comply with ISQC 1. These provide the foundation for a disciplined approach to risk assessment, planning, performing audit procedures and ultimately forming and expressing an opinion. Sometimes, audit firms' methodologies and internal policies and procedures provide more specific guidance on matters such as who undertakes specific activities, internal consultation requirements, and documentation formats.

13. While auditing standards and the audit firm's methodology will shape the audit process, the way that process is applied in practice will be tailored to a particular audit. Key attributes are:

- The engagement team complies with auditing standards, relevant laws and regulations, and the audit firm's quality control procedures.
- The engagement team makes appropriate use of information technology.
- There is effective interaction with others involved in the audit.
- There are appropriate arrangements with management so as to achieve an effective and efficient audit process.

### 2.2 **Audit Process and Quality Control Procedures – Firm Level** (Ref.: Para. 94-111 Appendix 2)

14. The audit firm's policies and procedures will impact the audit process. Key attributes that contribute to audit quality are:

- The audit methodology is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.
- The audit methodology encourages individual team members to apply professional skepticism and exercise appropriate professional judgment.



- The methodology requires effective supervision and review of audit work.
- The methodology requires appropriate audit documentation.
- Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action is taken.
- Where required, effective engagement quality control reviews (EQCRs) are undertaken.

2.3 **Audit Process and Quality Control Procedures – National Level** (Ref.: Para. 112-119 Appendix 2)

15. National audit regulatory activities can impact the audit process.
16. ISAs are issued by the IAASB. The International Ethics Standards Board for Accountants (IESBA) sets high-quality ethics standards for professional accountants through the development of a robust, internationally appropriate Code of Ethics for Professional Accountants. The International Accounting Education Standards Board (IAESB) develops and enhances professional accountancy education—encompassing technical competence, as well as professional skills, values, ethics, and attitudes for professional accountants—through the promulgation of International Education Standards (IESs). There is widespread adoption of these standards at a national level. Key attributes are:
- Auditing and other standards are promulgated that make clear the underlying objectives as well as the specific requirements that apply.
  - Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.
  - Effective systems exist for investigating allegations of audit failure and taking disciplinary action when appropriate.

### 3. **Output Factors**

17. Different stakeholders receive different outputs from an audit. These outputs are likely to be evaluated in terms of their usefulness and timeliness, and be seen as aspects of audit quality. They may also:
- Provide broader insights into audit quality. For example, reports from audit regulators are likely to describe weaknesses that have been identified from inspection activities; and
  - Directly impact audit quality. For example, having a specific responsibility to report on a matter, such as the effectiveness of internal controls, may result in more robust work in that area.

18. Some stakeholders, especially management, those charged with governance and some regulators, have more direct insights into some of the inputs to audit quality and are therefore better placed to evaluate it, at least in part. Outputs from these other stakeholders, for example, information provided by audit committees, may provide useful information on audit quality to external users.
19. Relevant outputs may include:

Level	Outputs
<p>3.1 <b>Engagement Level</b></p>	<p><b>From the Auditor</b></p> <p>3.1.1 Auditor’s Reports to Users of Audited Financial Statements</p> <p>3.1.2 Auditor’s Reports to Those Charged with Governance</p> <p>3.1.3 Auditor’s Reports to Management</p> <p>3.1.4 Auditor’s Reports to Financial and Prudential Regulators</p> <p><b>From the Entity</b></p> <p>3.1.5 The Audited Financial Statements</p> <p>3.1.6 Reports from Those Charged with Governance, including Audit Committees</p> <p><b>From Audit Regulators</b></p> <p>3.1.7 Regulators Providing Information on Individual audits</p>
<p>3.2 <b>Firm and National Levels</b></p>	<p><b>From the Audit Firm</b></p> <p>3.2.1 Transparency Reports</p> <p>3.2.2 Annual and Other Reports</p> <p><b>From Audit Regulators</b></p> <p>3.2.3 Providing an Aggregate View on the Results of Audit Firm Inspections</p>

### 3.1 **Outputs – Engagement Level**

#### 3.1.1 *Auditor's Reports to Users of Audited Financial Statements*

20. The primary output of an audit is an auditor's opinion that provides users with confidence as to the reliability of the audited financial statements. For the majority of users, the absence of a modified auditor's opinion is an important signal about the reliability of the financial information. The value of this signal may be influenced by a number of factors, including the reputation of the audit firm<sup>6</sup> that conducted the audit, and an assumption about the effectiveness of the audit process employed.
21. The auditor's report provides an opportunity for the auditor to provide information to give users some insights about the auditor's work and findings and therefore into the quality of the audit performed. However, this opportunity is not always taken by auditors and the auditor's report has, over the years, been standardized. Other than in circumstances when the auditor's opinion is modified, information is not usually provided about the auditor's work and findings.
22. In addition to expanding the information contained in the auditor's report, its usefulness may also be increased if it contains additional assurance on specific matters as required by law or regulations. In some cases, such assurance can be provided without extending the scope of the audit (for example, confirmation that management has provided to the auditor all the information and explanations required). In other cases, the scope of the audit needs to be extended (for example, providing assurance on the effectiveness of internal controls over financial reporting).
23. More information about the audit is usually provided by public sector auditors either in the main auditor's report or in a supplementary report that is publicly accessible. Additionally, public sector auditors sometimes carry out their work in an environment which gives citizens access to official documents. This freedom of information can result in the public sector auditor disclosing more detailed information about their audits, for example, on an entity's business risks and internal controls.

#### 3.1.2 *Auditor's Reports to Those Charged with Governance*

24. Auditing standards usually require the auditor to communicate with those charged with governance on specific matters on a timely basis. For example, ISAs<sup>7</sup> require communication about:

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<sup>6</sup> The audit firm's reputation is not specifically addressed in the Framework as it is not an element of audit quality but something that may emerge from sustained delivery of quality audits. There are a number of factors impacting a firm's reputation including its size, its marketing activities, and the degree to which it may be adversely affected by litigation or regulatory action.

<sup>7</sup> ISA 260, *Communication with Those Charged with Governance*

- The auditor’s responsibilities.
  - The planned scope and timing of the audit.
  - Information about threats to auditor objectivity and the related safeguards that have been applied.
  - The significant findings from the audit.
25. Such matters are often covered in written reports to those charged with governance. However, the requirements of auditing standards are expected to underpin wider and more extensive discussions between the auditor and those charged with governance. Those charged with governance are likely to evaluate the value and timing of both the written reports and the less formal communications when considering overall audit quality.
26. In relation to the quality and usefulness of communications, those charged with governance may particularly value auditor communications that provide:
- Unbiased insights regarding the performance of management in fulfilling its responsibilities for the preparation of the financial statements;
  - Insight into the entity’s financial reporting practices, including the operation of internal controls;
  - Recommendations for improvement to the entity’s financial reporting process; and
  - Information that enables them to effectively fulfill their governance responsibilities.

### 3.1.3 *Auditor’s Reports to Management*

27. During the course of the audit, the auditor will also have extensive communication with management. Many of these communications are informal but sometimes the auditor may decide, or management may request, the auditor to formalize observations in a written report. In such circumstances, management is likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.
28. Apart from communications on financial reporting issues, management may particularly value:
- Insights into, and recommendations for improvement in, particular areas of the entity’s business and systems;
  - Observations on regulatory matters; and
  - Global perspectives on significant industry issues or trends.
29. Management, in particular of smaller entities where resources may be limited, may value the business advice of the auditor. In such circumstances, the auditor must be cognizant of the threats to independence that may arise.

### 3.1.4 *Auditor's Reports to Financial and Prudential Regulators*

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

### 3.1.5 *The Audited Financial Statements*

32. Assurance enhances the credibility of financial reporting and potentially leads to improvement in the quality of financial reporting. For example, the audit may result in management making changes to the draft financial statements. These changes may be quantitative or qualitative in nature, such as clarification of disclosures in notes to the financial statements. While such changes are not usually transparent to users, faced with what they perceive to be high-quality financial statements, users may impute that a quality audit has been performed. The converse is certainly likely to be the case, i.e., faced with financial statements that contain arithmetical errors, inconsistencies and disclosures that are difficult to understand, in the absence of a qualified auditor's report, users may conclude that a poor quality audit has been performed.
33. In some jurisdictions entities are required to restate audited financial statements that had been found to contain material misstatements. The need for an entity to restate its financial statements may, depending on the reasons for the restatement, cause users to believe that there has been an audit failure.

### 3.1.6 *Reports from Those Charged With Governance, including Audit Committees*

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

### 3.1.7 *Regulators Providing Information on Individual Audits*

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

## 3.2 **Outputs – Firm and National Levels**

### 3.2.1 *Transparency Reports*

37. Audit firms may provide generic information on audit quality. 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>8</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.
38. 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.

### 3.2.2 *Annual and Other Reports*

39. Some audit firms issue annual reports. Annual reports provide an opportunity for these bodies to describe key performance indicators in relation to audit quality and initiatives undertaken to increase it. Such information may help them differentiate themselves on audit quality.
40. In addition, public sector audit bodies may issue other reports that draw general conclusions across the range of audits that they undertake, identifying common weaknesses in governance, accounting, and reporting. These reports may include recommendations for changes to general laws and regulations concerning government entities.

### 3.2.3 *Providing an Aggregate View on the Results of Audit Firm Inspections*

41. In many countries, audit regulators report annually on the outcome of audit inspection activities. The level of detail provided in such reports varies. In some

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<sup>8</sup> For European Union Member States, for example, the Statutory Audit Directive requires firms that audit public interest entities to disclose annually specified information covering the legal structure of audit firms, any network they are part of, corporate governance and quality control systems, financial information and information about the basis of partner remuneration.

countries, the reports aggregate the results of inspections of all audit firms; in other countries, reports are published for separate audit firms.

42. The publication of individual audit firm inspection reports may play an important role in relation to enhancing audit quality, including the perception of audit quality by key stakeholders (especially investors and users of audit reports). The debate on whether it is beneficial for audit regulators to report publicly on individual audit firms is finely balanced. Some believe that providing transparency on the inspection findings relating to individual audit firms will assist those charged with governance in fulfilling their responsibilities, and will have a positive impact on audit quality by giving firms the incentive to show year-on-year improvements in the quality of their work. Others believe that public reporting on audit-firm-specific findings may cause audit firms to adopt a more defensive approach to responding to the findings from inspections to the detriment of audit quality.

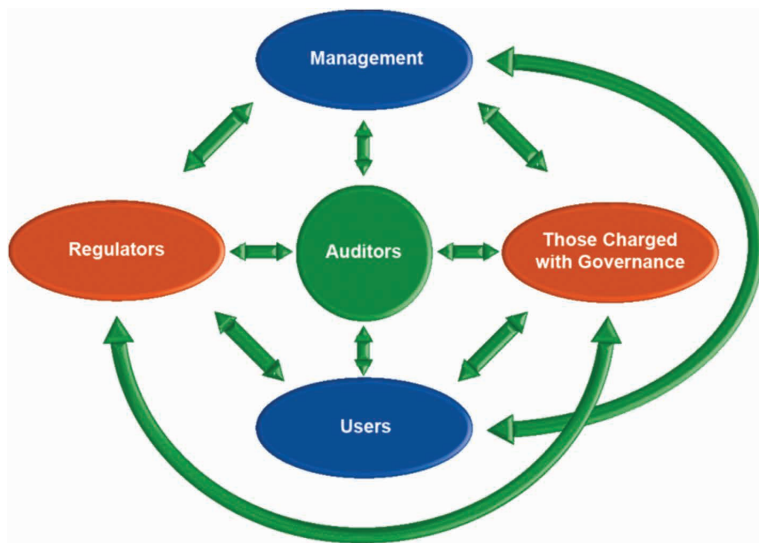
#### 4. **Key Interactions within the Financial Reporting Supply Chain**

43. In its 2008 report *Financial Reporting Supply Chain: Current Perspectives and Directions*,<sup>9</sup> the International Federation of Accountants (IFAC) describes the financial reporting supply chain as “the people and processes involved in the preparation, approval, audit, analysis and use of financial reports.”
44. IFAC observed that all the links in the chain need to be of high-quality and closely connected to supply high-quality financial reporting. While each separate link in the supply chain plays an important role in supporting high-quality financial reporting, the nature of the connections, or interactions, between the links can have a particular impact on audit quality.
45. It is through these interactions, including both formal and informal communications that participants in the supply chain can influence the behavior and views of others and thereby contribute to improvements in audit quality. The nature and extent of the interactions will be influenced both by the objectives of the individuals involved and the context in which the interactions take place.
46. The interactions described in the following sections are one-to-one interactions. However, there may be benefits to audit quality when auditors and key stakeholders meet together to discuss matters relevant to audit quality.

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

47. Some of the more important interactions<sup>10</sup> with regard to audit quality are described below.



#### 4.1 Interactions between Auditors and Management<sup>11</sup>

48. Management is responsible for the preparation of the financial statements and for such internal control necessary to ensure that the information for preparing the financial statements is reliable and available on a timely basis. Management is also responsible for ensuring that the financial statements comply with the applicable financial reporting framework and, where relevant, represent the underlying transactions and events in a manner that achieves fair presentation.
49. Full and timely access to relevant information and individuals both within and outside the entity assists the auditor in gathering audit evidence. An open and constructive relationship assists the auditor in identifying, assessing and responding to the risks of material misstatement, particularly with regard to complex or unusual transactions, or matters involving significant judgment or uncertainty. In the absence of cooperation and open dialogue, it is unlikely that a quality audit can be performed efficiently.
50. To assist audit efficiency, at an early stage in the audit the auditor is likely to discuss information needs with management and to agree an appropriate timetable. The auditor is also likely to discuss audit findings with management as they arise so that management can provide explanations on a timely basis or undertake additional analysis where necessary.

<sup>10</sup> This section deals only with external—that is, outside of the audit engagement team—interactions. Interactions within the audit engagement team are discussed in Section 1: Inputs.

<sup>11</sup> In many smaller entities there is little distinction between management and those charged with governance. An owner-manager will usually fulfill both roles.



51. An open and constructive relationship between auditors and management also helps create an environment in which management can benefit from auditors' observations on matters such as:
- Possible improvements to the entity's financial reporting practices.
  - Possible improvements in internal control over financial reporting.
  - New financial reporting requirements.
  - Perspectives on industry issues.
  - Observations on legal and regulatory matters.
52. An open and constructive relationship between the auditor and management needs to be distinguished from one of over-familiarity, which may occur when auditors spend extended periods during the year at the same audit client. It is vital for audit quality that auditors remain skeptical and objective and are prepared to challenge the reliability of the information they are given.
- 4.2 **Interactions between Auditors and Those Charged with Governance**
53. Those charged with governance are responsible for overseeing the strategic direction of the entity and its obligations related to accountability. This includes overseeing the entity's financial reporting process. In listed companies and other large entities, much of the work related to overseeing the entity's financial reporting process is often undertaken by an audit committee.
54. Effective two-way communication with auditors can assist those charged with governance in fulfilling these responsibilities. In particular, those charged with governance may benefit from the auditor's views on such matters as the financial reporting risks faced by the entity, the main areas of management judgment in the financial statements, and insights into the quality of the entity's financial reporting process including weaknesses in its internal financial controls. This information can assist those charged with governance to conclude on the fair presentation of the financial statements, especially if the auditor has concerns which have not been acted upon by management.
55. The auditor is required to communicate with those charged with governance (including the audit committee where one exists) about planning matters and the significant findings. Sometimes, effective communication is facilitated if at least one meeting, or part of a meeting, takes place without management in attendance. For smaller entities communication between the auditor and those charged with governance is often likely to be more frequent and less formal.
56. Those charged with governance are also in a position to influence the quality of the audit through:
- Providing views on financial reporting risks and areas of the business that warrant particular audit attention;

- Considering whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this;
- Considering independence issues and assessing their resolution;
- Assessing how management was challenged by the auditor during the audit, particularly with respect to the assessment of fraud risk, management’s estimates and assumptions, and the choices of accounting policies; and
- Creating an environment in which management is not resistant to being challenged by the auditors and is not overly defensive when discussing difficult or contentious matters.

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

57. In some countries, the regulatory framework provides users with an opportunity to interact, to some degree, with the auditors. For example, in a number of jurisdictions, proposals for the appointment, re-appointment or replacement of an entity’s auditor are required to be approved by the entity’s shareholders in the general meeting. Shareholders may also have the right to question the auditor on any significant matters pertaining to the audit in the general meeting. These interactions can provide an added motivation for auditors to perform quality audits.

58. Users may also wish to probe the rationale for a change in auditor. This will be facilitated when information related to the reasons for the changes are made publicly available on a timely basis.

59. Public sector auditors often have direct contact with primary users of the financial statements. It is not unusual for auditors to make presentations about their findings to the legislature or ministries (concerning government agencies of government-owned companies), as well as providing them with:

- Unbiased and politically neutral insights into the operations and financial reporting practices of the entity; and
- Constructive and timely recommendations in areas of performance (including value for money) and compliance with relevant mandates.

Such presentations may enhance the auditors’ knowledge of expectations of primary users of financial statements and provide the primary users with an opportunity to evaluate audit quality.

60. The auditing profession, in particular professional accountancy organizations, might at times organize forums, conferences, and other high level meetings and discussions, where auditors can engage with groups of financial statement users to discuss matters of relevance to audit quality.

#### 4.4 Interactions between Auditors and Regulators

61. There are a number of different types of regulators that impact the audit: regulators of the financial markets, of financial market participants, and of financial reporting (“financial regulators”); regulators of certain types of entities such as banks and insurance companies (“prudential regulators”); and regulators with direct oversight over some audit firms (“audit regulators”). In some countries, there are a number of financial and prudential regulators and it is beneficial for them to coordinate their activities related to audit quality.

##### 4.4.1 *Financial and Prudential Regulators*

62. In many respects, financial and prudential regulators and auditors have complementary concerns, although the focus of their concerns may be different. Appropriate sharing of information between these parties can therefore both enhance the regulatory process and contribute to audit quality.

63. An audit is important to financial and prudential regulators. These regulators usually require the financial statements of relevant entities to be audited, and sometimes extend the scope of the audit to include matters such as the effectiveness of the company’s system of internal financial control. In addition, these regulators sometimes request auditors to obtain assurance on specific matters.

64. In addition to formal reporting responsibilities, financial and prudential regulators may wish to be informed about matters that come to the auditor’s attention during the course of undertaking the audit. In the case of banking regulators, this may involve matters such as:

- Information that indicates a failure to fulfill one of the requirements of a banking license.
- Information that may indicate a material breach of laws and regulations.
- Material adverse changes in the risks of the banks’ business and going concern issues.

65. Financial and prudential regulators sometimes have information that, if known by the auditor, would impact the scope of the audit and potentially the auditor’s conclusions and audit opinion.

##### 4.4.2 *Audit Regulators*<sup>12</sup>

66. The formation of independent audit regulators in many countries tasked with the inspection of audit firms and individual audits provides an opportunity both for increasing audit quality and for making audit quality more transparent to users.

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<sup>12</sup> In the public sector, public sector audit bodies are usually not subordinated to external regulatory oversight. They answer to parliament, legislatures, or the equivalent, who from time to time may question the quality of audit activities.

67. Open communication between audit firms and the audit regulators will assist regulators to undertake their activities effectively. Furthermore, clear communication of the findings of audit inspections will enable audit firms to better understand the root causes of deficiencies identified and respond to them in a positive manner.
68. Dialogue between audit regulators in different countries, with the aim of promoting consistency of inspection approaches, will potentially strengthen global audit quality.<sup>13</sup>

#### 4.5 Interactions between Management and Those Charged with Governance

69. A strong commitment to honesty and integrity within an entity has a positive bearing on the quality and reliability of its financial reporting process. Such a culture, which is established and nurtured by those charged with governance working in conjunction with senior members of management, promotes the development and maintenance of appropriate accounting policies and processes as well as the open sharing of information that is necessary for high-quality financial reporting.
70. To achieve this, those charged with governance depend on a transparent and constructive relationship with management in assisting them to discharge their responsibility for oversight of the financial reporting process. This requires a willingness by management to come forward to discuss with those charged with governance matters such as:
- Identified, and potentially significant, issues relating to financial reporting and regulation.
  - Assumptions behind significant accounting judgments involved in the financial reporting process.
  - Areas where the financial reporting process may be strengthened.
71. If the auditor has concerns about the relationship between management and those charged with governance, the auditor is especially alert for significant deficiencies in internal control, errors in the financial reporting process and fraud risks. It will also be important for the auditor to seek to understand the reasons behind weaknesses in the relationship as the nature of any audit responses will depend on the circumstances. For example, an audit response where those charged with governance doubt management's integrity will differ from one where management harbors reservations about the competence of those charged with governance.

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<sup>13</sup> In an international context, the activities of the International Forum of Independent Audit Regulators (IFIAR) facilitate knowledge sharing and promote greater coordination among audit regulators. The IFIAR *Core Principles for Independent Audit Regulators* include that “*the Principles are intended to support cooperation between regulators and promote greater consistency of audit oversight.*” Further information about its activities can be found on its website: [www.ifiar.org](http://www.ifiar.org)

72. In extreme cases, where the auditor has serious concerns about the relationship between management and those charged with governance, the auditor considers whether an effective and efficient audit can be conducted, and therefore whether to continue the client relationship.

#### 4.6 **Interactions between Management and Regulators**

73. The extent to which financial regulators interact with management in relation to financial reporting varies between countries and industry sectors. Some financial regulators establish and enforce the financial reporting frameworks and may raise questions with management about aspects of the financial statements. This in turn, may cause management to raise issues with the auditor, which may impact audit quality in future years. Furthermore, in some sectors such as banking, prudential regulators may undertake direct supervisory activities that involve interaction with management. The auditor obtains an understanding of these interactions as they are a source of relevant information and perceptions.

#### 4.7 **Interactions between Management and Financial Statement Users**

74. Aside from issuing the financial statements themselves, management may interact with users, particularly investors, in a number of other ways, including through issuing press releases announcing significant transactions or events, and holding analyst briefings and other meetings with investors. Interactions between management and users provide opportunities to enhance the users' understanding of the financial statements. In addition, two-way interactions such as meetings between management and investors may provide an added motivation for management to achieve high-quality financial reporting.
75. More generally, users, such as institutional investors, can reinforce the importance of audit quality by taking an active interest in exploring with management matters on which the auditor has taken a public position – such as by modifying the audit opinion or issuing a statement to shareholders explaining relevant matters.

#### 4.8 **Interactions between Those Charged with Governance and Regulators**

76. As with management, the extent to which financial regulators interact with those charged with governance varies between countries and industries.
77. While there has been relatively little interaction between audit regulators and those charged with governance to date, the potential for this exists. For example, in some jurisdictions audit regulators communicate, or require the auditors to communicate, the findings from inspections of individual audits to those charged with governance of the relevant entities. Furthermore, audit inspectors might seek the views of those charged with governance on the quality of individual audits as part of their inspection activities.

#### 4.9 **Interactions between Those Charged with Governance and Financial Statement Users**

78. In a number of countries, those charged with governance, including audit committees where they exist, have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. Users' perceptions of audit quality are likely to be enhanced by the active involvement of a high-quality, transparent audit committee. However, there is considerable variability in the degree to which those charged with governance communicate to users the way in which they have fulfilled their responsibilities.

#### 4.10 **Interactions between Regulators and Financial Statement Users**

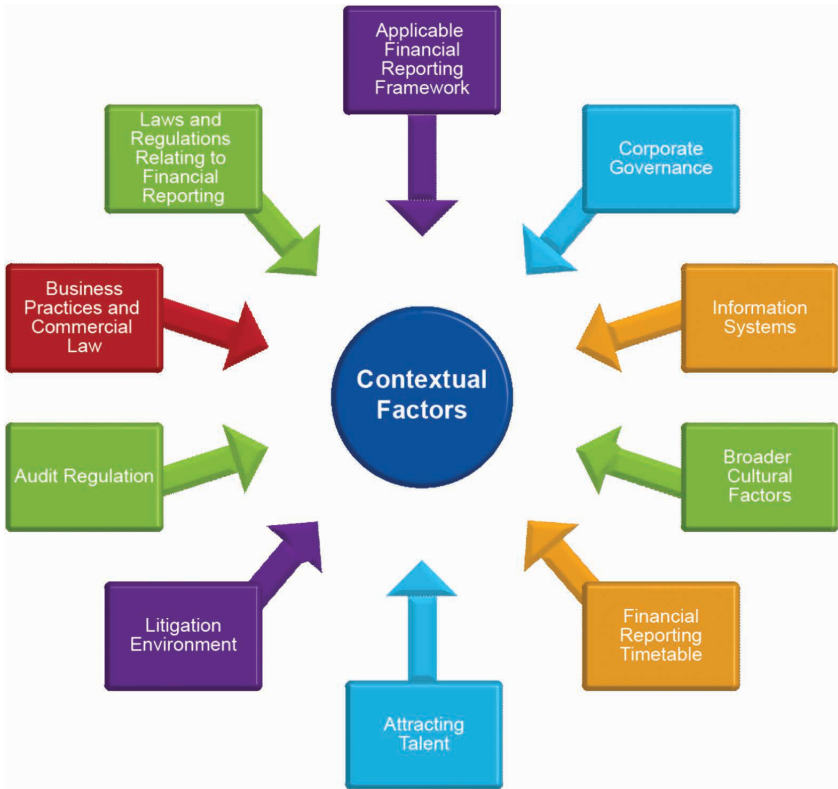
79. External inspection of audit quality takes place in a growing number of countries as part of independent audit oversight arrangements. Audit regulators usually report publicly on their activities in overall terms and this can give users an impression of audit quality generally. Some oversight bodies report publicly on their findings relating to individual audit firms and this will provide users with more specific information.

### 5. **Contextual Factors**

80. The environment in which financial reporting and audit takes place varies between countries. In some countries, business practices may be relatively informal and commercial law relatively less well developed. In such countries, external financial reporting may be limited, and user expectations related to it, low. As a country develops and, in particular, as businesses grows in size and need to obtain finance from capital markets, the environment becomes more complex. Financial reporting becomes more important and user expectations of its speed and reliability continuously grow. In response, law, financial reporting requirements and corporate governance processes evolve.

81. Collectively, these environmental factors – or contextual factors – have the potential to impact the nature and quality of financial reporting and, directly or indirectly, audit quality. Where appropriate, auditors respond to these factors when determining how best to obtain sufficient appropriate audit evidence.

82. Contextual factors include:



### 5.1 Business Practices and Commercial Law

83. The formality of the way business is undertaken will be influenced by national customs and commercial law. In some national environments, for example, it may be customary for entities to enter into transactions with other parties on an informal basis, relying on relationships of trust. Environments exist where trading parties primarily involve related parties, such as entities owned by family members of management or entities that are government controlled.
84. Commercial law will affect the formality with which businesses undertake transactions. In particular, contract law determines when rights are established and obligations created as transactions are completed. Where commercial laws are less developed, it can be challenging for management to assert ownership claims and assess the adequacy of provisions for liabilities.
85. In some circumstances, the terms and conditions of transactions may be vague or unrecorded and agreements may be subject to oral amendment. In such circumstances it will be difficult to segregate responsibilities and the effectiveness of internal control systems will be reduced, creating opportunities for fraud and corruption. The lack of adequate documentation in these

circumstances will present significant challenges for those charged with governance in understanding the economic substance of the transactions and determining whether they have been fully and appropriately accounted for.

86. Attitudes to tax compliance also vary. In some environments, management may seek to minimize tax liabilities through such measures as deferring issuing invoices even when performance obligations have been met. In other environments; more than one set of accounting records may be retained—one showing the “economic” position and one the “tax” position—which may create some confusion. Such circumstances are likely to create complexity and necessitate reserving for a contingent tax liability, which is usually subject to considerable measurement uncertainty.

## 5.2 **Laws and Regulations Relating to Financial Reporting**

87. Laws and regulations relating to financial reporting are generally developed in response to the accountability that businesses have to stakeholders. For listed entities where there is a lack of proximity between the owners and management, regulations and financial reporting disclosures are designed to protect the interests of shareholders that do not have access to internal financial information. In contrast, the extent of regulation and financial reporting disclosures in other entities are likely to be set at a lower level, given that stakeholders may be involved in the management of the business and so have access to internal information.
88. As well as providing a general framework for the way that business is conducted, laws and regulations can directly impact the nature and extent of financial reporting information provided to particular stakeholder groups, especially if they are rigorously enforced. In these circumstances, laws and regulations can usefully:
- Define management’s responsibilities in relation to financial reporting;
  - Provide for punitive action to be taken against management for committing fraudulent financial reporting;
  - Encourage compliance with financial reporting requirements through surveillance and enforcement mechanisms;
  - Impose obligations on management to cooperate fully with auditors, including providing auditors with all necessary information and access; and
  - Provide for punitive actions against management for providing misleading information to auditors.
89. However, even the strongest laws and regulations will not completely eliminate poor attitudes to compliance or unethical business practices. Accordingly, there are limitations to how far the legal and regulatory framework can influence management behavior.



### 5.3 The Applicable Financial Reporting Framework

90. The financial reporting framework is a critical factor in the quality of financial reporting. A clear framework assists management with accounting decisions and provides consistency of application. However, an overly complex financial reporting framework can make it difficult for management to understand the accounting requirements and for those charged with governance to provide effective oversight of the financial reporting process.
91. These difficulties are exacerbated by frequent changes in financial reporting and disclosure requirements which may, at least in the short term, increase the potential for greater inconsistency in how the standards are applied by different entities.
92. The nature and complexity of the financial reporting framework can also influence perceptions of audit quality. Some believe that a financial reporting framework that is unduly principles-based allows management too much latitude to account for transactions in a manner that suits management's objectives and makes it difficult for auditors to challenge. On the other hand, others believe that over-emphasis on rules encourages a strict compliance approach to financial reporting, which may mean that it is difficult for auditors to focus on the substance of transactions and challenge the fair presentation of the financial statements.
93. In recent years, developments in financial reporting have focused increasingly on meeting users' needs for financial information that is more "relevant," even if such information may be more subjective and less "reliable." This has led in particular to a trend towards greater use of fair value measurements and other estimates, which may have significant measurement uncertainty. Disclosures regarding the underlying assumptions made and measurement uncertainty (e.g., sensitivity analyses) are an integral part of faithful representation of such financial statement amounts. But some of those disclosures are qualitative in nature, such as hedging and risk management strategies. As a result, some question the "auditability" of such financial information as it is less objectively verifiable as financial statements items such as cash. Audit challenges include the following:
- Ensuring that an appropriate amount of time of senior members of the engagement team is allocated to the direction, supervision and review of the audit work, rather than a disproportionate amount being taken up with dealing with accounting complexities.
  - Gathering necessary information and making appropriate judgments when recognition, measurement and disclosure decisions may rely to a considerable extent on the exercise of judgment by management in applying the relevant financial reporting requirements, particularly when they involve assumptions, probabilities, forward-looking expectations, or the use of complex models.

- Confirming management’s intent, particularly if management has not faced identical circumstances in the past, when the applicable financial reporting framework provides for alternative accounting treatments depending on the entity’s intended actions (for example, whether an investment is held for trading or intended to be held to maturity).
- Verifying the fair values of financial instruments when there is not an active market and measurements are based on unobservable inputs. In such circumstances fair value calculations can involve complex models and highly judgmental assumptions, often requiring specialized expertise.
- Financial reporting frameworks do not usually set out requirements and guidance for management to obtain appropriate evidence to support their accounting judgments and document it.

94. The degree to which accounting estimates involving significant measurement uncertainty are required is likely to vary depending on the industry in which the entity operates and the general economic environment:

- Some businesses have a relatively short business cycle and goods or services are produced and sold relatively quickly. In these businesses, there is a fairly close correlation between profits and cash. In others, the business cycle is much longer and there is a need for increased estimation.
- Some businesses, such as banks, actively trade in financial instruments while others use them sparingly.
- Periods of adverse economic conditions are likely to require estimates of realizable values and impairment reserves. In these circumstances, there are also likely to be heightened risks regarding whether trading partners, as well as the entity itself, are going concerns.

#### 5.4 Information Systems

95. Sound information systems are necessary to support high-quality financial reporting. Some jurisdictions have specific legal requirements and standards relating to the entity’s accounting and other systems and internal controls over them. Many, however, do not. There may also be specific laws or regulations related to the auditor’s consideration of information systems but, even if not, the nature and quality of an entity’s information systems will affect the nature, timing and extent of audit evidence obtained.

96. The business undertaken by smaller entities is sometimes less complex, with few sources of income and activities. In such cases, accounting systems are usually simple and utilize relatively less complicated technology, and sometimes formal internal controls may be limited.

97. While the basic accounting systems of many entities may be well controlled and reliable, financial reporting requirements increasingly require additional information, especially for the notes to the financial statements. Information on matters such as the fair values of assets and non-financial key performance indicators will often need to be obtained as a discrete activity or from systems that are not normally a part of the accounting system. Such information may not be as well controlled as information from the accounting systems, and this can affect overall financial reporting quality.
98. Information systems are usually computerized. While computer systems will usually process information accurately, they can be subject to systemic weaknesses, security and continuity problems. Effective corporate governance arrangements will often require internal auditors to provide assurance to those charged with governance or management as appropriate, about the reliability of the entity's information systems.
99. The importance of information systems extends beyond financial reporting and, increasingly, businesses are becoming dependent on complex systems and the technology that underlie them. For example:
- Many manufacturers depend on automated processes to manage 'just in time' production processes.
  - Many retailers depend on automated stock and distribution systems.
  - Some retailers do business solely on-line.
  - Most financial institutions and telecommunications companies and many important public sector entities rely on automated systems for undertaking and processing high volumes of transactions with speed and accuracy, often on a global basis.
100. Failure of automated systems within IT dependent entities can result in significant costs to the business and, in extreme cases, to business failure.

## 5.5 Corporate Governance

101. Notwithstanding the detailed requirements of the applicable financial reporting framework, the quality of financial reporting is underpinned by management being motivated to disclose accurate and reliable financial information and having the knowledge and skills to do so.
102. Oversight of management by those charged with governance establishes expectations for behavior, and provides motivation to management to fulfill their responsibilities. Strong corporate governance practices can have a positive impact on the reliability of the financial information that an entity prepares.
103. Audit committees exist in many entities—especially larger entities—and can contribute to the strength of corporate governance, especially when members are independent from management and have an appropriate degree of financial

literacy. Differences in the strength of corporate governance arrangements can impact the approach taken to the audit, and interactions with management and those charged with governance.

104. Effective governance is equally important to smaller entities, although ownership profiles may mean that formal corporate governance structures are not as relevant and audit committees are less common. In many smaller entities there is little distinction between management and those charged with governance; an owner-manager will fulfill both roles.
105. Users' perception of the quality of an entity's financial reporting is likely to be increased if they believe that the audit committee is made up of members that are independent from management and have an appropriate degree of financial literacy. Confidence is also likely to be increased if users are made aware, perhaps in the form of an annual report, of the activities that the audit committee has undertaken, the main issues that they have addressed, and the reasons for their conclusions.
106. As part of their governance and internal control structures, many larger entities establish an internal audit function. While the objectives and scope of an internal audit function vary widely, they typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control. Those charged with governance may have oversight of the internal audit function and are likely to be interested in establishing that there is appropriate interaction between the work of the external auditor and the internal audit function.
107. In relation to the external audit, the attitude of the leaders of an entity, typically the directors of a company, is of fundamental importance. Some may consider the external audit as only a regulatory necessity, the cost of which needs to be minimized. Others may value the audit as a rigorous process that gives them confidence that published financial information is reliable as well as an opportunity to obtain insightful comments from a knowledgeable independent observer in relation to risks the entity faces, its control environment, and its financial reporting process. Those charged with governance of an entity can provide a positive influence on the quality of an audit by demonstrating an active interest in the auditor's work, and taking action when they do not consider that the appropriate quality has been provided.
108. In larger entities, especially listed companies, audit committees often exist to oversee the relationship between the entity and the auditor. This can include the appointment of the auditor, the assessment of the independence of the auditor (including the provision of non-audit services), and the approval of audit fees. As long as they are motivated to maximize the quality of an audit rather than minimize cost, audit committees provide a way of helping to ensure that sufficient, appropriate resources are allocated to the audit.

109. Some audit committees also have a responsibility to consider audit quality directly and do this as part of the process for the reappointment of auditors or when considering audit fees. This can be assisted if the audit committee has a formal process and criteria for describing the attributes of audit quality. Audit committee consideration of audit quality will be influenced by the interactions with the auditor (see paragraphs 53 to 56) and in particular by an assessment of the professional skepticism applied.
110. There is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance; this will usually be reflected in the audit fee. However, a low audit fee can never be a justification for failure to adequately resource an audit and obtain sufficient appropriate audit evidence. It is important that audit committees consider whether sufficient audit time is planned. This is especially important when audit fees are negotiated directly with management. Management is often highly influential in determining audit fees, and may have a different perspective on audit quality from that of the audit committee.

## 5.6 Broader Cultural Factors

111. National cultures could directly affect the attitudes and actions of all stakeholders involved in the financial reporting supply chain and indirectly affect the nature and extent of accounting requirements and applicable laws and regulations.
112. Cultural dimensions include:
- (a) Attitudes to authority - the degree of inequality within societies (the “power distance”) varies and this can impact the way more junior people interact with more senior people, and vice versa.
  - (b) Uncertainty avoidance - how individuals deal with uncertainty varies and this can impact their wish for structure and their response to unstructured situations.
  - (c) Collective behavior - the extent to which individuals are expected by a society to act collectively or independently.
  - (d) Transparency - the value given by a society to what the right balance is between transparency and confidentiality.
113. Such cultural dimensions are likely to impact objectivity and professional skepticism and the way that individuals work together, make judgments, and communicate with others.
114. Differences in business practices and cultural factors can present practical challenges to both multi-national entities and their auditors. Group management may decide to take specific actions to mitigate the effects of such challenges through the implementation and maintenance of effective group-wide controls over financial reporting. Such actions may include, for example:

- Consistent policies and procedures in all countries where the group operates.
- Group-wide programs, such as codes of conduct and fraud prevention programs.
- Internal auditors assessing the accuracy and completeness of financial information received from components.
- Central monitoring of components' operations and their financial results.
- Regular liaison visits from group management.
- Staff secondments.

Understanding the differences in business practices and broader cultural factors assists the group auditor in planning and conducting the group audit in different jurisdictions.

#### 5.6.1 *Attitudes to Authority*

115. In some cultures there is a wide range in the distribution of power between people in a hierarchy which is likely to impact behavior and communications. For example, in some cultures it can be considered disrespectful for less experienced staff to challenge the views of more senior people. Undue deference to authority can impact both the willingness of less experienced accountants in the entity to raise concerns with their supervisors and the working relationship within an engagement team.
116. Auditing is a process that involves an engagement team working together and communicating clearly both up, and down the team structure. It also requires a skeptical mindset. In cultures with a wide range in the distribution of power it can be difficult for less experienced auditors to directly question those in authority. In such situations, auditors may decide to extend their examination of documentation rather than directly challenging management through inquiry.

#### 5.6.2 *Uncertainty Avoidance*

117. Some cultures have a higher ability to tolerate uncertainty than others. This can impact attitudes towards risk taking and its converse, conservatism. Conservatism is likely to influence management's business strategies and internal conduct as well as the accounting judgments inherent in financial reporting.
118. Uncertainty avoidance is also likely to impact auditors' risk assessment and the amount of evidence that they determine is sufficient and appropriate.

#### 5.6.3 *Collective behaviors*

119. Some cultures place a high social value on collective behavior such as loyalty to the state, the employer or the family. In such circumstances individuals are

more likely to adhere to group norms and processes. In other societies individual views and approaches are valued and while this may encourage professional skepticism it is also likely to result in a greater variation in behavior and outcomes.

#### 5.6.4 *Transparency*

120. A further aspect of culture that may have an influence on financial reporting and on the effectiveness of the auditor's interactions with management is the extent to which secrecy or confidentiality is expected in business affairs. A lack of openness or transparency by management may make it more difficult for auditors to obtain the necessary understanding of the entity in order to properly identify and assess the risks of material misstatement in the financial statements.

### 5.7 **Audit Regulation**

121. Regulation involves the licensing of firms and individuals to undertake audit, the designation of standards, the inspection of audits for quality, and disciplinary action in the event of non-compliance with standards and audit failures. These functions are commonly undertaken at a national level by independent regulators, professional accountancy organizations, or a combination of the two.
122. Law, and auditing and ethics standards provide the foundation for many aspects of regulation. While auditing and ethical standards are prescribed at a national level, increasingly national standards draw upon international standards set by the IAASB and IESBA.
123. The requirements of auditing and other relevant standards are most effective if they are properly enforced. This involves the legal status of standards, inspection of audits, the investigation of allegations of audit failure, and where appropriate, disciplinary action being taken.
124. The inspection of audits is usually undertaken at a national level by a separate audit firm (a peer review), a professional accountancy organization (which sometimes has been delegated responsibility by a regulator), or by independent audit regulators. Increasingly, laws and regulations provide that the inspections of audits of listed companies, and sometimes those of other public interest entities, are undertaken by an independent audit regulator.
125. Audit inspections provide an important mechanism for evaluating auditors' compliance with auditing standards, and depending on the mandate, other aspects of audit quality. Actions taken by audit firms to address weaknesses identified by audit inspectors can lead to improvements in audit quality. Over a period of time, relevant findings from audit inspections need to be captured and fed back to standard setters.
126. The results of audit inspections are often published. Publication of the results of audit inspections will lead to greater awareness amongst stakeholders about audit quality issues.

127. As well as acting as an incentive to audit firms to comply with applicable standards, effective disciplinary arrangements give other stakeholders confidence in the quality of audit. Effective disciplinary arrangements involve those responsible for investigation and disciplinary functions having a clear mandate and sufficient resources to undertake their work.

### 5.8 **Litigation Environment**

128. In addition to direct costs incurred in performing an audit, there is a possibility that the audit firm will be required to compensate a litigant for the consequences on an audit failure. Litigation risk and its impact on audit quality varies between different countries.
129. Some believe that litigation risk will improve audit quality as it will cause the auditor to minimize the chance of an audit failure. Others believe that litigation risk will have an adverse impact on audit quality as it will result in a “checklist” mindset rather than a willingness to think about ways of addressing audit risk in an innovative manner, and act as a disincentive to talented individuals to join, or remain in the auditing profession.

### 5.9 **Attracting Talent**

130. Auditing is a demanding intellectual activity requiring the application of good judgment, an inquiring mind, and a considerable amount of business, financial reporting and auditing specific knowledge. While the profession endeavors to equip auditors with the necessary competence, the effectiveness of this will inevitably be influenced by the caliber of recruits.
131. In many countries university graduates are an important source of recruits and many of these will have specialized in accounting and business. This background can provide both relevant knowledge and appropriate ethical attitudes.
132. Recruiting the right caliber of staff to the auditing profession is essential to audit quality. The attractiveness of the accountancy profession needs to be communicated to potential recruits at an early a stage as possible. However, the attractiveness of the auditing profession varies between countries and will be influenced by factors such as the reputation and status of the profession, as well as more direct factors such as comparative remuneration levels and perceptions about likely work effort. If there is a shortage of suitably educated potential recruits, it can be difficult to recruit the right quality of candidate.

### 5.10 **Financial Reporting Timetable**

133. The timeframe within which the audit needs to be completed can influence financial reporting processes and the way that management and those charged with governance approve the financial statements. The advent of accelerated reporting regimes in many jurisdictions also limits the extent to which the auditor can perform detailed work after the end of the reporting period. As a



result, it has become increasingly necessary for the auditor to place reliance on systems of internal control and perform audit procedures before the period end.

134. The timing for the preparation of financial information is also influenced by the need for listed companies to release earnings estimates or preliminary results at an early stage. In some jurisdictions, auditors are required to agree such releases or perform specific work on them. This has the advantage that the auditor will be comfortable with the financial results before the information is released but adds further time pressure.
135. Reporting deadlines can be less onerous for audits of smaller entities than for listed entities, thus allowing the auditor to benefit from evidence obtained from events and transactions after the balance sheet date. Furthermore, it is less common for smaller entities to release earnings estimates prior to completion of the audit. However, it is not unusual for smaller entities to provide annual, monthly or quarterly unaudited financial statements to banks and other providers of capital.

## The Complexity of Defining Audit Quality

1. The term “audit quality” is frequently used in debates 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 definition or analysis of it that has achieved universal recognition.
2. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by auditors gathering sufficient appropriate audit evidence in order to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Often, that opinion is on whether the financial statements “present fairly, in all material respects” or give “a true and fair view” of the entity’s financial position as at the period end and of its results and cash flows for the period, in accordance with the applicable financial reporting framework.
3. While national laws and accounting standards provide criteria for “fair presentation,” many aspects of the financial reporting process, and therefore the audit of the financial statements, involve judgment.
4. Auditing standards provide an important foundation supporting audit quality. In particular, the ISAs issued by the IAASB describe the auditor’s objectives<sup>1</sup> and establish minimum requirements. However, the majority of the requirements in the ISAs either provides a framework for the judgments made in an audit or need judgment for them to be properly applied.
5. Audit is therefore a discipline that relies on competent individuals using their experience and applying integrity, objectivity, and professional skepticism to enable them to make appropriate judgments that are supported by the facts and circumstances of the engagement. The qualities of perseverance and robustness are also important in ensuring that necessary changes are made to the financial statements, or, where such changes are not made, to ensure that the auditor’s report is appropriately qualified.

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<sup>1</sup> Refer to paragraph 11 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*:

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.

6. In addition to the judgmental nature of aspects of the underlying financial statements, there are a number of factors that make it challenging to describe and evaluate the quality of an audit, including that:
- The existence, or lack, of material misstatements in the audited financial statements provides only a partial insight into audit quality.
  - Audits vary and what is considered to be sufficient appropriate audit evidence to support an audit opinion is, to a degree, judgmental.
  - Perspectives of audit quality vary among stakeholders.
  - There is limited transparency about the work performed and audit findings.

*The Existence, or Lack, of Material Misstatements in the Audited Financial Statements Provides Only a Partial Insight into Audit Quality*

7. Given the objective of an audit, the existence of material misstatements in the financial statements that were not detected by the audit may be an indicator of audit failure. However, the absence of material misstatements in the financial statements cannot, in and of itself, be the only measure of audit quality because there may have been no material misstatements to detect.
8. Even the existence of an undetected material misstatement in the audited financial statements may not necessarily indicate a poor quality audit as audits are designed to obtain reasonable, not absolute, assurance that the financial statements do not contain material misstatements. The difference between absolute and reasonable assurance is especially relevant when misstatements result from frauds that have been concealed through forgery, collusion and intentional misrepresentations.
9. The audit model reflects inherent limitations of an audit and is designed to obtain reasonable, rather than absolute, assurance which means that there is a possibility of undetected material misstatements. If material misstatements are subsequently identified that were not detected by the audit, it can be difficult to determine whether they were not detected as a result of the overall audit model or failings in the quality of the individual audit concerned.
10. The concepts of “sufficient appropriate audit evidence” and “reasonable assurance” are closely related. Neither can be defined with precision but both need to be considered in the context of applicable standards and established practice.

*Audits Vary and What Is Considered to Be Sufficient Appropriate Audit Evidence to Support an Audit Opinion, Is, to a Degree, Judgmental*

11. No two entities are exactly the same and therefore the audit work and judgments required will necessarily vary. What is considered to be “sufficient appropriate audit evidence” is therefore, to a degree, a matter of professional judgment,

reflecting the size, nature, and complexity of the entity, the industry and associated regulatory framework in which it operates, as well as the auditor's assessment of the risks that the financial statements prepared by management are materially misstated.

12. Audit firms are usually profit-making entities and the profitability of an audit firm is usually linked to the relationship between the audit fees charged and the cost involved in gathering sufficient appropriate audit evidence. This can lead to perceptions on the part of third parties that, notwithstanding the application of auditing standards and ethics requirements, audit firms may have a short-term incentive to limit the work performed while recognizing that in the longer term, sustained audit quality is needed to protect the audit firm's reputation and to avoid damaging regulatory or legal actions. Also, in the public sector, while public sector audit bodies are not profit-making entities, budget constraints may provide them with additional challenges in ensuring that the amount of work performed is appropriate.

*Perspectives of Audit Quality Vary Among Stakeholders*

13. The perspectives of audit quality vary among stakeholders. This, in itself, is not surprising as the level of their direct involvement in, and access to information relevant to, an audit varies greatly; and the value that is placed on an audit varies among different stakeholders.
14. Stakeholders in listed entities do not have access to audit communications except for those available to the public. In contrast, stakeholders in other entities may often have direct access to auditors and receive both formal and informal communications, which directly influence their perspectives of audit quality.
15. Some users of the financial statements may see audit quality as maximizing the amount of audit evidence obtained and the challenge provided to management. Considering audit quality solely from this perspective would suggest that the quality of an audit would be higher, the more resources (both in quantitative and qualitative terms) that are allocated to an audit.
16. Management may have an interest in ensuring that the cost of the audit is constrained, the audit is completed as quickly as possible and that the disruption to the entity's ongoing operations is minimized. By considering audit quality from this perspective, management may suggest that the resources allocated to an audit should be minimized.
17. Balancing these different views suggests that a quality audit involves an effective audit being performed efficiently, on a timely basis and for a reasonable fee. There is, however, subjectivity around the words "effective," "efficiently," "timely," and "reasonable." Those charged with governance, including audit committees, are often well placed to consider these matters. For this reason, in many countries audit committees have responsibilities for considering audit

quality and approving, or recommending for approval, the auditor appointment, and audit fees.

*There Is Limited Transparency About Audit Work Performed and Audit Findings*

18. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly. However, many stakeholders, including the shareholders of listed companies, or finance providers for any business, do not usually have detailed insights into the work performed in the audit and the issues that were identified and addressed. Therefore, users of financial reports, who are external to the entity being audited, often cannot directly evaluate audit quality.
19. Information about the auditor's work and findings could be provided in the auditor's report. However, many auditors' reports are standardized, and other than in the relatively unusual circumstances when the auditor's opinion is modified, information is not usually provided about the auditor's work and findings.
20. Users have challenged IAASB about whether more information should be provided in auditor's reports and the IAASB has responded by proposing changes to the structure, wording and content of the auditor's report including, for the audits of listed companies, the inclusion of Key Audit Matters. The IAASB hopes that changes to the auditor's report, and in particular the inclusion of Key Audit Matters, will provide useful information to users of the financial statements to enhance their understanding of those matters that, in the auditor's professional judgment, were of most significance in the audit.
21. The IAASB hopes that its auditor reporting initiative will provide users with some insight into the quality of the audit especially if there is an opportunity for there to be further discussion about it with audit committees or the auditor. However, the IAASB recognizes that such additional information will inevitably be only a relatively small portion of the total information known by the auditor and that may be relevant to a better appreciation of audit quality.

## Appendix 2

### Quality Attributes of Input- and Process Factors

1. This Appendix contains further descriptions of the quality attributes of input and process factors. These quality attributes apply at the audit engagement level, at the audit firm level, and at a national (or jurisdictional) level.

### Input Factors

#### 1.1 Values, Ethics and Attitudes – Engagement Level

2. Key attributes are:
  - The engagement team recognizes: that the audit is performed in the wider public interest; and the importance of complying with ethical requirements.
  - The engagement team exhibits objectivity and integrity.
  - The engagement team is independent.
  - The engagement team exhibits professional competence and due care.
  - The engagement team exhibits professional skepticism.

##### 1.1.1 *The Engagement Team Recognizes: that the Audit Is Performed in the Wider Public Interest; and the Importance of Complying with Ethical Requirements*

3. The engagement team is committed to performing the audit in the interests of the entity's stakeholders and in the wider public interest. The nature and extent of the public interest is likely to vary according to the nature of the entity. However, in all audits the engagement team needs to provide an appropriate degree of challenge to management, robustly express their views, and pursue matters to appropriate conclusions.

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

4. The principle of objectivity imposes an obligation on auditors not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.<sup>1</sup>
5. The need for auditors, in particular, to be objective arises from the fact that many of the important issues involved in the preparation of financial statements involve judgment. Few items included in the financial statements can be measured with certainty, and many involve estimation and therefore judgment. Auditors need to be objective when they evaluate management judgments to

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<sup>1</sup> International Ethics Standards Board for Accountants *Code of Ethics for Professional Accountants* (IESBA Code), paragraph 120.1

reduce the risk that the financial statements are materially misstated through management bias, whether deliberately or inadvertently.

6. Integrity is a prerequisite for all those who act in the public interest. It is essential that the engagement team acts, and is seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candor, and courage.

### 1.1.3 *The Engagement Team Is Independent*

7. Independence is required to safeguard individual members of the engagement team or the audit firm from influences that may compromise professional judgments, and helps them to act with integrity, and exercise objectivity and professional skepticism. It is also required to avoid facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's or a member of the engagement team's, integrity, objectivity or professional skepticism has been compromised.
8. Threats to auditor independence may include:
  - Financial interests existing between the auditor and the audited entity. Holding a financial interest in an audit client may create a self-interest threat.
  - Business relationships between the auditor and the audited entity. A close business relationship between the audit firm, or a member of the engagement team or an immediate family member, and the entity may create self-interest or intimidation threats.
  - Provision of non-audit services to audit clients. Audit firms have traditionally provided to their audit clients a range of non-audit services that are consistent with their skills and expertise. Providing non-audit services may, however, create threats to independence. The threats created are most often self-review, self-interest and advocacy threats.
  - Partners and staff may believe that their remuneration and, indeed, their ongoing careers with the audit firm are dependent on retaining an audit client, creating a familiarity or self-interest threat.
  - Situations where a former member of the engagement team, or partner of the firm, has joined the audited entity in a position to exert significant influence over the preparation of the accounting records and financial statements. The threats created are most often familiarity, self-interest and intimidation threats.
9. A familiarity threat may also be created by using the same senior personnel on an audit engagement over a long period of time. However, accumulated prior knowledge of the entity and its business is likely to be conducive to audit quality as it will enhance the auditor's assessment of, and responses to, risks. It also can

lead to efficiency and the most insightful recommendations for improvement in particular areas of an entity’s business operations.

10. The potential benefits to audit quality need to be balanced with the threats to auditor independence that may arise from the senior personnel’s detailed knowledge of the entity and its business resulting from involvement in the audit over a number of years. To address this threat, the IESBA Code requires key audit partners of public interest entities to change (or “rotate”) after seven years; ethics or legal requirements in some countries mandate a shorter rotation period. Some believe that in addition to the rotation of audit engagement partners, the perception of auditor independence would be improved if the audit firm itself were to be periodically changed. Others believe that retaining the same firm is likely to assist the auditors in understanding the entity’s business and systems and result in effective responses to risks of material misstatement in the financial statements, as well as audit efficiency.
11. The consideration of threats and safeguards when determining independence for public sector audits is as important as for audits in the private sector. However, some of the potential threats may differ. For example, it is less likely that auditors in the public sector will have direct financial interests in the entities they audit.
12. The auditor is often viewed as a valued business and tax advisor to the entity and there are usually frequent direct communications with senior management, resulting in the auditor being well informed about business developments. This gives the auditor good knowledge of both the client’s financial reporting process and its industry, but can also be seen as a threat to independence.

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

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

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

14. Professional skepticism is an attitude that includes the application of a questioning mindset in the context of an appropriate understanding of the entity, its business and the environment in which it operates. This understanding, together with more general business knowledge and experience, allows the auditor to assess the risks of material misstatement in an entity’s financial statements, assess the sufficiency and appropriateness of audit evidence, and reach appropriate conclusions.



15. Professional skepticism is an important aspect of auditor judgment related to planning, performing and evaluating the results of an audit. Unless auditors are prepared to challenge management's assertions (including when management has used an expert), they will not act as a deterrent to fraud nor be able to conclude, with confidence, whether an entity's financial statements are fairly presented in accordance with the financial reporting framework.
16. Professional skepticism involves all members of the engagement team:
  - Having a questioning mindset and a willingness to challenge management assertions;
  - Assessing critically the information and explanations obtained in the course of their work;
  - Seeking to understand management motivations for possible misstatement of the financial statements;
  - Keeping an open mind;
  - Challenging the judgments of other members of the engagement team;
  - Having the confidence to challenge management and the persistence to follow things through to a conclusion; and
  - Being alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.

## 1.2 Values, Ethics and Attitudes – Firm Level

17. Key attributes 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.

1.2.1 *Governance Arrangements are in Place that Establish the Appropriate “Tone at the Top”, and which Aim to Safeguard the Firm’s Independence*

18. It is important that an audit firm has robust internal governance arrangements to safeguard the public interest nature of the audit function and to avoid the firm’s commercial interests adversely affecting audit quality, for example, by inappropriately promoting other practice areas (such as tax, corporate finance and consultancy) to the detriment of audit quality.
19. The firm’s leadership has a vital role in promoting a culture that stresses the role of the audit in the public interest and the importance of audit quality in this regard, including avoiding situations that might compromise the firm’s objectivity or independence. Communicating on a regular basis expected behaviors creates an appropriate environment within the audit firm that includes encouraging adherence to the principles underlying ethics requirements that apply to auditors.
20. Sole practitioners have direct control over their firm’s culture, and in Small- and Medium-Practices (SMPs) a small number of partners can have a very direct influence over input factors such as governance arrangements, consultation, and monitoring activities. Depending on the tone, this could be either a strength or a weakness of the small firm environment.

1.2.2 *Necessary Personal Characteristics are Promoted through Appraisal and Reward Systems Supporting Audit Quality*

21. Appraisal and reward systems can nurture and develop appropriate personal characteristics and behavior, including integrity, objectivity, professional competence and due care. This involves embedding these characteristics in recruitment selection criteria, advancement and remuneration processes, and training programs, using appropriate competence frameworks.
22. Competence frameworks might best be developed by reference to the competence areas of the IESs, which would promote harmonization of the frameworks among audit firms.
23. On a regular basis the firm assesses its partners and staff against the competences developed to support audit quality. In doing this, audit firms ensure that partners and staff will not be penalized for taking a robust position on audit issues, even if this may jeopardize a client relationship. Conclusions reached are used to support advancement and remuneration decisions; as well as other actions that may be taken by firms when partners’ or staff performance has not met expected standards.

1.2.3 *Financial Considerations Do Not Drive Actions and Decisions that Impair Audit Quality*

24. Financial considerations both at the firm level (such as the financial target that a firm sets for the profit margin to be achieved on audit work and the willingness

to invest in training and support systems for audit) and at the engagement level (such as the relationship between the audit fee and the underlying cost of the work performed) should not prevent the performance of a robust audit that meets the public interest.

25. There should also not be, at the expense of audit quality:
- Emphasis on winning audit appointments and on the retention of audit clients, particularly at unrealistically low fees;
  - Emphasis on marketing non-audit services to entities that the firm audits; or
  - Cost cutting (including by reducing partners and staff) in the audit practice (for example, during times of economic downturn).

1.2.4 *The Firm Emphasizes the Importance of Providing Partners and Staff with Continuing Professional Development Opportunities and Access to High-Quality Technical Support*

26. Auditing requires knowledge of a considerable number of technical areas including financial reporting, auditing and ethics standards, and corporate and tax laws and regulations. It is important that audit firms have technical support arrangements to help individual partners and staff keep up to date with developments in these areas and to provide assistance on complex areas.
27. Audit quality can also be enhanced if an information infrastructure is developed that enables the firm to support audit judgments (for example, by assembling business and industry-related databases), to track and appropriately address independence issues, and to plan and effectively manage the rotation of partners on audit engagements.
28. The size of audit firms and the technical support available can vary considerably. For smaller practices with a small number of staff and a client base with relatively little complexity in operations, it is possible to develop relatively straightforward quality control policies and procedures. However, smaller practices can face challenges in relation to consultation and may employ external consultants to provide technical expertise or rely on technical support services provided by local professional accounting organizations

1.2.5 *The Firm Promotes a Culture of Consultation on Difficult Issues*

29. A culture of consultation is important for all audit firms, including sole practitioners. Auditing often requires difficult decisions and judgments to be made. Staff will discuss these issues within the engagement team and with the audit engagement partner. Audit engagement partners discuss difficult decisions and judgments with other partners or with technical specialists and give careful consideration to the advice given. For this process to function effectively it is important that there is a culture of consultation and where those involved have sufficient time available to deal properly with issues as they arise.

30. Where internal resources may be limited, external technical resources may be available through their professional accountancy organizations, their relationships with other firms, or suitably resourced third-party organizations.

1.2.6 *Robust Systems Exist for Making Client Acceptance and Continuance Decisions*

31. Prior to accepting an audit engagement, and annually thereafter, it is important that audit firms consider whether they are competent to perform the engagement and have the capabilities and resources to do so. This includes whether the firm can comply with relevant ethics requirements.

32. While auditors need to apply professional skepticism, auditing also involves a degree of trust in management. Management lacking in integrity, by definition, cannot be trusted. Good client acceptance and continuance systems therefore evaluate whether there is information to suggest that client management lack integrity to the extent that it will not be possible to perform a quality audit. Having a rigorous client acceptance and continuance system is therefore important in helping an audit firm avoid engagements where there is a high chance of fraud or illegal acts, and thereby maintain a reputation for providing quality audits.

1.3 **Values, Ethics and Attitudes – National Level**

33. Key attributes are:

- Ethics requirements are promulgated that make clear both the underlying ethics principles and the specific requirements. that apply
- Regulators, national standard setters and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied.
- Information relevant to client acceptance decisions is shared between audit firms.

1.3.1 *Ethics Requirements Are Promulgated that Make Clear Both the Underlying Ethics Principles and the Specific Requirements that Apply*

34. Ethics requirements may be imposed by law or regulations or mandated through professional accountancy organizations. The IFAC requires its member bodies to take actions to adopt and implement the IESBA Code in their jurisdictions, and to assist in its implementation, depending on the member bodies' responsibilities in national environments. In some countries, the IESBA Code is supplemented by additional national requirements, and audit firms and public sector audit bodies may choose to impose higher requirements on their partners and staff.

35. Ethics requirements cannot address all possible situations. Therefore, auditors gain an understanding of both the requirements and the fundamental principles

underlying them in order to understand how to apply them in practice. An understanding of how to apply the principles can be developed through internal communications within the audit firm, through coaching or on-the-job training, and through staff observing more experienced staff in action.

36. The IESBA Code establishes, and requires auditors to comply with, the following fundamental principles of professional ethics:<sup>2</sup>
- Integrity – to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.<sup>3</sup>
  - Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
  - Professional competence and due care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
  - Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
  - Professional behavior – to comply with relevant laws and regulations and avoid any action that discredits the profession.
37. In addition, the IESBA Code contains additional requirements for auditor independence and describes the approach auditors should take, including:
- Identifying threats to independence;
  - Evaluating the significance of the threats identified; and
  - Applying safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
38. The IESBA Code states that when auditors determine that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement<sup>4</sup>. In some situations, the IESBA Code recognizes that the threat created would be so significant that no safeguards could reduce the

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<sup>2</sup> IESBA Code, paragraph 100.5

<sup>3</sup> IESBA Code, Section 110.1

<sup>4</sup> IESBA Code, paragraph 290.7. Public sector audit bodies are, however, not usually able to resign from audit engagements.

threat to an acceptable level; and accordingly an auditor is prohibited from undertaking the audit.

1.3.2 *Regulators, National Standard Setters and Professional Accountancy Organizations Are Active in Ensuring that the Ethics Principles Are Understood and the Requirements Are Consistently Applied*

39. Consistent application of ethics requirements, and the principles that underlie them, is facilitated by guidance, training and support activities provided by regulators, national standard setters, professional accountancy organizations and others. This can include the issuance of guidance material such as answers to frequently asked questions as well as organizing presentations and workshops.

1.3.3 *Information Relevant to Client Acceptance Decisions Is Shared between Audit Firms*

40. Individual audit firms will make decisions on whether to accept a new, or continue with an existing, audit client. Firms may choose not to continue with an audit client if they have concerns about financial reporting practices or management integrity. In such circumstances, it is important that other audit firms who are invited to tender for the audit are aware of this information.

1.4 **Knowledge, Skills, Experience and Time – Engagement Level**

41. Key attributes are:

- Partners and staff have the necessary competences.
- Partners and staff understand the entity’s business.
- Partners and staff make reasonable judgments.
- The audit engagement partner is actively involved in risk assessment, planning, supervising, and reviewing the work performed.
- Staff 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.
- Partners and staff have sufficient time to undertake the audit in an effective manner.
- The audit engagement partner and other experienced members of the engagement team are accessible to management and those charged with governance.

1.4.1 *Partners and Staff Have the Necessary Competences*

42. While not all members of the team can be expected to have the same level of knowledge and experience, it is the responsibility of the audit engagement partner to ensure that the team collectively has the appropriate competences, and that external specialists, or experts, are engaged as required to meet the

needs of engagement circumstances. For example, expertise may be needed in relation to such matters as:

- The valuation of complex financial instruments, land and buildings, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
  - The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
  - The estimation of oil and gas reserves.
  - The valuation of environmental liabilities, and site clean-up costs.
  - The interpretation of contracts, laws and regulations.
  - The analysis of complex or unusual tax compliance issues.
  - The entity's information systems, especially if the entity is considered to be information technology dependent.
43. Expertise may be obtained either from within the audit firm or from external sources. If specialists or experts are involved, it is important, as with other members of the engagement team, that their work is appropriately directed, supervised and reviewed.
44. The appropriate development of professional knowledge and skills begins with the initial professional development of the aspiring professional accountant.<sup>5</sup> Then, further specialization by the professional accountant to perform the role as an auditor is achieved through continuing professional development and additional auditing work experience. Continuing professional development of professional competence and lifelong learning are critical if auditors are to continue to meet the expectations of their clients and the public.<sup>6</sup>

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

45. 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.

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<sup>5</sup> Competence areas and learning outcomes for the aspiring professional accountant are provided in IES 2, *Initial Professional Development – Technical Competence*; IES 3, *Initial Professional Development – Professional Skills*; and IES 4, *Initial Professional Development – Professional Values, Ethics, and Attitudes*; while, competence areas and learning outcomes for the engagement partner are provided in IES 8, *Professional Development for Engagement Partners Responsible for Audits of Financial Statements*.

<sup>6</sup> The IAESB is working on revising IES 8. It is likely to recognize the auditor's need for continuous improvement of competence by first identifying learning outcomes and then requiring continuing professional development in competence areas required of engagement partners who are responsible for audits of financial statements.

46. Industry knowledge, including an understanding of relevant regulations and accounting issues, can be especially important for clients in, for example, the financial services industry. However, it is important that knowledge areas are not so narrow that they prevent the auditor from seeing broader issues. Auditors can acquire general business knowledge from undertaking non-audit work and from exposure to different clients in different industries. This allows them to stand back from the specifics of a particular entity's business and reflect upon their broader knowledge of business issues, risks, and control systems.
47. Audits of smaller entities are often conducted on site by experienced personnel who have been involved with the entity for a number of years. While such personnel usually have a good knowledge of the entity's business, there may be threats to their objectivity and professional skepticism.

#### 1.4.3 *Partners and Staff Make Reasonable Judgments*

48. Auditors use their experience and the values of integrity, objectivity and professional skepticism to make reasonable professional judgments that are supported by the facts and circumstances of the engagement.
49. Making reasonable judgments may involve partners and staff:
- Identifying the issue;
  - Applying knowledge of business, financial accounting and reporting and information technology;
  - Researching the topic and considering different perspectives;
  - Evaluating alternatives in the light of the relevant facts and circumstances;
  - Considering whether a suitable process was followed in reaching a conclusion and whether sufficient appropriate audit evidence exists to support it;
  - Consulting, as appropriate; and
  - Documenting the conclusion and the rationale for it.

#### 1.4.4 *The Audit Engagement Partner Is Actively Involved in Risk Assessment, Planning, Supervising, and Reviewing the Work Performed*

50. As engagement partners are responsible for the audits they undertake, it is important that they are directly involved in planning the audit, evaluating the evidence obtained and in reaching final conclusions.
51. While much of the detailed audit work may be delegated to less experienced staff, the accessibility of audit engagement partners allows them to provide timely input as the audit progresses.
52. Some believe that disclosure of the engagement partner's name in the auditor's report should be required for all entities, as it would provide the engagement



partner with a greater sense of personal accountability, as this individual is ultimately responsible for the conduct of the audit. In many jurisdictions this is already required, usually by a requirement for a personal signature. Others believe that such a requirement would have no impact on an engagement partner's sense of accountability. Potential difficulties of such a requirement include a perceived reduction in the responsibility of the firm and the possibility of increased legal liability for the engagement partner in certain jurisdictions.

- 1.4.5 *Staff 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*
53. The structure of many audit firms, especially larger audit firms, is hierarchical, – often described as having a “pyramid structure” – and the make-up of many engagement teams for individual engagements reflects this structure. As a result, much of the detailed “on-site” audit work is likely to be performed by staff members who are relatively inexperienced; indeed, many may still be completing an accounting qualification. However, experience is generally needed for staff to make reasonable professional judgments.
54. Furthermore, having the same staff members on an audit, one year after another, is likely to assist them in understanding the entity's business and systems and this is often viewed positively by management and those charged with governance. Some believe that this is likely to result in effective responses to risks of material misstatement in the financial statements, as well as audit efficiency. However, prolonged involvement may result in a lack of professional skepticism and threats to auditor independence.
55. In many countries, public sector audit bodies have to keep within fixed limits for how much they may spend on staff resources. There may also be regulations that impact recruitment of staff and the salaries that can be paid. This can mean it is challenging for some audit bodies to recruit and retain sufficient numbers of high-quality staff to consistently achieve audit quality.
- 1.4.6 *Partners and Staff Have Sufficient Time to Undertake the Audit in an Effective Manner*
56. Partners and staff often have responsibilities other than the audit of a single entity, and audits can be undertaken to challenging timetables. Planning is important, both at the level of an individual audit and at the level of the audit firm, to ensure that adequate resources are available to gather sufficient appropriate audit evidence and to interact appropriately with management and those charged with governance.
57. Audit firms are usually profit-making entities and the profitability of an audit firm is influenced by the relationship between the audit fees charged and the cost involved in gathering sufficient appropriate audit evidence. Audit engagement partners are usually accountable within their audit firms for the financial return

on the audits they perform and, if audit fees are restricted by management, this may put pressure on the engagement team to change the nature and timing of audit procedures or reduce testing. This, in turn potentially threatens audit quality.<sup>7</sup>

1.4.7 *The Audit Engagement Partner and Other Experienced Members of the Engagement Team Are Accessible to Management and Those Charged With Governance*

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

1.5 **Knowledge, Skills, Experience and Time – Firm Level**

59. Key attributes are:

- Partners and staff have sufficient time to deal with difficult issues as they arise.
- Engagement teams are properly structured.
- Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.
- Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.

1.5.1 *Partners and Staff Have Sufficient Time to Deal with Difficult Issues as They Arise*

60. Partners and senior staff usually work on a number of audits often with similar reporting timetables. This can lead to concentrated periods of activity. Partners and senior staff also often undertake non-audit services for clients or other activities within the audit firm. It is important that firms anticipate, as best they can, and manage possible time conflicts when allocating responsibilities. Firm management proactively monitors work levels in order to reduce the risk that an unacceptable burden is put on individual partners or staff.

1.5.2 *Engagement Teams Are Properly Structured*

61. Human resource allocation takes account of risk. A danger exists that the most competent partners and staff will be allocated to the firm’s largest most prestigious clients and, as a result, will not be available to audit other clients where the risks that the financial statements are materially misstated may be greater.

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<sup>7</sup> Ethics requirements (for example, paragraph 240.2 of the IESBA Code) often describe this threat and require it to be evaluated and, where appropriate, safeguards applied.

62. The appropriate allocation of resources facilitates engagement teams having the expertise and time to undertake particular audits. This involves allocating partners and senior staff who have both an appropriate knowledge of the industry in which the client operates and its applicable financial reporting framework, and sufficient time to be able to perform quality audits.
63. Allocating resources involves the firm gathering information on:
- Knowledge, skills and experience;
  - Estimated time commitments; and
  - Periods of service – to facilitate compliance with ethics requirements, for example, in relation to the rotation of audit partners.
64. Audits of smaller entities are not mandated in some countries. This can mean that in such countries it is challenging for SMPs that have only a small number of audit clients to retain partners and staff with relevant audit knowledge and experience.
- 1.5.3 *Partners and More Senior Staff Provide Less Experienced Staff with Timely Appraisals and Appropriate Coaching or “On-the-Job” Training*
65. An audit firm’s appraisal process is an important aspect of developing an individual’s capabilities. Although it is difficult to measure, audit quality is likely to be improved if it is specifically addressed in the appraisals for both partners and staff. This can be used to promote the exercise of good audit judgment, including consultation on difficult issues.
66. A distinction can usefully be made between providing staff with periodic performance appraisals and giving coaching and on-the-job training. While appraisals can be used to help identify an important skill or competence, that needs improvement, coaching or on-the-job training can be used to help an individual develop that skill or competence. Coaching and on-the-job training are likely to be especially important in relation to developing key personal characteristics such as integrity, objectivity, rigor, professional skepticism, and perseverance as well as assisting less experienced staff deal with unfamiliar audit areas.
67. Being able to coach effectively requires additional skills, knowledge, and experience, and there are not an unlimited number of people within audit firms with the appropriate competences. Such people may have other demands on their time. It is important that firms provide incentives to their more experienced staff to allocate the necessary time to undertake this important staff development role effectively and, as part of the appraisal process, evaluate them on whether this is achieved.

1.5.4 *Sufficient Training Is Given to Audit Partners and Staff on Audit, Accounting and, Where Appropriate, Specialized Industry Issues*

68. The profession endeavors to equip auditors with the necessary competence through initial professional development (IPD), comprising training in technical and professional skills and values, ethics and attitudes and practical experience, and continuing professional development (CPD) requirements.
69. Firms generally provide training in the technical aspects of auditing and in the requirements of their audit methodologies. Firms also provide essential practical experience by including trainees in engagement teams undertaking audit work.<sup>8</sup> Merging learning about the technical aspects of auditing with gaining practical experience is important because formal training is only part of the process by which auditors develop skills and experience.
70. Professional accountancy organizations that are members of IFAC have requirements relating to CPD and the development programs used by the firms are designed to build the competence of audit professionals. Such programs often address a wide range of areas relevant to the firm's business as a whole, such as project management, information technology, and communication skills. It is important that firms dedicate sufficient time, resources and importance to training in audit and accounting matters including, where appropriate, specialized industry issues so as to provide the technical skills needed to support audit quality

1.6 **Knowledge, Skills, Experience and Time – National Level**

71. Key attributes are:

- Robust arrangements exist for licensing audit firms/individual auditors.
- Education requirements are clearly defined and training is adequately resourced and effective.
- Arrangements exist for updating auditors on current issues and for providing training to them in new accounting, auditing or regulatory requirements.
- The auditing profession is well-positioned to attract and retain individuals with appropriate qualities.

1.6.1 *Robust Arrangements Exist for Licensing Audit Firms/Individual Auditors*

72. Auditing is a public interest activity which needs to be performed by suitably qualified individuals working in an appropriate environment. To achieve this, there will commonly be national arrangements for licensing audit firms or individual auditors to perform audits. A register of approved firms and individuals will often be maintained by a competent authority. Authorities will often have the power to revoke the license in defined circumstances.

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<sup>8</sup> IES 8, paragraphs 54 and 59, establishes requirements for practical experience for audit professionals.

1.6.2 *Education Requirements Are Clearly Defined and Training Is Adequately Resourced and Effective*

73. Criteria for obtaining a license will usually involve educational requirements both for IPD and CPD. Audit quality will be facilitated if educational requirements are clearly defined and sufficient resources are applied to ensure training is effective.
74. The professional skills described in IESs underlie the competences needed to support audit quality. These competences are developed by a combination of theoretical training and practical experience and coaching within audit firms. IESs are written for IFAC member bodies (which may have responsibility for the theoretical training), but do not apply directly to audit firms (which provide the practical experience and coaching). It may assist audit quality if both training organizations and audit firms use the same competence framework.

1.6.3 *Arrangements Exist for Updating Auditors on Current Issues and for Providing Training to Them in New Accounting, Auditing or Regulatory Requirements*

75. In addition to training related to an auditor's IPD, appropriate arrangements within a country for CPD are an important factor in contributing to audit quality. CPD needs to be provided in order that more experienced auditors continue to develop their skills and knowledge related to auditing, and keep informed about changes in the accounting and regulatory requirements.
76. CPD is particularly important when there are major changes to requirements relating to financial reporting and auditing. This provides an opportunity to brief auditors on the new technical requirements, to explain the objectives of those changes, and to help create the understanding necessary for the new requirements to be implemented in a cost effective manner.

1.6.4 *The Auditing Profession Is Well-Positioned to Attract and Retain Individuals with Appropriate Qualities*

77. The competences of audit partners and staff are a critical factor underlying audit quality. While training is important, some of the required qualities are, to a degree, inherent in the individuals. It is therefore important that individuals with the right qualities are attracted to a career in the auditing profession.
78. There are likely to be a number of factors that will influence the individuals attracted to a career in the auditing profession, including:
- The status of auditing as a profession in the national environment;
  - Perceptions of career opportunities and remuneration incentives;
  - The nature of the work, including its role in relation to the public interest; and
  - The quality of training provided.

79. The same factors are likely to influence individuals' decisions to remain in the auditing profession, and pursue an extended career in auditing. In some countries, there is a tendency for large numbers of accountants to leave the audit firms and take jobs in business. While this may have a beneficial impact on financial reporting, it can limit the number of experienced staff available to audit firms and thereby jeopardize audit quality.
80. The status of the auditing profession in a national environment can also impact the respect for auditors and therefore the effectiveness of the audit function. In environments where the audit profession is not well respected or given appropriate authority, auditors will be in a weaker position relative to management. In such circumstances, there may be a lower likelihood that auditors will probe management on significant matters or stand firm on significant audit issues. Conversely, where the profession is highly regarded or is conferred appropriate authority through the relevant mechanisms, it will be easier for auditors to demonstrate professional skepticism and undertake robust audits.

## **Process Factors**

### **1.7 Audit Process and Quality Control Procedures – Engagement Level**

81. Key attributes are:
- The engagement team complies with auditing standards, relevant laws and regulations, and the audit firm's quality control procedures.
  - The engagement team makes appropriate use of information technology.
  - There is effective interaction with others involved in the audit.
  - There are appropriate arrangements with management so as to achieve an effective and efficient audit process.
- 1.7.1 *The Engagement Team Complies with Auditing Standards, Relevant Laws and Regulations, and the Audit Firm's Quality Control Procedures*
82. Auditing standards serve a fundamental role in underpinning audit quality and users' confidence in the audit. The ISAs are designed to support the auditor in obtaining reasonable assurance and require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control;
  - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to those risks; and

- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.
83. ISAs require documentation to be prepared sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of the procedures performed, the results of those procedures, the significant matters arising and the conclusions reached. This documentation supports quality control activities both within the engagement team, before the audit is completed, and by others who review the quality of work performed.
84. Auditors are often required by national law or regulations to comply with auditing standards. However, not all aspects of the audit process are defined by auditing standards, and audit firms will usually have methodologies that provide further specification. Even within the structure created by auditing standards and firm methodologies, there is flexibility for the engagement team in terms of what specific audit work is performed, how it is undertaken in practice, and the nature and timing of interactions with management. The way that the work is performed in practice can be an important factor in both effectiveness and efficiency.

#### 1.7.2 *The Engagement Team Makes Appropriate Use of Information Technology*

85. The increasing use and complexity of computerized information systems provides opportunities for auditors to gather audit evidence both more effectively and more efficiently; for example, through the use of computer-assisted audit techniques including file interrogations and the use of test data. These techniques have the advantage that greater coverage of transactions and controls can be achieved. However, sometimes the use of such techniques requires the involvement of specialists, which can be time consuming, especially in the first year that they are used.
86. Information technology platforms within audit firms have an effect on the way auditors conduct an audit and record the work performed. Increasingly, audit software is provided to assist engagement teams in applying a firm's methodology. While this can result in efficiencies and improved quality control processes, risks to audit quality associated with their use include:
- Over-emphasizing compliance with the audit firm's audit software rather than encouraging thinking about the unique characteristics of the entity being audited; and
  - New staff spending too much of their time learning how to use the firm's audit software rather than understanding auditing concepts.
87. While having partners and experienced staff reviewing audit work from remote locations might reduce the opportunities for mentoring and on-the-job training, it has the potential benefits of:

- Permitting more effective review of audit work where engagement team members are working across many sites or located across different time zones; and
- Providing a more effective means of undertaking supplemental reviews of audit work, after initial reviews have been performed.

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

### 1.7.3 *There Is Effective Interaction with Others Involved in the Audit*

89. 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.<sup>9</sup>

90. Others involved in the audit could include specialists and experts (for example, IT specialists), or, in a group context, the auditors of components. Where others are involved in the audit, it is important that:

- The engagement team clearly communicates with them about the work to be performed;
- Others involved clearly communicate the findings from the work performed; and
- The engagement team determines that the work performed is adequate for its purpose and reacts appropriately to the findings.

91. Many large entities will have an internal audit function. It is likely to be important for both audit efficiency and effectiveness for there to be effective interaction between the external and internal auditors. For example, the internal

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<sup>9</sup> Refer to ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph A57.



audit function is likely to have obtained insight into the entity's operations and business risks that will provide valuable input into the auditor's understanding of the entity and risk assessments or other aspects of the audit.

92. Group management usually expects the group auditor to co-ordinate the work undertaken on components efficiently. Some believe that this can be facilitated if the audits of components are undertaken by the same audit firm or firms within the same audit network or association. The firm's geographic reach, and therefore its ability to provide audit coverage for subsidiaries and other components of the group, can therefore be important. Others believe that having a number of different audit firms involved in a group audit provides an opportunity for a range of views on the risks of the entity, and appropriate audit responses, to be considered.

#### 1.7.4 *There Are Appropriate Arrangements with Management so as to Achieve an Effective and Efficient Audit*

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

#### 1.8 **Audit Process and Quality Control Procedures – Firm Level**

94. Key attributes are:
- The audit methodology is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.
  - The audit methodology encourages individual team members to apply professional skepticism and exercise appropriate professional judgment.
  - The methodology requires effective supervision and review of audit work.
  - The methodology requires appropriate audit documentation.
  - Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action is taken.

- Where required, effective engagement quality control reviews (EQCRs) are undertaken.

1.8.1 *The Audit Methodology is Adapted to Developments in Professional Standards and to Findings from Internal Quality Control Reviews and External Inspections*

95. It is important that the audit firm’s audit methodology does not remain static but evolves with changes in professional standards and the business environment and that continual and timely improvement to the firm’s audit methodology and tools are made to respond to findings from internal reviews and regulatory inspections.

96. In demonstrating a commitment to continuous improvement, audit firms can usefully undertake root cause analysis in response to findings from internal and external inspections in order to identify any systemic issues, and respond accordingly by taking actions to improve their methodologies and processes.

1.8.2 *The Audit Methodology Encourages Individual Team Members to Apply Professional Skepticism and Exercise Appropriate Professional Judgment*

97. Most audit firms use methodologies to assist staff in achieving an efficient and effective audit and for quality control processes. These methodologies sometimes involve the use of audit software that supports decisions and generates electronic working papers that can be viewed at remote locations.

98. Such methodologies can be an effective mechanism for achieving consistent compliance with auditing standards and for checking whether all necessary steps in the audit process have been performed. Methodologies also assist with documentation and, if in an electronic form, with the rapid sharing of information, including with specialists at remote locations.

99. However, there is a risk that too high a level of prescription in audit methodologies will have negative implications for other elements of audit quality. Highly prescriptive methodologies may arise from threats of litigation or overly compliance-based approaches to auditor regulation and inspections. Examples of the risk to audit quality include:

- If compliance with a very prescriptive methodology is over-emphasized, there is a risk that insufficient emphasis will be given to experienced staff tailoring the specified audit procedures to the circumstances and considering whether further procedures need to be performed.
- Over-emphasizing the process by which an audit is performed may detract from experienced audit partners and staff making important judgments.
- Reducing too far the freedom of action of staff may undermine the motivation of these individuals and cause them not to pursue a career in auditing.

- The potential to distance both partners and staff from the company being audited.

### 1.8.3 *The Methodology Requires Effective Supervision and Review of Audit Work*

100. Much detailed audit work may be performed by staff who is relatively less experienced. In such circumstances, it is vital that its work, whether performed ‘on-site’ or elsewhere, including the practice of offshoring, is supervised and reviewed by experienced staff, manager, and partners.
101. Some modern methodologies provide the opportunity for electronic, off-site review of working papers, which can enable audit issues to be shared and considered efficiently, especially when dealing with different countries and across different time zones. However, off-site review may not always be an effective means: of assessing whether staff have undertaken the audit thoroughly and demonstrated an appropriate degree of professional skepticism; and for developing the skills and competences of less experienced staff.

### 1.8.4 *The Methodology Requires Appropriate Audit Documentation*

102. Audit documentation performs a number of roles, including:
- Assisting the engagement team to plan and perform the audit.
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work.
  - Enabling the engagement team to be accountable for its work.
  - Retaining a record of matters of continuing significance to future audits.
  - Enabling the conduct of intra-firm quality control reviews and inspections, and external inspections in accordance with applicable legal, regulatory or other requirements.
103. Documentation of the rationale for significant audit judgments is likely to increase the rigor, and therefore the quality, of that judgment. The process of documenting the issues and how they have been resolved is likely to improve the rigor of the auditor’s thought process and the validity of the conclusions reached.

### 1.8.5 *Rigorous Quality Control Procedures Are Established and Audit Quality Is Monitored and Appropriate Consequential Action Is Taken*

104. Quality control procedures need to be established to provide the audit firm with assurance that:
- The firm complies with professional standards and applicable legal and regulatory requirements, and

- Reports issued by the firm or engagement partners are appropriate in the circumstances.<sup>10</sup>
105. Quality control procedures will include monitoring and taking remedial action when needed. Auditing involves compliance with standards and internal firm policies and procedures. It also involves difficult decisions and judgments made by staff at different levels of experience and sometimes under time pressure.
  106. 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.
  107. 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.
  108. In addition to internal processes to monitor audit quality, audits may be subject to external review. The results of these reviews (including inspections performed by independent audit regulators) provide important feedback that lead to actions that contribute to enhancing audit quality.
  109. 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.
- 1.8.6 *Where Required, Effective Engagement Quality Control Reviews (EQCRs) Are Undertaken*
110. EQCRs allow for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor’s report. They are required to be performed on audits of listed companies and those other audit engagements for which the audit firm considers them appropriate, such as audits of public interest entities.
  111. To be effective, EQCRs involve discussion of significant matters and conclusions, a review of selected engagement documents, and a review of the financial statements. They need to be performed by individuals with the necessary experience, authority and time. EQCRs require appropriate liaison between the review partner and the engagement partner so that they can be performed on a timely basis and allow the engagement team to respond appropriately to findings.

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<sup>10</sup> The IAASB has issued ISQC 1, which sets out those activities in which firms are required to develop policies and procedures and thereby meet this objective.

## 1.9 Audit Process and Quality Control Procedures – National Level

112. Key attributes are:

- Auditing and other standards are promulgated that make clear the underlying objectives as well as the specific requirements that apply.
- Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.
- Effective systems exist for investigating allegations of audit failure and taking disciplinary action when appropriate.

### 1.9.1 *Auditing and Other Standards Are Promulgated that Make Clear the Underlying Objectives as Well as the Specific Requirements that Apply*

113. Auditing and other requirements may be imposed by law or regulations or mandated through the national professional accountancy organization. It is important that such requirements are high-quality and make clear the underlying objectives. ISAs, as issued by the IAASB, contain objectives, requirements, and application and other explanatory material.

114. The IESBA sets high-quality ethics standards for professional accountants through the development of a robust, internationally appropriate Code of Ethics for Professional Accountants. The IAESB develops and enhances professional accountancy education—encompassing technical competence, as well as professional skills, values, ethics, and attitudes for professional accountants—through the promulgation of International Education Standards (IESs). There is widespread adoption of these standards at a national level.

115. It is important that standards are revised in response to feedback received about their use and implementation. However, it is important for standard-setters to be cognizant of the impact that regular revisions to standards may have on auditors' training and implementation needs in using the standards. IFAC requires its member bodies to take actions to adopt and implement ISAs, the Code of Ethics for Professional Accountants and the IESs in their jurisdictions, and to assist in their implementation, depending on the member bodies' responsibilities in national environments. In some countries, the ISAs are modified to take account of, or are supplemented by additional, national requirements.

### 1.9.2 *Bodies Responsible for External Audit Inspections Consider Relevant Attributes of Audit Quality, Both Within Audit Firms and on Individual Audit Engagements*

116. External audit inspections provide an opportunity for evaluating auditors' compliance with auditing standards, and depending on their mandate, other aspects of audit quality. Actions taken by audit firms to address findings identified by audit inspectors can lead to improvements in audit effectiveness and, where the results of audit inspections are published, will lead to greater

awareness among stakeholders about audit quality issues. Over a period of time, the findings from external audit inspections need to be analyzed and fed back to standard setters.

- 1.9.3 *Effective Systems Exist for Investigating Allegations of Audit Failure and Taking Disciplinary Action When Appropriate*
117. Investigation and disciplinary action can be undertaken by professional accountancy organizations. However, as is the case with audit inspection, in relation to listed companies and other public interest entities, it is increasingly being undertaken by independent audit regulators.
118. Audit failures can be difficult to define, especially as so much of an audit involves judgment, and criteria in laws and regulations are sometimes vague and difficult to enforce. The effectiveness of disciplinary activities is increased when clear criteria have been established as to what represents an audit failure.
119. Authorities also need a range of sanctions available to them, including the power to revoke the license of audit firms or individual auditors in defined circumstances. While such actions may be appropriate in extreme cases, the regulatory process is enhanced when more proportional sanctions are also available for lesser issues. These may include fines and mandatory retraining.

# INTERNATIONAL FRAMEWORK FOR ASSURANCE ENGAGEMENTS

This amended *International Framework for Assurance Engagements* will replace the extant *International Framework for Assurance Engagements* at the time ISAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, comes into effect.

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FRAMEWORK

## Introduction

1. This Framework is issued solely to facilitate understanding of the elements and objectives of an assurance engagement and the engagements to which International Standards on Auditing (ISA), International Standards on Review Engagements (ISRE) and International Standards on Assurance Engagements (ISAE) (hereinafter referred to as Assurance Standards) apply.
2. This Framework is not a Standard and, accordingly, does not establish any requirements (or basic principles or essential procedures) for the performance of audits, reviews, or other assurance engagements.<sup>1</sup> An assurance report cannot, therefore, claim that an engagement has been conducted in accordance with this Framework, but rather should refer to relevant Assurance Standards. Assurance Standards contain objectives, requirements, application and other explanatory material, introductory material and definitions that are consistent with this Framework, and are to be applied in audit, review, and other assurance engagements. Appendix 1 illustrates the ambit of pronouncements issued by the International Auditing and Assurance Standards Board (IAASB) and their relationship to each other and to the *Code of Ethics for Professional Accountants* issued by the International Ethics Standards Board for Accountants (IESBA Code).
3. This Framework provides a frame of reference for
  - (a) Assurance practitioners;
  - (b) Others involved with assurance engagements, including the intended users of an assurance report and those engaging a practitioner (the “engaging party”); and
  - (c) The IAASB in its development of Assurance Standards, Practice Notes and other papers.
4. The following is an overview of this Framework:
  - *Introduction:* This Framework deals with assurance engagements performed by practitioners.
  - *Description of assurance engagements:* This section describes assurance engagements and distinguishes direct engagements from attestation engagements, and reasonable assurance engagements from limited assurance engagements.
  - *Scope of the Framework:* This section distinguishes assurance engagements from other engagements, such as consulting engagements.
  - *Preconditions for an assurance engagement:* This section sets out preconditions for a practitioner to accept an assurance engagement.

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<sup>1</sup> See the *Preface to the International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements*.



- *Elements of an assurance engagement:* This section identifies and discusses five elements assurance engagements exhibit: a three party relationship; an underlying subject matter; criteria; evidence; and an assurance report. It further explains important distinctions between reasonable assurance engagements and limited assurance engagements. This section also discusses, for example, the significant variation in the underlying subject matters of assurance engagements, the required characteristics of suitable criteria, the role of risk and materiality in assurance engagements, and how conclusions are expressed in reasonable assurance engagements and in limited assurance engagements.
- *Other matters:* This section discusses communication responsibilities other than the practitioner's assurance report, documentation, and the implications of a practitioner's association with an underlying subject matter or with subject matter information.

### **Ethical Principles and Quality Control Standards**

5. Quality control within firms that perform assurance engagements, and compliance with ethical principles, including independence requirements, are widely recognized as being in the public interest and an integral part of high-quality assurance engagements. Such engagements are performed in accordance with Assurance Standards, which are premised on the basis that:
  - (a) The members of the engagement team and the engagement quality control reviewer (for those engagements where one has been appointed) are subject to Parts A and B of the IESBA Code related to assurance engagements, other professional requirements, or requirements in law or regulation, that are at least demanding; and
  - (b) The practitioner performing the engagement is a member of a firm that is subject to ISQC 1,<sup>2</sup> or other professional requirements, or requirements in law or regulation, regarding the firm's responsibility for its system of quality control, that are at least as demanding as ISQC 1.

#### *The IESBA Code*

6. Part A of the IESBA Code establishes the following fundamental principles with which the practitioner is required to comply:
  - (a) Integrity;
  - (b) Objectivity;
  - (c) Professional competence and due care;

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<sup>2</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*

- (d) Confidentiality; and
  - (e) Professional behavior.
7. Part A also provides a conceptual framework for professional accountants to apply to identify threats to compliance with the fundamental principles, evaluate the significance of the threats identified, and apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
8. Part B of the IESBA Code describes how the conceptual framework in Part A applies in certain situations to professional accountants in public practice, including independence. The IESBA Code defines independence as comprising both independence of mind and independence in appearance. Independence safeguards the ability to form an assurance conclusion without being affected by influences that might compromise that conclusion. Independence enhances the ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

### *ISQC 1*

9. ISQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for assurance engagements. Compliance with ISQC 1 requires, among other things, that the firm establish and maintain a system of quality control that includes policies and procedures addressing each of the following elements, and that it documents its policies and procedures and communicates them to the firm's personnel:
- (a) Leadership responsibilities for quality within the firm;
  - (b) Relevant ethical requirements;
  - (c) Acceptance and continuance of client relationships and specific engagements;
  - (d) Human resources;
  - (e) Engagement performance; and
  - (f) Monitoring.

### **Description of Assurance Engagements**

10. An assurance engagement is an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria.
11. The outcome of the measurement or evaluation of an underlying subject matter is the information that results from applying the criteria to the underlying subject matter. For example:

- The financial statements (outcome) result from measuring an entity’s financial position, financial performance and cash flows (underlying subject matter) by applying a financial reporting framework (criteria).
- A statement about the effectiveness of internal control (outcome) results from evaluating the effectiveness of an entity’s internal control process (underlying subject matter) by applying relevant criteria.
- Entity-specific performance measures (outcome) result from measuring various aspects of performance (underlying subject matter) by applying relevant measurement methodologies (criteria).
- A greenhouse gas statement (outcome) results from measuring an entity’s greenhouse emissions (underlying subject matter) by applying recognition, measurement and presentation protocols (criteria).
- A statement about compliance (outcome) results from evaluating the compliance of an entity (underlying subject matter) with, for example, law and regulation (criteria).

The term “subject matter information” is used to mean the outcome of the measurement or evaluation of an underlying subject matter against the criteria. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence as the basis for the practitioner’s conclusion.

### **Attestation Engagements and Direct Engagements**

12. In an attestation engagement, a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. The practitioner’s conclusion addresses whether the subject matter information is free from material misstatement (see also paragraph 85).
13. In a direct engagement, the practitioner measures or evaluates the underlying subject matter against the criteria. In addition, the practitioner applies assurance skills and techniques to obtain sufficient appropriate evidence about the outcome of the measurement or evaluation of the underlying subject matter against the criteria. The practitioner may obtain that evidence simultaneously with the measurement or evaluation of the underlying subject matter, but may also obtain it before or after such measurement or evaluation. In a direct engagement, the practitioner’s conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria and is phrased in terms of the underlying subject matter and the criteria. In some direct engagements, the practitioner’s conclusion is, or is part of, the subject matter information (see also Appendix 2).

## Reasonable Assurance Engagements and Limited Assurance Engagements

14. In a reasonable assurance engagement, the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.
15. In a limited assurance engagement, the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.
16. Across the range of all limited assurance engagements, what is meaningful assurance can vary from just above assurance that is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential to just below reasonable assurance. What is meaningful in a particular engagement represents a judgment within that range that depends on the engagement circumstances, including the information needs of intended users as a group, the criteria, and the underlying subject matter of the engagement. In some cases, the consequences to intended users of receiving an inappropriate conclusion may be so great that a reasonable assurance engagement is needed for the practitioner to obtain assurance that is meaningful in the circumstances.

## Scope of the Framework

17. Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that are not consistent with the description in paragraph 10 above (and therefore are not covered by this Framework) include:
  - Engagements covered by International Standards on Related Services (ISRSs), such as agreed-upon procedures and compilation engagements.<sup>3</sup>
  - The preparation of tax returns where no assurance conclusion is expressed.

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<sup>3</sup> ISRS 4400, *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*, and ISRS 4410 (Revised), *Compilation Engagements*

- Consulting (or advisory) engagements,<sup>4</sup> such as management and tax consulting.
18. An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to obtain assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.
19. The following engagements, which may be consistent with the description in paragraph 10, are not considered assurance engagements in terms of this Framework:
- (a) Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and
  - (b) Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:
    - (i) Those opinions, views or wording are merely incidental to the overall engagement;
    - (ii) Any written report issued is expressly restricted for use by only the intended users specified in the report;
    - (iii) Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and
    - (iv) The engagement is not represented as an assurance engagement in the practitioner's report.

### Reports on Non-Assurance Engagements

20. A practitioner reporting on an engagement that is not an assurance engagement within the scope of this Framework clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:
- Implying compliance with this Framework, or with Assurance Standards.
  - Inappropriately using the words “assurance,” “audit” or “review.”

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<sup>4</sup> In a consulting engagement, the practitioner applies technical skills, education, observations, experiences, and knowledge of the consulting process. Consulting engagements involve an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results, and sometimes implementation and follow-up. Reports (if issued) are generally written in a narrative (or “long-form”) style. Generally the work performed is only for the use and benefit of the client. The nature and scope of work is determined by agreement between the practitioner and the client. Any service that meets the definition of an assurance engagement is not a consulting engagement but an assurance engagement.

- Including a statement that could reasonably be mistaken for a conclusion based on sufficient appropriate evidence that is designed to enhance the degree of confidence of intended users about the outcome of the measurement or evaluation of an underlying subject matter against criteria.
21. The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of relevant Assurance Standards are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

### **Preconditions for an Assurance Engagement**

22. The following preconditions for an assurance engagement are relevant when considering whether an assurance engagement is to be accepted or continued:
- (a) The roles and responsibilities of the appropriate parties (that is, the responsible party, the measurer or evaluator, and the engaging party, as appropriate) are suitable in the circumstances; and
  - (b) The engagement exhibits all of the following characteristics:
    - (i) The underlying subject matter is appropriate;
    - (ii) The criteria that the practitioner expects to be applied in the preparation of the subject matter information are suitable to the engagement circumstances, including that they exhibit the characteristics described in paragraph 44;
    - (iii) The criteria that the practitioner expects to be applied in the preparation of the subject matter information will be available to the intended users;
    - (iv) The practitioner expects to be able to obtain the evidence needed to support the practitioner's conclusion;
    - (v) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
    - (vi) A rational purpose including, in the case of a limited assurance engagement, that the practitioner expects to be able to obtain a meaningful level of assurance.
23. The underlying subject matters of different assurance engagements can vary greatly. Some underlying subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner. It is important, however, that the practitioner be satisfied that those persons who are to perform the engagement collectively have the appropriate competence and capabilities (see also paragraph 31).

24. When a potential engagement cannot be accepted as an assurance engagement, the engaging party may be able to identify a different engagement that will meet the needs of intended users. For example:
- (a) If the criteria that the practitioner expects to be applied are not suitable, an assurance engagement that meets the other preconditions in paragraph 22 may still be performed if:
    - (i) The practitioner can identify one or more aspects of the underlying subject matter for which those criteria are suitable. In such cases, the practitioner could perform an assurance engagement with respect to that aspect of the underlying subject matter in its own right. In such cases, the assurance report may need to clarify that the report does not relate to the original underlying subject matter in its entirety; or
    - (ii) Alternative criteria suitable for the underlying subject matter can be selected or developed.
  - (b) The engaging party may request an engagement that is not an assurance engagement, such as a consulting or an agreed-upon procedures engagement.
25. Having been accepted, it is not appropriate to change an assurance engagement to a non-assurance engagement, or a reasonable assurance engagement to a limited assurance engagement, without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, may justify a request for a change in the engagement. If such a change is made, evidence that was obtained prior to the change is not disregarded. An inability to obtain sufficient appropriate evidence to form a reasonable assurance conclusion is not an acceptable reason to change from a reasonable assurance engagement to a limited assurance engagement.

### **Elements of an Assurance Engagement**

26. The following elements of an assurance engagement are discussed in this section:
- (a) A three party relationship involving a practitioner, a responsible party, and intended users;
  - (b) An appropriate underlying subject matter;
  - (c) Suitable criteria;
  - (d) Sufficient appropriate evidence; and
  - (e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

### Three Party Relationship

27. All assurance engagements have at least three separate parties: the practitioner, the responsible party and the intended users. Depending on the engagement circumstances, there may also be a separate role of measurer or evaluator, or engaging party (see also Appendix 3).
28. The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the executive board of that entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

#### *Practitioner*

29. The "practitioner" is the individual(s) conducting the engagement (usually the engagement partner or other members of the engagement team, or, as applicable, the firm) by applying assurance skills and techniques to obtain reasonable assurance or limited assurance, as appropriate, about whether the subject matter information is free from material misstatement.<sup>5</sup> In a direct engagement, the practitioner both measures or evaluates the underlying subject matter against the criteria and applies assurance skills and techniques to obtain reasonable assurance or limited assurance, as appropriate, about whether the outcome of that measurement or evaluation is free from material misstatement.
30. If a competent practitioner other than a professional accountant in public practice chooses to represent compliance with an Assurance Standard, it is important to recognize that those Standards include requirements that reflect the premise in the paragraph 5 regarding the IESBA Code and ISQC 1, or other professional requirements, or requirements in law or regulation that are at least as demanding.
31. An engagement is not accepted if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding competence will not be satisfied. In some cases, these requirements can be satisfied by the practitioner using the work of a practitioner's expert.
32. In addition, the practitioner needs to be able to be sufficiently involved in the work of the practitioner's expert and other assurance practitioners to an extent that is sufficient to accept responsibility for the assurance conclusion on the

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<sup>5</sup> "Engagement partner" and "firm" should be read as referring to their public sector equivalents where relevant.



subject matter information, and to obtain the evidence necessary to conclude whether the work of that expert or other assurance practitioner is adequate for the practitioner's purposes.

33. The practitioner has sole responsibility for the assurance conclusion expressed, and that responsibility is not reduced by the practitioner's use of the work of a practitioner's expert or other assurance practitioners. Nonetheless, if the practitioner using the work of a practitioner's expert, having followed the relevant Assurance Standards, concludes that the work of that expert is adequate for the practitioner's purposes, the practitioner may accept that expert's findings or conclusions in the expert's field as appropriate evidence.

#### *Responsible Party*

34. The responsible party is the party responsible for the underlying subject matter. In an attestation engagement, the responsible party is often also the measurer or evaluator. The responsible party may or may not be the party that engages the practitioner to perform the assurance engagement (the engaging party).

#### *Intended Users*

35. The intended users are the individual(s) or organization(s), or group(s) thereof that the practitioner expects will use the assurance report. The responsible party can be one of the intended users, but not the only one.
36. In some cases, there may be intended users other than those to whom the assurance report is addressed. The practitioner may not be able to identify all those who will read the assurance report, particularly where a large number of people will have access to it. In such cases, particularly where possible users are likely to have a broad range of interests in the underlying subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law or regulation.
37. Intended users or their representatives may be directly involved with the practitioner and the responsible party (and the engaging party if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting factual findings based upon the procedures agreed with the engaging party and any appropriate third parties, rather than a conclusion):
- (a) The practitioner is responsible for determining the nature, timing and extent of procedures; and
  - (b) The practitioner may need to perform additional procedures if information comes to the practitioner's attention that differs significantly from that on which the determination of planned procedures was based.

38. In some cases, intended users (for example, bankers and regulators) impose a requirement for, or request, the appropriate party(ies) to arrange for an assurance engagement to be performed for a specific purpose. When engagements use criteria that are designed for a specific purpose, the assurance report includes a statement alerting readers to this fact. In addition, the practitioner may consider it appropriate to indicate that the assurance report is intended solely for specific users. Depending on the engagement circumstances, this may be achieved by restricting the distribution or use of the assurance report. While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular user or purpose does not itself indicate that a legal responsibility is owed by the practitioner in relation to that user or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

### **Underlying Subject Matter**

39. The underlying subject matter of an assurance engagement can take many forms, such as:
- Historical financial performance or condition (for example, historical financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
  - Future financial performance or condition (for example, prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in a financial forecast or projection.
  - Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
  - Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
  - Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be a statement about effectiveness.
  - Behavior (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

Appendix 4 shows a categorization of the range of possible underlying subject matters with some examples.

40. Different underlying subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:
- (a) Precision with which the underlying subject matter can be measured or evaluated against criteria; and
  - (b) The persuasiveness of available evidence.

The assurance report may note characteristics that are of particular relevance to the intended users.

41. The appropriateness of an underlying subject matter is not affected by the level of assurance, that is, if an underlying subject matter is not appropriate for a reasonable assurance engagement, it is also not appropriate for a limited assurance engagement, and vice versa. An appropriate underlying subject matter is identifiable and capable of consistent measurement or evaluation against the identified criteria such that the resulting subject matter information can be subjected to procedures for obtaining sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

### Criteria

42. Criteria are the benchmarks used to measure or evaluate the underlying subject matter. Criteria can be formal, for example in the preparation of financial statements, the criteria may be International Financial Reporting Standards or International Public Sector Accounting Standards; when reporting on the operating effectiveness of internal controls, the criteria may be based on an established internal control framework or individual control objectives specifically designed for the purpose; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).
43. Suitable criteria are required for reasonably consistent measurement or evaluation of an underlying subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same underlying subject matter there can be different criteria, which will yield a different measurement or evaluation. For example, one of the criteria a measurer or evaluator might select as a measure of the underlying subject matter of customer satisfaction is the number of customer complaints resolved to the acknowledged satisfaction of the customer, while another measurer or evaluator might select the number of repeat purchases in the three months following the initial purchase. Further, criteria may be suitable

for a particular set of engagement circumstances, but may not be suitable for a different set of engagement circumstances. For example, reporting to governments or regulators may require the use of a particular set of criteria, but these criteria may not be suitable for a broader group of users.

44. Suitable criteria exhibit the following characteristics:
- (a) **Relevance:** Relevant criteria result in subject matter information that assists decision-making by the intended users.
  - (b) **Completeness:** Criteria are complete when subject matter information prepared in accordance with them does not omit relevant factors that could reasonably be expected to affect decisions of the intended users made on the basis of that subject matter information. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
  - (c) **Reliability:** Reliable criteria allow reasonably consistent measurement or evaluation of the underlying subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by different practitioners.
  - (d) **Neutrality:** Neutral criteria result in subject matter information that is free from bias as appropriate in the engagement circumstances.
  - (e) **Understandability:** Understandable criteria result in subject matter information that can be understood by the intended users.
45. Vague descriptions of expectations or judgments of an individual's experiences do not constitute suitable criteria.
46. The relative importance of each of the above characteristics when assessing the suitability of criteria to a particular engagement is a matter of professional judgment. The suitability of criteria is not affected by the level of assurance, that is, if criteria are unsuitable for a reasonable assurance engagement, they are also unsuitable for a limited assurance engagement, and vice versa. Criteria may be prescribed by law or regulation, or issued by authorized or recognized bodies of experts that follow a transparent due process (established criteria). Other criteria may be specifically developed for the purpose of preparing the subject matter information in the particular circumstances of the engagement. Whether criteria are established or specifically developed affects the work needed to assess their suitability for a particular engagement, for example, in the absence of indications to the contrary, established criteria are presumed to be suitable if they are relevant to the intended users' information needs.
47. Criteria need to be available to the intended users to allow them to understand how the underlying subject matter has been measured or evaluated. Criteria are made available to the intended users in one or more of the following ways:
- (a) Publicly.

- (b) Through inclusion in a clear manner in the presentation of the subject matter information.
  - (c) Through inclusion in a clear manner in the assurance report.
  - (d) By general understanding, for example the criterion for measuring time in hours and minutes.
48. Criteria may also be available only to specific intended users, for example the terms of a contract, or criteria issued by an industry association that are available only to those in the industry because they are relevant only to a specific purpose (see also paragraph 38).
49. As part of the engagement, the practitioner determines whether the criteria are suitable.

### **Evidence**

50. Assurance engagements are planned and performed with an attitude of professional skepticism to obtain sufficient appropriate evidence in the context of the engagement about the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria. Professional judgment needs to be exercised in considering materiality, engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of procedures.

#### *Professional Skepticism*

51. Professional skepticism is an attitude that includes being alert to, for example:
- (a) Evidence that is inconsistent with other evidence obtained;
  - (b) Information that calls into question the reliability of documents and responses to inquiries to be used as evidence;
  - (c) Circumstances that suggest the need for procedures in addition to those required by relevant Assurance Standards; and
  - (d) Conditions that may indicate likely misstatement.
52. Maintaining professional skepticism throughout the engagement is necessary to, for example, reduce the risk of:
- Overlooking unusual circumstances;
  - Overgeneralizing when drawing conclusions from observations; and
  - Using inappropriate assumptions in determining the nature, timing and extent of procedures and evaluating the results thereof.
53. Professional skepticism is necessary to the critical assessment of evidence. This includes questioning inconsistent evidence and the reliability of documents and

responses to inquiries. It also includes consideration of the sufficiency and appropriateness of evidence obtained in the light of the circumstances.

54. Unless the engagement involves assurance about whether documents are genuine, records and documents may be accepted as genuine unless the practitioner has reason to believe the contrary. Nevertheless, the practitioner considers the reliability of information to be used as evidence.
55. The practitioner cannot be expected to disregard past experience of the honesty and integrity of those who provide evidence. Nevertheless, a belief that those who provide evidence are honest and have integrity does not relieve the practitioner of the need to maintain professional skepticism.

### *Professional Judgment*

56. Professional judgment is essential to the proper conduct of an assurance engagement. This is because interpretation of relevant ethical requirements and relevant Assurance Standards and the informed decisions required throughout the engagement cannot be made without the application of relevant training, knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:
- Materiality and engagement risk.
  - The nature, timing and extent of procedures used to meet the requirements of relevant Assurance Standards and obtain evidence.
  - Evaluating whether sufficient appropriate evidence has been obtained, and whether more needs to be done to achieve the objectives of relevant Assurance Standards. In particular, in the case of a limited assurance engagement, professional judgment is required in evaluating whether a meaningful level of assurance has been obtained.
  - In the case of a direct engagement, applying the criteria to the underlying subject matter, and if the practitioner selects or develops the criteria, selecting or developing them. In the case of an attestation engagement, evaluating such judgments made by others.
  - The appropriate conclusions to draw based on the evidence obtained.
57. The distinguishing feature of the professional judgment expected of a practitioner is that it is exercised by a practitioner whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.
58. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the practitioner. Consultation on difficult or contentious matters during the course of the engagement, both within the engagement team and between the engagement team and others at

the appropriate level within or outside the firm assist the practitioner in making informed and reasonable judgments.

59. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of assurance and measurement or evaluation principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the practitioner up to the date of the practitioner's assurance report.
60. Professional judgment needs to be exercised throughout the engagement. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate evidence.

#### *Sufficiency and Appropriateness of Evidence*

61. The sufficiency and appropriateness of evidence are interrelated. Sufficiency is the measure of the quantity of evidence. The quantity of evidence needed is affected by the risks of the subject matter information being materially misstated (the higher the risks, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Obtaining more evidence, however, may not compensate for its poor quality (see also paragraphs 81–82).
62. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability in providing support for the practitioner's conclusion.
63. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from external sources, circumstances may exist that could affect its reliability. For example, evidence obtained from an external source may not be reliable if the source is not knowledgeable or objective. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful:
  - Evidence is more reliable when it is obtained from sources outside the appropriate party(ies).
  - Evidence that is generated internally is more reliable when the related controls are effective.
  - Evidence obtained directly by the practitioner (for example, observation of the application of a control) is more reliable than evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
  - Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously

written record of a meeting is ordinarily more reliable than a subsequent oral representation of what was discussed).

64. More assurance is ordinarily obtained from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may either corroborate other evidence or indicate that an individual item of evidence is not reliable. When evidence obtained from one source is inconsistent with that obtained from another, it is necessary to determine what additional procedures are needed to resolve the inconsistency.
65. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the practitioner provides no conclusion about whether the process will continue to function in the specified manner in the future.
66. Whether sufficient appropriate evidence has been obtained on which to base the practitioner's conclusion is a matter of professional judgment, which involves considering the relationship between the cost of obtaining evidence and the usefulness of the information obtained. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

### *Materiality*

67. Materiality is relevant when planning and performing the assurance engagement, including when determining the nature, timing and extent of procedures, and when evaluating whether the subject matter information is free of misstatement. Professional judgments about materiality are made in light of surrounding circumstances, but are not affected by the level of assurance, that is, for the same intended users and purpose, materiality for a reasonable assurance engagement is the same as for a limited assurance engagement because materiality is based on the information needs of intended users.
68. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence relevant decisions of intended users taken on the basis of the subject matter information. The practitioner's consideration of materiality is a matter of professional judgment, and is affected by the practitioner's perception of the common information needs of intended users as a group. Unless the engagement has been designed to meet the particular information needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered.



69. Materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. The relative importance of qualitative and quantitative factors when considering materiality in a particular engagement is a matter for professional judgment.
70. Materiality relates to the information covered by the practitioner's assurance report. Therefore, when the engagement covers some, but not all aspects of the subject matter information, materiality is considered in relation to only that portion of the subject matter information that is covered by the engagement.

### *Engagement Risk*

71. Subject matter information can fail to be properly expressed in the context of the underlying subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to measure or evaluate the underlying subject matter.
72. Engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated. Engagement risk does not refer to or include the practitioner's business risks, such as loss from litigation, adverse publicity, or other events arising in connection with particular subject matter information.
73. Reducing engagement risk to zero is very rarely attainable or cost beneficial and, therefore, "reasonable assurance" is less than absolute assurance, as a result of factors such as the following:
- The use of selective testing.
  - The inherent limitations of internal control.
  - The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
  - The use of professional judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
  - In some cases, the characteristics of the underlying subject matter when measured or evaluated against the criteria.
74. In general, engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:
- (a) Risks that the practitioner does not directly influence, which in turn consist of:
- (i) The susceptibility of the subject matter information to a material misstatement before consideration of any related controls applied by the appropriate party(ies) (inherent risk); and

- (ii) The risk that a material misstatement that occurs in the subject matter information will not be prevented, or detected and corrected, on a timely basis by the appropriate party(ies)'s internal control (control risk); and
- (b) Risks that the practitioner does directly influence, which, in turn, consist of:
- (i) The risk that the procedures performed by the practitioner will not detect a material misstatement (detection risk); and
  - (ii) In the case of a direct engagement, the risks associated with the practitioner's measurement or evaluation of the underlying subject matter against the criteria (measurement or evaluation risk).
75. The degree to which each of these components is relevant to the engagement is affected by the engagement circumstances, in particular:
- The nature of the underlying subject matter and the subject matter information. For example, the concept of control risk may be more useful when the underlying subject matter relates to the preparation of information about an entity's performance than when it relates to information about the effectiveness of a control or the existence of a physical condition.
  - Whether a reasonable assurance or a limited assurance engagement is being performed. For example, in limited assurance engagements the practitioner may often decide to obtain evidence by means other than testing of controls, in which case consideration of control risk may be less relevant than in a reasonable assurance engagement on the same subject matter information.
  - Whether it is a direct engagement or an attestation engagement. While the concept of control risk is relevant to attestation engagements, the broader concept of measurement or evaluation risk is more relevant to direct engagements.

The consideration of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

#### *Nature, Timing and Extent of Procedures*

76. A combination of procedures is typically used to obtain either reasonable assurance or limited assurance. Procedures may include:
- Inspection;
  - Observation;
  - Confirmation;

- Re-calculation;
- Re-performance;
- Analytical procedures; and
- Inquiry.

The exact nature, timing and extent of procedures will vary from one engagement to the next. For many assurance engagements, infinite variations in procedures are possible in theory. In practice, however, these are difficult to communicate clearly and unambiguously.

77. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the underlying subject matter and other engagement circumstances.
78. A reasonable assurance engagement involves:
- (a) Based on an understanding of the underlying subject matter and other engagement circumstances, identifying and assessing the risks of material misstatement in the subject matter information;
  - (b) Designing and performing procedures to respond to the assessed risks and to obtain reasonable assurance to support the practitioner's conclusion; and
  - (c) Evaluating the sufficiency and appropriateness of the evidence obtained in the context of the engagement and, if necessary in the circumstances, attempting to obtain further evidence.
79. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are limited relative to a reasonable assurance engagement. An underlying subject matter-specific Assurance Standard may establish that, for example, sufficient appropriate evidence for a particular type of limited assurance engagement is obtained primarily through analytical procedures and inquiries. In the absence of underlying subject matter-specific Assurance Standards for other types of limited assurance engagements, however, the procedures for gathering sufficient appropriate evidence may or may not primarily be analytical procedures and inquiries and will vary with the circumstances of the engagement, in particular, the underlying subject matter, and the information needs of the intended users and the engaging party, including relevant time and cost constraints. Determining the nature, timing and extent of procedures is a matter of professional judgment and will vary from one engagement to the next.

80. A limited assurance engagement involves:
- (a) Based on an understanding of the underlying subject matter and other engagement circumstances, identifying areas where a material misstatement of the subject matter information is likely to arise;
  - (b) Designing and performing procedures to address those areas and to obtain limited assurance to support the practitioner's conclusion; and
  - (c) If the practitioner becomes aware of a matter(s) that causes the practitioner to believe the subject matter information may be materially misstated, designing and performing additional procedures to obtain further evidence.

#### *Quantity and Quality of Available Evidence*

81. The quantity or quality of available evidence is affected by:
- (a) The characteristics of the underlying subject matter and subject matter information. For example, less objective evidence might be expected when the subject matter information is future oriented rather than historical (see paragraph 40); and
  - (b) Other circumstances such as when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the practitioner's appointment, an entity's document retention policy, inadequate information systems, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

82. An unmodified conclusion is not appropriate for either a reasonable assurance or a limited assurance engagement when:
- (a) Circumstances prevent the practitioner from obtaining evidence required to reduce engagement risk to the appropriate level; or
  - (b) A party to the engagement imposes a restriction that prevents the practitioner from obtaining evidence required to reduce engagement risk to the appropriate level.

#### **Assurance Report**

83. The practitioner forms a conclusion on the basis of the evidence obtained, and provides a written report containing a clear expression of that assurance conclusion about the subject matter information. Assurance Standards establish basic elements for assurance reports.
84. In a reasonable assurance engagement, the practitioner's conclusion is expressed in the positive form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter.

85. Examples of conclusions expressed in a form appropriate for a reasonable assurance engagement include:

- When expressed in terms of the underlying subject matter and the applicable criteria, “In our opinion, the entity has complied, in all material respects, with XYZ law;”
- When expressed in terms of the subject matter information and the applicable criteria, “In our opinion, the financial statements present fairly, in all material respects, the financial position of the entity as at [date] and its financial performance and its cash flows for the year then ended in accordance with XYZ framework;” or
- When expressed in terms of a statement made by the appropriate party, “In our opinion, the [appropriate party’s] statement that the entity has complied with XYZ law is, in all material respects, fairly stated,” or “In our opinion, the [appropriate party’s] statement that the key performance indicators are presented in accordance with XYZ criteria is, in all material respects, fairly stated.”

In a direct engagement, the practitioner’s conclusion is phrased in terms of the underlying subject matter and the criteria.

86. In a limited assurance engagement, the practitioner’s conclusion is expressed in a form that conveys whether, based on the engagement performed, a matter(s) has come to the practitioner’s attention to cause the practitioner to believe the subject matter information is materially misstated, for example, “Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that the entity has not complied, in all material respects, with XYZ law.”

87. The practitioner may choose a “short-form” or “long-form” style of reporting to facilitate effective communication to the intended users. “Short-form” reports ordinarily include only the basic elements. “Long-form” reports include other information and explanations that are not intended to affect the practitioner’s conclusion. As well as the basic elements, long-form reports may describe in detail the terms of the engagement, the criteria being used, findings relating to particular aspects of the engagement, details of the qualifications and experience of the practitioner and others involved with the engagement, disclosure of materiality levels, and, in some cases, recommendations. Whether to include any such information depends on its significance to the information needs of the intended users.

88. The practitioner’s conclusion is clearly separated from information or explanations that are not intended to affect the practitioner’s conclusion, including any Emphasis of Matter, Other Matter, findings related to particular aspects of the engagement, recommendations or additional information included in the assurance report. The wording used makes it clear that an Emphasis of

Matter, Other Matter, findings, recommendations or additional information is not intended to detract from the practitioner's conclusion.

89. The practitioner expresses a modified conclusion in the following circumstances:
- (a) When, in the practitioner's professional judgment, a scope limitation exists and the effect of the matter may be material. In such cases, the practitioner expresses a qualified conclusion or a disclaimer of conclusion. In some cases, the practitioner considers withdrawing from the engagement.
  - (b) When, in the practitioner's professional judgment, the subject matter information is materially misstated. In such cases, the practitioner expresses a qualified conclusion or adverse conclusion. In those direct engagements where the subject matter information is the practitioner's conclusion, and the practitioner concludes that some or all of the underlying subject matter does not, in all material respects, conform with the criteria, such a conclusion would also be considered to be qualified (or adverse as appropriate).
90. A qualified conclusion is expressed when the effects, or possible effects, of a matter are not so material and pervasive as to require an adverse conclusion or a disclaimer of conclusion.
91. If it is discovered after the engagement has been accepted that one or more preconditions for an assurance engagement is not present, the practitioner discusses the matter with the appropriate party(ies), and determines:
- (a) Whether the matter can be resolved to the practitioner's satisfaction;
  - (b) Whether it is appropriate to continue with the engagement; and
  - (c) Whether and, if so, how to communicate the matter in the assurance report.
92. If it is discovered after the engagement has been accepted that some or all of the criteria are unsuitable or some or all of the underlying subject matter is not appropriate for an assurance engagement, the practitioner considers withdrawing from the engagement, if withdrawal is possible under applicable law or regulation. If the practitioner continues with the engagement, the practitioner expresses:
- (a) A qualified conclusion or adverse conclusion depending on how material and pervasive the matter is, when, in the practitioner's professional judgment, the unsuitable criteria or inappropriate underlying subject matter is likely to mislead the intended users; or
  - (b) A qualified conclusion or a disclaimer of conclusion depending on, in the practitioner's professional judgment, how material and pervasive the matter is, in other cases.

**Other Matters***Other Communication Responsibilities*

93. The practitioner considers whether, pursuant to the terms of the engagement and other engagement circumstances, any matter has come to the attention of the practitioner that is to be communicated with the responsible party, the measurer or evaluator, the engaging party, those charged with governance or others.

*Documentation*

94. Engagement documentation provides a record of the basis for the assurance report when it is prepared on a timely basis and is sufficient and appropriate to enable an experienced practitioner, having no previous connection with the engagement, to understand:
- (a) The nature, timing and extent of the procedures performed to comply with relevant Assurance Standards and applicable legal and regulatory requirements;
  - (b) The results of the procedures performed, and the evidence obtained; and
  - (c) Significant matters arising during the engagement, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.
95. Engagement documentation includes how the practitioner addressed any inconsistency between information identified by the practitioner and the practitioner's final conclusion regarding a significant matter.

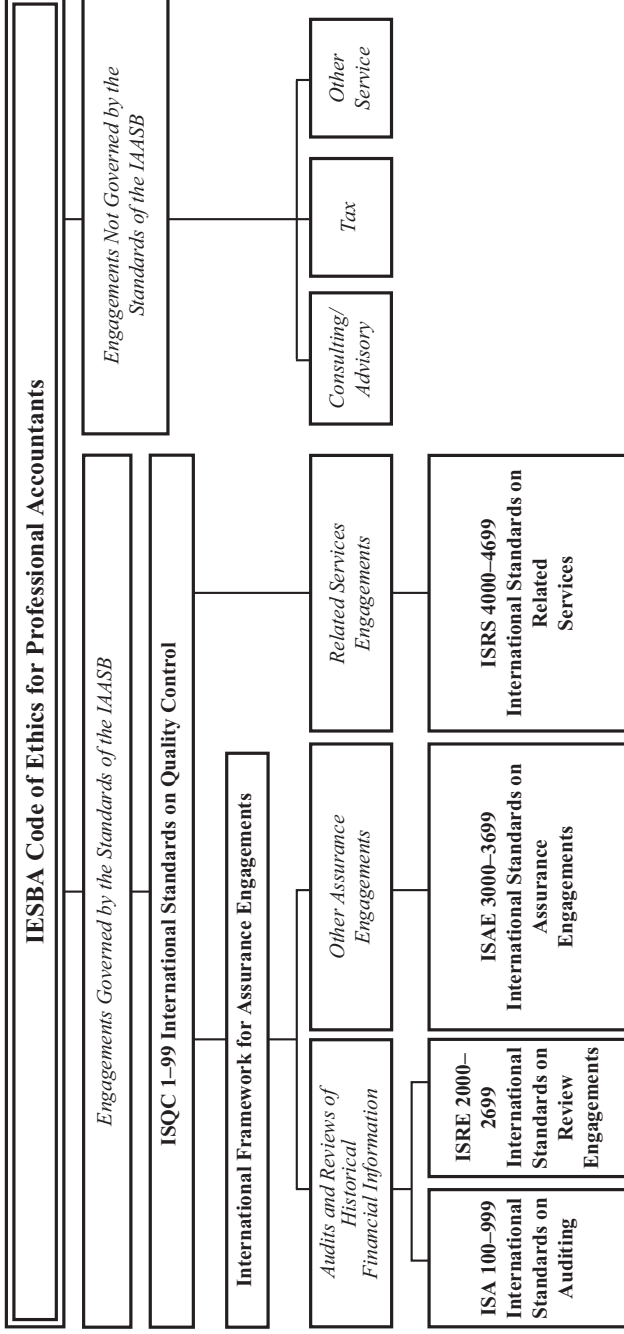
**Inappropriate Use of the Practitioner's Name**

96. A practitioner is associated with an underlying subject matter, or with the related subject matter information, when the practitioner reports on information about that underlying subject matter or consents to the use of the practitioner's name in a professional connection with that underlying subject matter, or with the related subject matter information. If the practitioner is not associated in this manner, third parties can assume no responsibility of the practitioner. If the practitioner learns that a party is inappropriately using the practitioner's name in association with an underlying subject matter, or with the related subject matter information, the practitioner requires the party to cease doing so. The practitioner also considers what other steps may be needed, such as informing any known third party users of the inappropriate use of the practitioner's name or seeking legal advice.

# Appendix 1

## Pronouncements Issued by the IAASB, and Their Relationship to Each Other and the IESBA Code

This Appendix illustrates the ambit of pronouncements issued by the IAASB, and their relationship to each other and to the IESBA Code of Ethics for Professional Accountants.





## Attestation Engagements and Direct Engagements

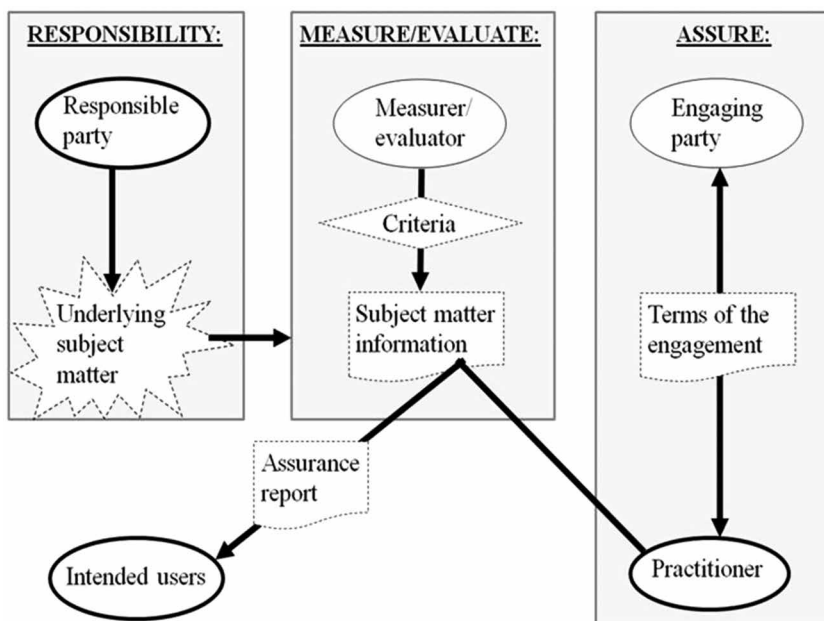
This Appendix outlines the differences between an attestation engagement and a direct engagement.

1. In an attestation engagement, the measurer or evaluator, who is not the practitioner, measures or evaluates the underlying subject matter against the criteria, the outcome of which is the subject matter information. Subject matter information can fail to be properly expressed in the context of the underlying subject matter and the criteria, and can therefore be misstated, potentially to a material extent. The role of the practitioner in an attestation engagement is to obtain sufficient appropriate evidence in order to express a conclusion about whether the subject matter information, as prepared by the measurer or evaluator, is free from material misstatement.
2. In a direct engagement, the practitioner measures or evaluates the underlying subject matter against the criteria and presents the resulting subject matter information as part of, or accompanying the assurance report. The practitioner's conclusion in a direct engagement addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria. In some direct engagements, the practitioner's conclusion is, or is part of, the subject matter information. Depending on the underlying subject matter:
  - (a) The outcome of the measurement or evaluation in a direct engagement may be similar to a report or statement prepared by the measurer or evaluator in an attestation engagement. In other circumstances, however, the outcome, that is, the subject matter information, may be reflected in the description of the findings and basis for the practitioner's conclusion in a long-form assurance report; and
  - (b) The practitioner may use data collected or compiled by others. For example, the data may come from an information system maintained by the responsible party.
3. In addition to measuring or evaluating the underlying subject matter, in a direct engagement the practitioner also applies assurance skills and techniques to obtain sufficient appropriate evidence in order to express a conclusion about whether the subject matter information is materially misstated. The practitioner may obtain that evidence simultaneously with the measurement or evaluation of the underlying subject matter, but may also obtain it before or after such measurement or evaluation.
4. The value of a direct engagement lies in the combination of:
  - (a) The independence of the practitioner from the underlying subject matter, the engaging party, intended users and the responsible party,

notwithstanding that the practitioner is not independent of the subject matter information because the practitioner prepared the subject matter information; and

- (b) The assurance skills and techniques applied when measuring or evaluating the underlying subject matter, which results in the accumulation of evidence that is of a similar quantity and quality as for an attestation engagement. It is this obtaining of sufficient appropriate evidence that distinguishes a direct engagement from a mere compilation. To illustrate this point, if a practitioner were compiling an entity's greenhouse gas statement, the practitioner would not, for example, test the calibration of monitoring devices. In a direct engagement, however, the practitioner would, where relevant, either calibrate monitoring devices as part of the measurement process, or test the calibration of monitoring devices performed by others to the same extent as would be the case if the engagement were an attestation engagement.

## The Parties to an Assurance Engagement



1. All assurance engagements have at least three parties: the responsible party, the practitioner, and the intended users. Depending on the engagement circumstances, there may also be a separate role of measurer or evaluator, or engaging party.
2. The above diagram illustrates how the following roles relate to an assurance engagement:
  - (a) The responsible party is responsible for the underlying subject matter.
  - (b) The measurer or evaluator uses the criteria to measure or evaluate the underlying subject matter resulting in the subject matter information.
  - (c) The engaging party agrees the terms of the engagement with the practitioner.
  - (d) The practitioner obtains sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information.

- (e) The intended users make decisions on the basis of the subject matter information. The intended users are the individual(s) or organization(s), or group(s) thereof that the practitioner expects will use the assurance report. In some cases, there may be intended users other than those to whom the assurance report is addressed.

3. The following observations can be made about these roles:

- Every assurance engagement has at least a responsible party and intended users, in addition to the practitioner.
- The practitioner cannot be the responsible party, the engaging party or an intended user.
- In a direct engagement, the practitioner is also the measurer or evaluator.
- In an attestation engagement, the responsible party, or someone else, but not the practitioner, can be the measurer or evaluator.
- Where the practitioner has measured or evaluated the underlying subject matter against the criteria, the engagement is a direct engagement. The character of that engagement cannot be changed to an attestation engagement by another party assuming responsibility for the measurement or evaluation, for example, by the responsible party attaching a statement to the subject matter information accepting responsibility for it.
- The responsible party can be the engaging party.
- In many attestation engagements the responsible party may also be the measurer or evaluator, and the engaging party. An example is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is different from the measurer or evaluator is when the practitioner is engaged to perform an assurance engagement regarding a report prepared by a government organization about a private company's sustainability practices.
- In an attestation engagement, the measurer or evaluator ordinarily provides the practitioner with a written representation about the subject matter information. In some cases, the practitioner may not be able to obtain such a representation, for example, when the engaging party is not the measurer or evaluator.
- The responsible party can be one of the intended users, but not the only one.
- The responsible party, the measurer or evaluator, and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the executive board of that

entity. The relationship between the responsible party, the measurer or evaluator, and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

- An engaging party that is not also the responsible party can be the intended user.
4. The practitioner's conclusion may be phrased either in terms of:
    - The underlying subject matter and the applicable criteria;
    - The subject matter information and the applicable criteria; or
    - A statement made by the appropriate party.
  5. The practitioner and the responsible party may agree to apply the principles of the Assurance Standards to an engagement when there are no intended users other than the responsible party but where all other requirements of the Assurance Standards are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

## Appendix 4

## Categorization of Underlying Subject Matters

The table below shows a categorization of the range of possible underlying subject matters with some examples. For some categories no example is given because it is unlikely that assurance engagements with respect to information in these categories would be undertaken. The categorization is not necessarily complete, the categories are not necessarily mutually exclusive, and some underlying subject matter or subject matter information may have components in more than one category, for example, integrated reporting and corporate social responsibility reporting will likely have both historical and future-oriented information and both financial and non-financial information. Also, in some cases, the examples are the subject matter information, in other cases they are the underlying subject matter or merely an indication of the type of question that information could assist with, whichever is more meaningful in the circumstances.

Information about:		Historical Information	Future Oriented Information
Financial	Performance	Financial Statements prepared in accordance with an acceptable financial reporting framework	<ul style="list-style-type: none"> <li>Forecast/projected cash flow</li> </ul>
	Position		<ul style="list-style-type: none"> <li>Forecast/projected financial position</li> </ul>
Non-Financial	Performance Use of Resources/ Value for Money	<ul style="list-style-type: none"> <li>Greenhouse Gas Statement</li> <li>Sustainability Report</li> <li>KPIs</li> <li>Statement on effective use of resources</li> <li>Statement on Value for Money</li> <li>Corporate social responsibility reporting</li> </ul>	<ul style="list-style-type: none"> <li>Expected emissions reductions attributable to a new technology, or Greenhouse Gases to be captured by planting trees</li> <li>Statement that a proposed action will provide value for money</li> </ul>
	Condition	<ul style="list-style-type: none"> <li>Description of a system/process as implemented at a point in time</li> <li>Physical characteristics, for example, the size of leased property</li> </ul>	

Information about:		Historical Information	Future Oriented Information
System/ Process	Description	<ul style="list-style-type: none"> <li>The description of a system of internal control</li> </ul>	
	Design	<ul style="list-style-type: none"> <li>The design of controls at a service organization</li> </ul>	<ul style="list-style-type: none"> <li>The design of proposed controls for a forthcoming production process</li> </ul>
	Operation/ Performance	<ul style="list-style-type: none"> <li>The operating effectiveness of procedures for hiring and training staff</li> </ul>	
Aspects of Behavior	Compliance	<ul style="list-style-type: none"> <li>An entity's compliance with, for example, loan covenants, or specific legal or regulatory requirements</li> </ul>	
	Human Behavior	<ul style="list-style-type: none"> <li>Evaluation of audit committee effectiveness</li> </ul>	
	Other	<ul style="list-style-type: none"> <li>The fitness for purpose of a software package</li> </ul>	

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