

IRBA Manual of Information
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THE IRBA INSPECTIONS STRATEGY AND PROCESS
SEVENTH INSPECTIONS CYCLE
2018/2019-2020/2021

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1. BACKGROUND

The IRBA's objective is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors (RAs), in accordance with internationally and locally recognised standards¹, codes of conduct² and legislation. The IRBA's mandate includes having to perform inspections, in terms of Section 47 of the Auditing Profession Act (APA), Act 26 of 2005, as amended; and this function is the responsibility of the Inspections Department.

The IRBA is a founding and Board member of the International Forum of Independent Audit Regulators (IFIAR), an international body of more than 50 independent audit regulators. Our membership and representation on the board and its working groups, such as the Inspections Workshop Working Group, the Investor and Other Stakeholder Working Group, the Enforcement Working Group and the Standards Coordination Working Group, allow the IRBA to keep up to date with international developments in audit regulation, including inspections.

Objective Statement of the Inspections Department

Inspections is a crucial regulatory function that gives effect to the IRBA's mandate and strategy to protect the public interest by monitoring compliance and influencing auditors and relevant stakeholders pursuing consistent sustainable high audit quality that adheres to the highest standards, while maintaining good professional relationships. This is achieved by employing adequate competent staff and deploying available resources, tools and technology effectively to perform high-quality independent inspections of predominantly public interest entity audits selected on a risk basis; performing and reporting on the outcomes of inspections in an objective and fair manner that promotes transparency, accountability and remediation by auditors, where required; and helping drive broader proactive audit quality improvement strategies with relevant stakeholders on areas where these are most needed.

2. RISK-BASED INSPECTIONS APPROACH

The IRBA has adopted the IFIAR³ Core Principles, which state that audit regulators should ensure that a risk-based inspections programme is implemented. The purpose of the risk-based inspections approach is to ensure that firms performing *high-risk assurance engagements*⁴ are analysed, categorised and selected for inspections at the appropriate frequency, based on inherent and identified risk factors.

¹ All applicable auditing and financial reporting standards, including authoritative guidance and pronouncements.

² Applicable codes of professional conduct.

³ www.ifiar.org.

⁴ Entities that require statutory audits in terms of legislation or regulation, and are categorised by the IRBA as *high-risk assurance engagements*.

Firms providing assurance services are classified into categories based on their size (per annual assurance fees declared); the number of RAs performing assurance engagements; and the nature/type of assurance engagements. This is done to stratify the population and help determine the nature and extent of both firm level and engagement level inspections to be performed.

Audit firms are categorised as:

- *High-risk firms* – those that perform high-risk assurance engagements as defined.
- *Low-risk firms* – those that perform low-risk assurance work as defined.

The Inspections Department focuses mainly on *high-risk firms*. For compliance monitoring purposes, the department inspects entities that require mandatory/statutory audits and prioritises the inspection of public interest entities, as defined in the IRBA Code of Professional Conduct. This is in line with the IRBA's mandate and strategy to help protect the broader investing public from potential audit failures that could impact a higher percentage of the public, and to also protect the reputation of the auditing profession. The list of firms classified as *high-risk* is reviewed and revised on an annual basis, as part of the annual fee declaration process, and then published in the *Annual Return Explanatory Manual* that is circulated yearly to all RAs. At the IRBA's discretion, and where risks are identified, *low-risk firms* may be inspected.

Risk factors may include the nature and complexity of the entity being audited; its industry and level of public interest; audit issues likely to be encountered; and the maturity of markets. Other risk factors considered are specific to the audit firm and include the type and range of its assurance engagements; prior inspection reportable deficiencies; and reportable deficiencies from inspections of the firm's internal quality control and risk management processes.

The gathering and analysis of intelligence data forms the basis of a comprehensive risk analysis that enables the Inspections Department to make informed decisions on which audit firms and specific assurance engagements, or parts thereof, to select for inspection.

Risk factors are generally assessed at the following three levels:

- Level 1 – Firm level.
- Level 2 – Specific assurance engagements of the firm.
- Level 3 – Scope of the inspection (specific areas within an assurance engagement).

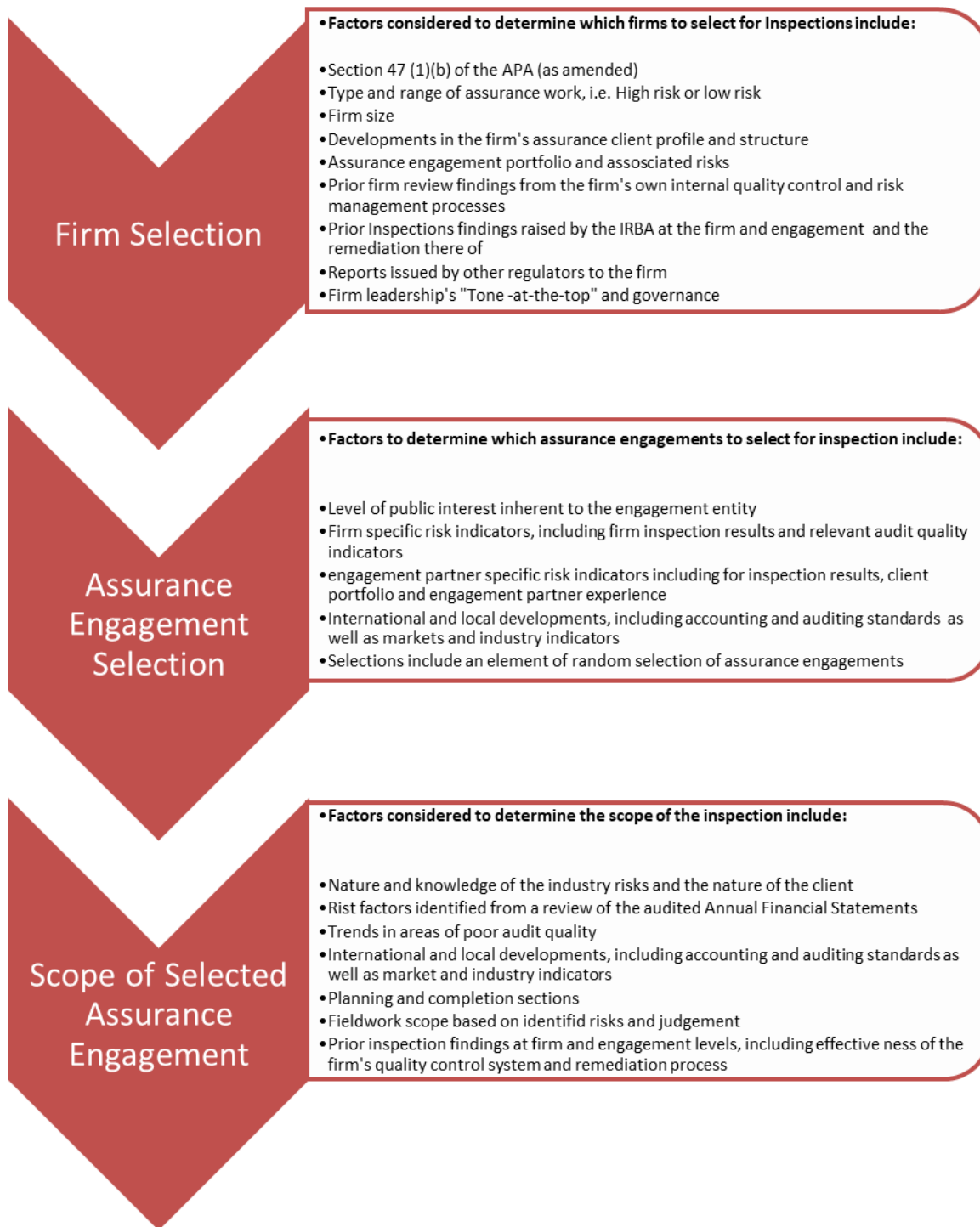


Figure 1: Risk-based selection and scope of inspections (factors are not exhaustive)

To enable effective Business Intelligence and risk-based selections, additional information is obtained through declarations, Audit Quality Indicators (AQIs), collaboration with other regulators and conducting robust financial reporting reviews.

The inspections approach also includes elements of unpredictability and randomly selecting firms, engagement partners and assurance engagements to complement its risk-based selections and scope.

The risk-based inspections approach is not intended to select a representative sample of a firm's assurance work. Instead, it is focused on higher-risk engagements and audit areas where deficiencies are likely; and areas that, if not appropriately responded to by the auditor, create a risk of an inappropriate auditor's report being issued. This approach also means that inspection results cannot be extrapolated across the entire auditor population.

Inspections are designed to address inherent and identified risks and not to cover all RAs or assurance engagements in a cycle. In fact, an inspection is not designed to identify every deficiency that may exist; and the IRBA's scope, reportable deficiencies and reports are not necessarily exhaustive. Accordingly, the formal inspections report and the decision of the Inspections Committee (INSCOM), established in terms of Section 20(2) of the APA, do not provide any assurance regarding the firm's quality control system or assurance engagements. They rather describe reportable deficiencies that the IRBA wishes to bring to the auditor's attention, at a particular point in time, to prompt remediation by the firm, as part of its quality improvement processes on all of its audits.



3. ANNUAL FEE DECLARATION INSPECTIONS

The Inspections Department performs standard procedures during selected inspections to verify the completeness and accuracy of annual firm fee declarations. A separate specific fee declaration inspection can also be scheduled at any time, if the IRBA suspects that the firm's declaration is incorrect or incomplete.

Any errors or omissions in the declarations are regarded in a serious light, as they do not only adversely impact the scope of inspections but also the IRBA's fee base. These cases may result in reportable deficiencies in the formal inspections report and then be referred to the IRBA's Operations Department for correction and/or to its Investigations Department for investigation, where negligence, dishonesty or failure to cooperate with the regulator is suspected.

4. INSPECTIONS PROCESS

Two types of inspections, firm inspections and assurance engagement inspections, are performed over three-year cycles.

It is important that the inspections process be comparable to international best practice. To ensure this, the inspections approach, methodology, scope and procedures are regularly (at least annually) benchmarked against those of other reputable international regulators. Also, the inspections process is regularly updated in response to changes in the environment, and this may include new international standards of accounting and auditing, changes in relevant legislation as well as trends identified in the political and economic landscape.

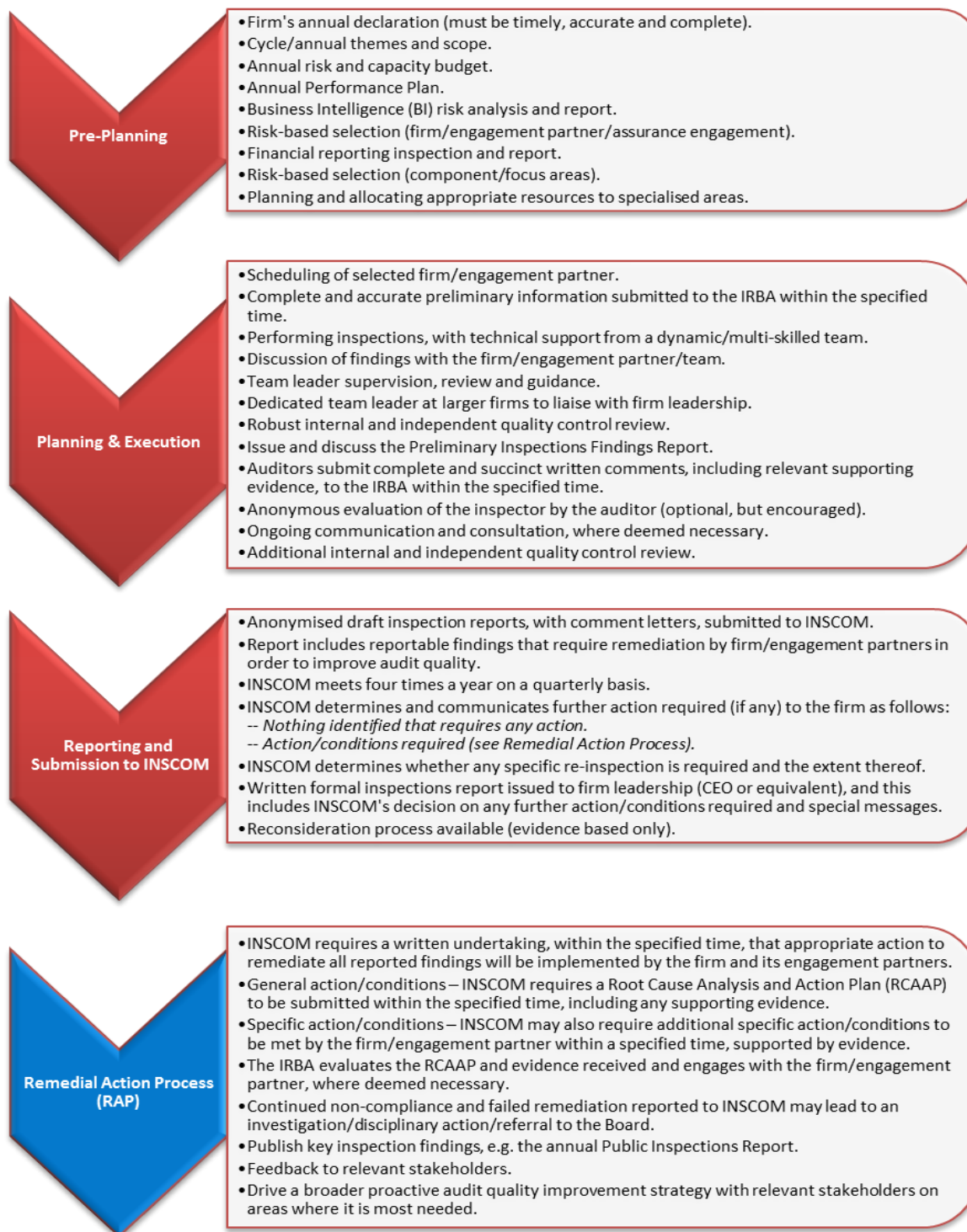


Figure 1: An overview of the inspections and remediation processes.

4.1 Firm Inspections

The objective of firm inspections is to inspect the design and implementation of an audit firm's system of quality control in terms of International Standard on Quality Control (ISQC) 1. Firm inspections monitor compliance with the elements of ISQC 1; leadership responsibilities; ethical requirements (including independence); client acceptance and continuance; human resources;

engagement performance; monitoring; and documentation thereof. Firm inspections also include a selection of assurance engagements to assess the implementation and effectiveness of the firm's system of quality control and the overall sustainability, consistency and quality of assurance engagements by its engagement partners.

As part of the firm inspections process, there will be an increased focus on those individuals who assume leadership responsibilities within the firm, i.e. the *Chief Executive Officer or equivalent and assigned senior executives whose primary responsibility is to operationalise the quality control system within the firm (firm leadership)*.

Logistical arrangements, including suitable office space for the inspectors, laptop computers, software licences and engagement file back-ups, must be arranged in advance; and all requested information must be provided to the Inspections Department by the specified time before the commencement of the inspection and during the inspection. Requested information shall be provided to the inspectors and an offer to inspect information is not regarded as information provided, unless agreed to between the inspector and the firm in advance.

4.2 Assurance Engagement Inspections

The objective of individual assurance engagement file inspections is to monitor firms' and engagement partners' compliance with applicable standards, codes of conduct and legislation in performing assurance work of a consistent, sustainable high quality. The risk-based approach may result in the selection of one or more assurance engagements of the same audit firm and/or engagement partner in a cycle. Engagement quality on selected assurance engagements is used as an indicator of the effectiveness of the firm's quality control system.

4.3 Leadership Responsibilities

There is an increased focus on firm leadership, which is ultimately responsible for promoting a culture of quality that ensures consistent, sustainable high quality on all audits within the firm. This includes a responsibility that any reported quality control review or inspection reportable deficiencies are promptly evaluated, internally communicated and remediated as part of the firm's ongoing quality improvement processes. This is in line with ISQC 1, which requires the firm leadership to assume ultimate responsibility for the firm's system of quality control, including consistency and the quality of engagement performance.

A dedicated Team Leader will be allocated to all firms to drive the IRBA's strategy with firm leadership to promote consistent, sustainable high audit quality within the firms.

Leadership and those delegated to manage quality control in the firm should at all times remain up to date with the inspections process and any possible reportable deficiencies. The firm leadership

will be required to attend key meetings with the Inspections team during inspections to avoid any disagreements or delays in the inspections process. The Team Leaders remain aware of their independence at all times.

4.4 General Inspection and Remediation Procedures

The general inspection procedures followed by the Inspections Department include the following:

- a) The firm is normally notified of the planned dates of the scheduled inspection, for logistical purposes, by the Senior Administrator: Planning. However, in terms of Section 47 of the APA, the IRBA may at any time inspect or review the practice of an RA.
- b) Once the internal risk-based selection and planning process has been concluded by the team, pre-inspection information is requested from the firm/engagement partner. The firm/engagement partner must ensure that all relevant information and documentation are provided to the IRBA by the specified time before the inspection commences. This includes all relevant electronic and hardcopy documents or working papers.
- c) Selected completed assurance engagement files are requested prior to the commencement of the inspection and should be promptly provided by the firm. This includes all relevant electronic and hardcopy documents or working papers.
- d) The inspector performs the inspection, scheduling the necessary kick-off, progress and close-out meetings with the firm/engagement partner.
- e) The inspector may request (or make) copies of any relevant documents and working papers during the inspection.
- f) Inspectors may, at any time, interview firm staff, including members of the engagement team.
- g) Initial or potential draft reportable deficiencies (preliminary reportable deficiencies) are promptly communicated and discussed with the firm/engagement partner throughout the duration of the inspection.
- h) The draft reportable deficiencies are subjected to a robust internal quality control review and then a preliminary inspection report (PIR) is issued and discussed within the internal timeframes. The PIR is subject to change and, in some cases, additional reportable deficiencies may be raised later in the process.
- i) The inspector obtains written comments on the PIR from the firm/engagement partner on the firm's letterhead (PDF version) together with a separate MS-Word version (to allow for anonymisation) within the specified timeframe.

- j) The inspector assesses the written responses and prepares an anonymised draft formal inspection report (which includes the reportable deficiencies, comments received attached thereto and conclusions, where applicable). Following a final internal quality control review, the report is submitted to the IRBA's independent INSCOM for a decision on any further action/conditions (if any).
- k) INSCOM's decision, including any required action/conditions, an executive summary highlighting key inspection themes and risks, any special paragraphs and inspection report/s are formally communicated to the firm leadership as one reporting pack.
- l) Where the formal inspections report requires further action/conditions, the firm/engagement partner is required to respond within 30 calendar days from the date of the formal inspections report. Further communication with the firm/engagement partner is initiated, where deemed necessary.

4.5 Reportable Deficiencies

Following an IRBA inspection, there are two types of reportable deficiencies communicated to the firm/engagement partner in the formal inspections report: (1) firm level – those related to the audit firm's system of quality control; and (2) engagement level – those related to the firm's assurance engagements.

A reportable deficiency at a **firm level** includes any significant or systemic deficiency related to the firm's conduct or system of quality control that may have an impact on audit quality by creating a risk of an inappropriate auditor's report being issued by the firm, including failure to implement remedial/corrective action on all assurance engagements performed by the firm, resulting in recurring inspection reportable deficiencies.

A reportable deficiency at an **engagement level** includes any significant deficiency where the firm has failed to perform sufficient and appropriate audit procedures and/or has failed to obtain or document sufficient and appropriate audit evidence to support its auditor's report, including a failure to identify or address a material or potential material financial reporting/accounting related deficiency; or any non-compliance with applicable standards, codes of conduct and legislation, including a departure from the firm's adopted policies, procedures or methodology.

Reportable deficiencies on assurance engagements do not necessarily imply that the financial statements are materially misstated or that the auditor's opinion is inappropriate. However, they may relate to a lack of documented procedures or sufficient and appropriate evidence that would have detected misstatements.

The purpose of communicating reportable deficiencies is to formally alert the firm/engagement partner to any identified deficiency of a significant or systemic nature that requires prompt

remediation or corrective action to be implemented by the firm and its engagement partners in order to promote consistent, sustainable high audit quality on all audits within the firm.

4.6 Action Required

INSCOM assesses the reportable deficiencies, comments and then determines any further action it deems necessary as follows:

- There may be nothing pertinent identified during an inspection that requires any action on the part of the firm/engagement partner, and this will be reported as such. (“No further action required.”)
- Where there are reported reportable deficiencies, the firm will be required to, by the specified time, submit a written undertaking that prompt remedial/corrective action will be taken to address the reportable deficiencies within the firm. This includes submitting a Root Cause Analysis and a Remedial Action Plan in the prescribed format to the IRBA for evaluation (general action/conditions). (“Some improvement required”, “Significant improvement required” or “Investigations referral with significant improvement required”.)
- INSCOM may also decide to provide the firm/engagement partner with specific action/conditions, e.g. to submit supporting evidence or information on a specific matter within a prescribed timeframe for evaluation. (“Specific action/conditions.”) Failure to meet any action/conditions or requests by INSCOM may result in a referral to the IRBA’s Investigations Department for an investigation/disciplinary action. INSCOM, at any time, reserves the right to refer any firm/engagement partner to the Investigations Department, based on the significance, systemic nature or extent of reported reportable deficiencies, including recurring reportable deficiencies of a similar nature being reported. A referral for an investigation does not negate the responsibility on the part of the firm and all its partners to implement prompt remedial/corrective action. INSCOM, if no specific decision is taken, or the Remedial Action Manager may decide that a specific follow-up inspection be performed on a firm and/or an engagement partner to determine whether the firm/engagement partner remediated previously reported reportable deficiencies. Follow-up inspections will be scheduled after allowing a reasonable time for the firm and engagement partners to implement remediation (usually 12-18 months after the INSCOM decision letter date). Follow-up inspections might not necessarily be performed on the same assurance engagement or engagement partner previously inspected at the firm. If during any inspection, including a follow-up inspection, previously reported inspection reportable deficiencies of a similar nature are raised, with no or little improvement, this will be viewed in a serious light and may result in a referral to the Investigations Department for an investigation/disciplinary action.

INSCOM may implement more proactive and strict decisions, where deemed necessary. These may include conditional results that require more specific proactive action by firms; being subjected to a more robust and focused remedial action process; and escalating poor performing firms to the Board for it to take appropriate action to protect the public interest, including escalating concerns to all structures of leadership, requesting and monitoring audit firms' turnaround strategies and plans on a quarterly basis, etc.

4.7 Reporting

4.7.1 Preliminary Inspections Report

A PIR is issued to the firm/engagement partner and discussed, followed by an opportunity to provide succinct and complete written comments (which must, as far as possible, be supported by accompanying documented evidence) to be submitted separately on the firm's letterhead (PDF version) together with a separate MS-Word version (to allow for anonymisation) within the prescribed timeframe. Firms/practitioners should not wait for the final formal report before responding. The only opportunity available to the firm/practitioner to formally respond in writing is through the written comments in the PIR. The comment letter must be numbered exactly in the same way as the PIR reportable deficiencies and signed by the relevant engagement partner and the firm's appointed quality control representative (or equivalent). The firm/engagement partner's comment letter must be attached to the formal inspections report and the content of the letter should, as far as possible, be anonymised.

The PIR is subjected to the IRBA's internal quality control process and may be changed or, in some cases, additional reportable deficiencies may be raised later in the process. If the latter applies, that will be duly discussed and communicated.

4.7.2 Formal Inspections Report

The final formal inspections report – including INSCOM's decision on any required action/conditions, the inspection scope, key themes and risks, any firm level reportable deficiencies and any engagement level reportable deficiencies, with the firm/engagement partner's written comment letters attached – will be formally reported to the firm leadership by the Director Inspections. Since firm leadership is ultimately responsible for ensuring consistent, sustainable high-quality audits and the remediation of deficiencies at the firms, all inspection reports will be directed to the Chief Executive Officer (or equivalent). The firm/engagement partner is expected to study the report and address any required action/conditions as soon as possible and, where required, start the process to identify the root causes and implement remedial/corrective action on all subsequent audits, and then monitor this. The report, which is anonymised as far as possible, is written with the users in

mind, and these may include the firm leadership, engagement partner/team, INSCOM and other relevant users (such as audit committees or other regulators).

Since quality control and remediation are ongoing processes of the firm, a firm/engagement partner may receive multiple inspections at different times during a cycle. As such, separate formal inspection reports will be issued to the firm/engagement partner after every visit and these will supersede or supplement any reports previously issued, and they, in turn, can also be superseded as a result of subsequent inspections. Any issued report to the firm/engagement partner will clearly spell out the scope, assurance engagement/s, disclaimer, reportable deficiencies, responses and decisions by INSCOM.

The scope of an inspection visit may not necessarily be the same every time and may or may not include a firm level quality control inspection; therefore, the formal report should be read in that context. As a result, any previous firm report (in particular the firm executive report) and the related INSCOM decision letter remain relevant to the extent that the previously reported deficiencies would have been subjected to the firm's internal quality improvement process and successfully remedied.

4.7.3 *Special Paragraphs*

INSCOM, from time to time, deems it necessary to focus a firm/engagement partner's attention to specific matters that are not necessarily reported as a finding in the formal inspection report. These specific messages are communicated with the formal inspections report in the form of special paragraphs. These specific messages do not constitute additional reportable inspection deficiencies, but are rather other matters or general observations that INSCOM deems important to bring to the firm's attention. Reportable deficiencies (if any) are reported in the formal inspections report that forms the basis of INSCOM's decision on any required action/conditions; and any special paragraphs stated in the formal inspections report should not be regarded as additional inspection reportable deficiencies. Special messages to the firm/engagement partner will, however, be considered in subsequent inspections and might lead to reportable deficiencies, if not appropriately addressed.

4.7.4 *Public Inspections Report*

Annually, the Inspections Department issues a Public Inspections Report that provides an analysis of key finding themes arising from inspections performed during a particular year. These reports are available on the IRBA website and auditors are encouraged to analyse them and proactively identify and address similar reported deficiencies that might exist in their respective firms.

The objective of the report is to promote audit quality at a broader level by highlighting significant themes arising from firm-wide and assurance engagement file inspections reported on annually. The report is aimed at auditors, those responsible for quality management systems within firms and other relevant stakeholders, such as audit committees, investors, oversight bodies, company directors and financial accountants who are responsible for the integrity of financial information. The intention is to assist these stakeholders in their respective roles by encouraging robust discussion with regard to matters that affect audit quality, and as reported by the IRBA.

4.8 Evidence-based Reconsiderations

A firm/engagement partner that believes INSCOM's decision should be reconsidered, due to the Inspections Department and the committee not having considered any audit documentation or information available at the time the initial decision was made, may submit a written request to the Director Inspections for reconsideration. This request must be clearly headed as a "Request for Reconsideration" and should be submitted within 45 calendar days from the date of the formal inspections report.

If additional audit documentation or information is presented that reasonably warrants a reconsideration by INSCOM of its original decision, the anonymised request will be tabled before the committee at its next meeting. Firms are for this purpose required to appropriately anonymise any supporting documentation or new information attached to the request for reconsideration letter. It is important to note that it remains the primary responsibility of the Inspections Department, and not the committee, to inspect any additional documentation or information presented.

The committee's decision will be final and will be communicated to the firm/engagement partner in writing by the Director Inspections.

5. REMEDIAL ACTION PROCESS

In a continuous effort to meet the objectives of the IRBA, as stated in point 1 above, the Inspections Department is driving a formal Remedial Action Process with firm leadership and relevant engagement partners. Inspected firms/engagement partners that have received inspection reports with reportable deficiencies are requested to analyse all the reportable deficiencies and submit to the IRBA a Root Cause Analysis and an action plan within 30 calendar days from the date of the formal inspections report, with a written undertaking that all deficiencies that were reported will be addressed by the firm on all of its audits going forward.

After a reasonable time allowing for corrective measures to be implemented by the firm and engagement partners, an inspection, including a follow-up inspection, may be performed to assess the effectiveness of the remedial/corrective action undertaken by the firm on previously reported reportable deficiencies.

This process can be highly effective and yield the necessary improvements, if firm leadership assumes ultimate responsibility for quality and approaches the remediation process constructively by developing and implementing appropriate remedial action plans and strategies based on effective root cause analyses. Firms and engagement partners must recognise that remediation of inspection reportable deficiencies forms part of a firm's process of continuous improvement; and remediation should happen continuously on all internal and external reportable deficiencies, and not only when deficiencies are identified during the IRBA inspections.

The IRBA's remedial action process feeds back into the Business Intelligence and the Inspections Department processes for follow-ups to determine whether the firm remediated previously reported deficiencies in terms of its Root Cause Analysis and Remedial Action Plan. A failure to remediate reportable deficiencies throughout the firm may indicate that the firm's system of quality improvement is ineffective, which may result in a firm level inspection finding. Such reportable deficiencies, which are seen in a very serious light by the regulator, may be raised based on a firm's failure to cooperate with the regulator, demonstrating an inability or reluctance to promptly and effectively remediate previously reported inspection reportable deficiencies as required by the standards and the IRBA's remedial action process.

It is critically important for firm leadership to set the correct tone at the top, promoting an internal culture of high audit quality that is supported by prompt and effective remediation of identified root causes and deficiencies.

6. INSPECTIONS TEAM

All staff involved in performing inspections are employed by the IRBA on a full-time basis. In addition to being independent of audit firms, they are suitably qualified and experienced.

7. INSPECTIONS COMMITTEE

INSCOM consists of a maximum of eight (8) suitably qualified and experienced members, who are not directly or indirectly involved in public practice and are not members of the IRBA's Investigating Committee, Disciplinary Advisory Committee or Disciplinary Committee.

The function of INSCOM is to independently participate in the inspections process by:

- Monitoring the progress of the inspections cycle;

- Considering whether the inspection reports and recommendations are consistent and of an appropriate quality (on an anonymous basis);
- Considering the recommendations made by the IRBA's inspectors (Inspections Department) and determining the outcome of inspections; and
- Providing guidance to and advising the Inspections Department on its strategy, challenges and contentious matters.

The committee meets at least four (4) times in a calendar year, and these meetings are closed to the public and RAs, without exception, due to confidentiality requirements.

8. FEES

Specific fees are charged for inspections, in addition to the normal fees charged by the IRBA. Any *ad-hoc* work performed by the Inspections Department to external stakeholders (not RAs) is also charged based on the actual time spent and at an hourly rate determined and gazetted by the Board from time to time, and disbursements recovered at cost.

Cancellation fees may be charged where scheduled inspections are cancelled at short notice by the audit firm/engagement partner without an acceptable reason that can be corroborated. The cancellation fee must be reasonable in relation to the size of the firm or the RA's assurance portfolio and subject to the Director Inspection's discretion and approval.

9. CONFIDENTIALITY

The confidentiality requirements of Section 47 of the APA are strictly respected and enforced by all staff within the Inspections Department and the IRBA.

The IRBA is however promoting a broader stakeholder approach to audit quality improvement that requires enhanced transparency and accountability in the public interest. Firms are therefore required to promptly share their inspection decision letters, formal reports and remedial action plans with audit committees of listed companies to facilitate robust dialogue on matters affecting audit quality. Firms are also encouraged to share the above information with non-listed entities, for the same reasons.