![IAIS - International Association of Insurance Supervisors logo]

04 May 2016

Ref: 16/23

Prof. Arnold Schilder
Chairman
International Auditing and Assurance Standards Board
International Federation of Accountants
529 Fifth Avenue, 6th Floor
New York, New York
10017 U.S.A.

Dear Professor Schilder,

RE: IAASB Invitation to Comment - *Enhancing Audit Quality in the Public Interest*

The International Association of Insurance Supervisors (IAIS) welcomes the opportunity to comment on the IAASB's Invitation to Comment (ITC): *Enhancing Audit Quality in the Public Interest.*

The IAIS acknowledges the significant work done by the IAASB in developing the ITC to identify current audit quality issues and to consider possible responses to effectively address those issues. In general, the IAIS believes that the IAASB is moving in the right direction with respect to enhancing audit quality in the public interest.

The appendix to this letter provides more detailed responses to the questions set out in the overview to the ITC. This appendix was prepared on behalf of the IAIS by its Accounting and Auditing Working Group (AAWG). The AAWG`s membership represents a subset of all IAIS members.

If you have further questions regarding this letter, please contact Mark Causevic at the IAIS Secretariat (tel: +41 61 280 8323; email: mark.causevic@bis.org) or Markus Grund, Chair of the IAIS Accounting and Auditing Working Group (tel: +49 228 4108 3671; email: markus.grund@bafin.de).

Yours sincerely,

Victoria Saporta   Michael McRaith
Chair, Executive Committee   Chair, Financial Stability and
                                           Technical Committee

International Association of Insurance Supervisors
c/o Bank for International Settlements, CH-4002 Basel, Switzerland
Telephone: 41 61 225 7300 Telefax: 41 61 280 9151 Website: www.iaisweb.org E-mail: iais@bis.org

IAIS (logo)

Appendix: IAIS Responses to Questions set out in Overview of the IAASB's Invitation to Comment - *Enhancing Audit Quality in the Public Interest*

General Questions
G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional skepticism, quality control, and group audits. In that context: **(a) Are these public interest issues relevant to our work on these topics?**

We broadly agree with the list of public interest issues identified by the IAASB. Whilst we believe that, at first sight, there may appear to be a large number of items in a list that is intended to show front-line issues, we suggest that they may be summed up in three key areas, being:

   i.   The application of judgement (which necessarily includes skepticism), and the documentation of that judgement;

   ii. Quality management, including work on inspection findings and remedial action; and

   iii. Transparency and communication around (i) and (ii) above.

The IAIS would like to stress the following points:

- Professional skepticism is by nature a state of mind. The risk exists that a creation of too rigid a framework may be counter-productive, and result in a 'tick-box' mind-set to what is required. Therefore, any addition to IAASB literature needs to be sufficiently flexible and open-ended such that it not interpreted as an exhaustive or self-contained set of rules or procedures designed to 'prove' skepticism, and can be meaningfully applied to new situations as they arise; and

- It is important for the IAASB to consider carefully the drivers for, and impediments to, the appropriate application of skepticism in considering its approach. The IAIS has set out its thoughts in this area in the response to question PS2 below.

(b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.

In the IAIS's view, an expectations gap may exist between the perception (of some users of financial statements) and the reality of the work and role of external auditors – some users may believe that the scope of the audit and the responsibilities of auditors are broader than is actually the case.

In part, this expectations gap might be closed by changes to the audit framework. However, we believe that it is key to the public interest that stakeholders are better informed on the nature of an audit, making the boundaries of the auditor's responsibilities clearer. In doing so, the IAASB may wish to build on the work that has been done in this area through the changes made to auditor reports.

This in turn gives rise to the broader question of how the audit in the form we know it can remain relevant in the public interest. We believe this question should be considered by the

IAASB on an ongoing basis in its work, particularly when contemplating questions that impact on the scope of an auditor's responsibilities.

> **(c) Are there actions you think others need to take, in addition to those by the IAASB, to address the public interest issues identified in your previous answers? If so, what are they and please identify who you think should act.**

We think the IAASB should work closely with the International Forum of Independent Audit Regulators (IFIAR) on areas where the inspectors believe that more requirements are needed. In our view, the findings of audit inspections should play an important role in considering the future focus of standard-setting activities.

As explained in our response to question PS3, we believe the work of IAESB and IESBA, in the areas of education and ethics respectively, also play an important role in supporting audit quality.

We believe that there is scope for continuing dialogue with the IASB, given that certain concepts (such as Going Concern) play a role in both the accounting and audit frameworks.

We also recommend the IAASB engage with those charged with governance (for example, with Chairs of Audit Committees) to better understand how they discharge their responsibilities.

> **G2.   To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional skepticism, quality control, and group audits) that you believe should be taken into account) If yes, what are they and how should they be prioritized?**

Our responses to G1 (a) and (b) above make a number of overarching observations around the nature and scope of audit, and we believe it is important that the IAASB keep these considerations uppermost in its mind when developing new work plans.

In the near term, we believe it is important for the IAASB to focus on delivering its policy priorities. In particular, we view the work of the ISA 540 Task Force, in which the IAIS is an active member, as a key priority.

> **G3. Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.**

The IAIS defers to the academic community for the most relevant research on the topics discussed within the consultation. Further, we encourage the IAASB to more broadly consider materials which may be useful to its objectives, beyond strictly those considered as research. For example, the Canadian Auditing and Assurance Standards Board and the Institute of Chartered Accountants of Australia published a document in 2013 on practical considerations in exercising and documenting professional skepticism (accessible using this link), which may be helpful to consider if more detailed requirements or guidance is considered necessary.

IAIS

Professional Skepticism

PS1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

ISA definition: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence (ISA 200, §13 (I)).

The IAIS believes it is difficult for a single definition to fully capture a complex abstract concept. In our view, this definition does not stress enough the three important aspects of professional skepticism:

– It should apply on a permanent basis;

– It is a questioning mind based on a propensity to doubt;

– It requires professional experience and judgement.

Firstly, professional skepticism is a permanent attitude that should assimilate new information throughout the audit process.

Secondly, the definition of professional skepticism should drive appropriate action or behaviour by the auditor. We recommend the IAASB reinforce this definition, to make it less 'neutral' by introducing a concept of a questioning mind that would tend to exhibit a more doubting attitude. This doubting attitude, depending on the circumstances and the information available regarding an account or an assertion, would lead the auditor to undertake actions and decisions so as to gather the evidence needed to be convinced that the risk of material misstatement is effectively low. Too neutral a vision of professional skepticism could lead to an approach where audits focus too much on corroborating management assertions and do not really exercise professional skepticism until some combination of facts and indicators suggest a clear problem with those assertions.

Furthermore, professional skepticism is closely interrelated with professional judgment. Professional skepticism cannot be considered as professional without sound professional experience and judgment. In order for skepticism to function properly, the auditor must have the requisite technical knowledge and experience that relates to key judgement areas in the audit of a particular industry. For example, in order to challenge the valuation of an insurer's assets and liabilities adequately, which may also involve challenging the auditor's own actuarial or other expert, the auditor must have appropriate expertise in assessing underwriting, credit and market risk. Even where an auditor has extensive experience and sound accounting knowledge, an auditor that does not have the requisite technical knowledge in these specialist areas is often not well-placed to challenge clients or his own expert on more technical matters that involve judgement. Thus there is a greater risk that the auditor in such cases seeks to justify the client's conclusion and accepts outcomes over a wide range, and so is not sufficiently skeptical.

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

The importance of professional skepticism to an effective audit cannot be overstated, particularly given the increasing judgment and complexity in financial reporting and issues posed by the current economic environment.

The application of professional skepticism could be better supported by acknowledging that there are a number of factors that can influence professional skepticism. Such factors include performance metrics that drive compensation, mind-set (e.g. objectivity, independence and familiarity threats), time pressures, individual traits of the auditor (e.g. integrity and fortitude), as well as environmental and contextual factors.

The impediments and drivers for the appropriate application of professional skepticism are detailed below.

Impediments

There are several factors that may impede a consistent and appropriate application of professional skepticism by auditors:

(a) The personal background of the auditor, including their behavioural traits, cultural/ environmental considerations, and competence level (especially for particular industries such as financial services) when undertaking an audit;

(b) At the level of an engagement team assigned to a specific client:

- o Time pressures to meet short filing deadlines, may limit the extent to which auditors on their engagements exercise professional skepticism in different ways:

  - less time available for actions relating to the exercise of professional skepticism, especially for those that are time consuming and cognitively demanding; and

  - Indirect pressure for providing an unqualified audit opinion.

- o Economic pressures linked to audit fees can lead to incentives to keep audit costs low and consequently discourage the application of professional skepticism that might lead to increased audit work without certainty of identifying a misstatement;

- o Inappropriate or out-of-date technical knowledge in key judgement areas can lead to a situation where management's information and expertise is greatly superior to that of the auditor, which may supress the auditor's appetite to challenge management and lead the auditor to simply corroborate management's view;

- o Human resource constraints due to turnover and staff workloads could result in detrimental effects on the composition of the engagement team with respect to the competence and expertise needed, having an overall impact on the ability of the team to appropriately exercise professional skepticism;

- o Where inexperienced auditors are left to interact with difficult client management, less professional skepticism may be exercised (reduced evidence collection) as those auditors may in fact attempt to avoid interactions with management; and

o   Performance and compensation metrics and incentives for auditors that do not appropriately encourage professional skepticism may lead to reduced professional skepticism by the auditor.

(c) At the level of the audit firm:

According to some studies, firms are reporting downward pressure on audit fees due to the economic climate, users questioning the value of an audit ("the commoditization of audit"), and underbidding by rival firms. At the same time, the growth in the advisory businesses of the firms is expected to continue to increase at a faster rate than the assurance business, through both organic growth and acquisition.

Such trends in firm revenue, profitability and growth can have several impacts:

o   Leadership of the assurance practice may play a less significant role in the governance of the firm at the network level. This could impact the level of investment in the audit service line and/or the culture of the firm and the value placed by leadership on maintaining independence, objectivity, and professional skepticism;

o   The assurance practice may be pressured to keep pace with growth in advisory revenues and profits, which may result in audit partners accepting new clients with riskier profiles and/or in industries where the firm has little or no experience, or incentivise audit partners to place the maintenance and cultivation of client relationships as their primary objective;

o   Firm leaders and audit partners may focus greater attention and more experienced resource to the advisory line of business rather than the assurance practice, despite the possible need for greater involvement and supervision by experienced auditors in the assurance practice given the growing complexity of audits and the judgement areas involved; and

o   Firms may be unable to effectively manage compensation and cultural challenges between the assurance and advisory lines of business.

- Pressures relating to profitability (such as time budget pressures) may act to reduce the application of professional skepticism;

- Unrealistic incentives created by office/regional performance measurement could reduce professional skepticism; and

- Excessive reliance on IT processes, in the context of the automation of audit files, may lead to reduced professional skepticism as the staff focus may be on completion of IT audit steps in a virtual environment instead of learning how to "read people," think critically, and probe.

Drivers

Drivers of consistent and appropriate application of the professional skepticism by auditors will include:

- Good hiring and compensation practices, experience, training and education can foster and encourage the appropriate application of professional skepticism at the individual auditor level;

    o Incorporating ethics screening in the hiring process may help flag those individuals who may not have a propensity to apply professional skepticism;

    o Setting performance and compensation metrics that reward auditors for high quality work could help in increasing the application of professional skepticism.

- At the engagement team level, the tone set by the engagement leadership through activities such as:

    o Effective resourcing and planning commensurate with the work to be performed, as well as considering appropriate contingency plans for dealing with unexpected developments;

    o Effective review and coaching by experienced members; and

    o Regular communication and brainstorming sessions among the team members on risk assessment and audit related matters.

- Support of the tone of the engagement leader by the firm through actions, procedures and policies that effectively support audit quality.

> **PS3. What actions should others take to address the factors that inhibit the application of professional skepticism and the actions needed to mitigate them (e.g., the International Accounting Education Standards Board, the International Ethics Board for Accountants, other international or national standards setters, those charged with governance (including audit committee members), firms, or professional accountancy organizations)?**

International audit standards

As explained above, the IAIS believes that the definition of 'professional skepticism' should be more encouraging for auditors to undertake actions and decisions in the gathering of evidence. As a starting point, the IAASB could develop a common definition or framework of professional skepticism across the ISAs, IESs and IESBA Code (jointly with the IAESB or/and the IESBA) to better ensure a shared understanding for its appropriate application. The IAASB could also develop further application guidance.

Moreover, the IAIS believe that audit standards and guidance could be written in a way to better encourage a skeptical mind-set. The words used could change the current confirmatory framework (obtain evidence to support management's assertion) to a framework which leads more to auditors seeking evidence both supporting and disconfirming management's assertions.

Oversight committees and others charged with governance (e.g. audit committees)

Whilst it is the responsibility of the auditor to ensure that an appropriate degree of professional skepticism is applied in an audit, senior management and relevant oversight bodies such as audit committees can have a significant influencing role through activities such as overseeing

the integrity of financial reporting and the related processes (including internal financial controls and the effectiveness of the audit process).

This emphasises the need for strong governance generally and, in particular, the importance of the responsibility that independent oversight bodies such as audit committees can have in assessing whether the auditors have executed a high quality audit.

The IAIS is convinced that such oversight committees, and in particular audit committees, have a critical role to play in enhancing audit quality. Consequently, the IAIS supports on-going efforts to strengthen the role and responsibility of the audit committees, particularly:

- To raise the level of expertise and independence; and

- Improve communications between audit committees and external auditors.

Currently, it is difficult for audit committees to differentiate between audit firms on the basis of audit quality. There is little line of sight, or transparency, to the audit committee with respect to the quality of audit work. Audit committees must largely rely on the audit regulators' inspections to ensure audit firms have appropriate processes in place to promote audit quality.

Audit committees would be able to better evaluate and select audit firms on the basis of audit quality, if they had more relevant and meaningful information and indicators of firm audit quality, and perhaps this would lead to less focus on price as the key factor in the external audit purchase decision.

Firm / network

As mentioned above, the tone at the top of the audit firm can have a significant influence on the engagement team's attitude and practices in the application of professional skepticism. Consistent communication from firm leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed.

Also, audit firm hiring practices may be able to pre-screen candidates for behavioural traits linked to a propensity to apply professional skepticism. Indicators or experiences that exemplify certain key traits in a candidate – perhaps such as high integrity and fortitude - could be helpful in ensuring that new hires have the traits necessary to exercise professional skepticism.

Furthermore, a firms' internal systems can help promote better application of professional skepticism in a number of ways, including through:

- Greater recognition of audit quality considerations with performance appraisals, promotions, and compensation schemes;

- Training that continually reinforces the appropriate application of professional skepticism and professional judgment throughout the audit;

- Ensuring engagement personnel have appropriate technical training, experience, and time required to apply sufficient professional skepticism;

- Effective review and coaching by experienced members and regular communication and brainstorming sessions among engagement team members; and

– Striking the right balance between efficiency (including use of IT approaches) and application of professional skepticism through more time intensive personal dialogue and inquiry of client staff.

Also, independent regulatory oversight and inspections including appropriate public reporting of results may work to increase professional skepticism at the firm level.

Audit oversight bodies

IFIAR has identified (from audit inspection findings) that insufficient exercise of professional skepticism during the audit is a factor underlying many audit deficiencies. The sharing of an audit regulator's inspection findings with external auditors and audit committees, and more general information on audit quality indicators/ metrics, will better hold external auditors accountable for remediating their audit deficiencies.

Also, increased information sharing between audit regulators and financial services prudential supervisors can help put further pressures on specific firms with audit clients in that sector to fully address their audit quality issues, and also more broadly if the audit quality issues are seen to be systemic in nature or have financial stability implications.

Quality Control
QC1. We (IAASB) support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51-66.

The IAIS considers that the existing IAASB documentation provides a solid and valuable basis for performing quality control, both at the firm (ISQC 1) and the engagement (ISA 220) level.

However, the IAIS believes the quality control requirements for firms providing audit and non-audit services should be strengthened.

Consequently, the IAIS welcomes the effort made by the IAASB in this ITC to highlight the importance of quality control issues. On the whole, the IAIS agrees with the main direction of the IAASB proposals.

(a)	**Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?**

The Quality Management Approach (QMA) as described within the ITC would "integrate a firm's policies and procedures within its system of quality control through identification of relevant risks to quality and design of appropriate policies and procedures to address those risks". Revising ISQC 1 to incorporate the use of a QMA may have the positive effect of reinforcing the firm leadership's responsibility for the management of quality and may lead to quality control processes being made more proactive and scalable for differences in the size and nature amongst firms in the services they provide and in the type of entities to whom those services are provided.

However, at this stage the proposals relative to the QMA are not sufficiently detailed to be able to fully appreciate their potential implications. As matters stand, without appropriate safeguards, there is some risk of seeing audit firms with similar activities and circumstances set quite different quality objectives and tolerance levels for non-compliance risk. Accordingly,

it seems essential to ensure a common understanding of what constitutes quality objectives, quality risk responses, and how these could be appropriately scaled for differences in size and nature amongst firms. Consequently, the IAIS is of the view that the IAASB should primarily consider changes to ISC1 and to ISA 220 to strengthen the current requirements.

> **(b)** **If ISQC 1 is restructured to require the firm's use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?**

Revising ISQC 1 to require the firm's use of a QMA would be challenging as it imposes significant changes of both form and substance.

The IAIS notes that it may be useful to also draw attention to the linkages between the QMA and the:

- Public interest as the primary objective of auditors and audit firms;
- Firm strategy, especially when deciding on accepting a new client;
- Firm governance, as this is an essential element for making the processes of quality management more proactive;
- Availability of appropriate human resources to perform audit work, addressing issues such as staff turnover, seniority, experience, skills and knowledge; and
- Staff performance and compensation metrics and incentives.

Also, it may be useful if the QMA focused more on communication considerations, in particular:

– Internal communications, including at the network level, that should:

  o Make the quality objectives clear and easily understandable to all staff; and

  o Share relevant and timely information concerning quality findings, their consequences, and remediation actions.

– External communications, such as to audit committees, of the global assessment of audit quality processes of the firm and the quality issues in relation to the client, if any. Special guidance or application material could also be provided in the case of entities with no audit committee (communication to others charged with governance) and for the groups.

> **(c)** **In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?**

The proposed changes in ISQC 1 including incorporating the QMA, would require revising ISA 220 "Quality Control for an Audit of Financial Statements" to adopt a more proactive, scalable and robust approach to audit quality at the engagement level. Any such revisions should aim to develop better interaction between the system of quality control at the firm (and network) level and its implementation at the engagement level.

The other standards that might be particularly affected by revision of ISQC 1 are ISA 600 "Audit of Group Financial Statements", ISA 210 "Agreeing the Terms of Audit Engagements", ISA 260 "Communication with Those Charged with Governance", ISA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", ISA

300 "Planning an Audit of Financial Statements", and ISA 315 "Identifying and Assessing the Risk of Material Misstatement".

> **(d) If ISQC 1 is not restructured to require the firm's use of a QMA, how can we address the call for improvements to the standard to deal with differences in the size and nature of a firm or the services it provides?**

Concerns have previously been raised that ISQC 1 cannot be proportionately applied by small and medium practices (SMPs). Some SMPs see ISQC 1 requirements as too constraining in areas such as quality reviews, reviewers, corporate governance, and documentation. Consequently, as a start, the IAASB could further explore how best to address the concerns of SMPs in those particular areas.

> **QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67-83).**

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 given the environment in which the engagement team works can materially affect the mind-set of staff and the way they discharge their responsibilities.

The engagement partner, being responsible for individual audit engagements, plays an essential role in ensuring audit quality and maintaining the confidence of financial statement users.

Consequently, it is in the public interest that the roles and responsibilities of both the firm and the engagement partner in promoting audit quality are robust and clearly articulated within IAASB standards.

> **(a) Would the actions described in paragraphs 68-83 improve audit quality at the firm and engagement level? If not, why?**

The IAIS agrees with the list of specific audit quality related issues identified by the IAASB. In our view, effectively addressing those issues is crucial for enhancing audit quality. In terms of actions proposed to address those issues, we have the following comments:

Firm level: monitoring and remediation

Monitoring audit quality within an audit firm implies an effective quality control system, based on policies and procedures, which provide for regular assessment of the adequacy and effectiveness of that system. This quality control system is important for identifying emerging risks and opportunities and ensuring that standards are being adhered to. 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.

While ISQC 1 contains requirements related to monitoring of an audit firm's system of quality control, it does not contain explicit requirements for audit firms with respect to policies and procedures to address and respond to the results of inspections performed by external inspectors. Strengthening requirements and adding new application material within ISQC 1 to

address such matters could lead to improved audit quality with firms achieving greater consistency in practice with respect to responding effectively to inspection findings of individual engagements. Such requirements could address:

- An analysis of any external findings and appropriate responses thereto, in the same way that internal findings are considered;

- Consideration of whether such findings would have implications for other engagements as well as the quality control system, including appropriate remediation;

- Consideration of performance of other types of reviews at different stages of an audit that are also focused on achieving quality such as "pre-issuance" and "post-issuance" reviews and the results thereof; and

- Obtaining an understanding of the causal factors of audit deficiencies and addressing those factors in the internal monitoring system in terms of updating policies and procedures and monitoring the effectiveness of those updates.

Such enhanced requirements could be supported by appropriate application material.

Firm level: quality control policies and procedures when operating as part of a network

Some audit firms operate through a network of firms, sharing common methodologies, quality control processes, and monitoring of compliance with policies and procedures. Moreover, some audit firms are developing audit delivery models (or ADMs) that centralise some elements of the firm's system of quality control, or certain aspects within a standard audit, in a location that could be physically set in a (sometimes offshore) location from where the majority of the engagement team is located. For audit firms, these types of activities are viewed as opportunities to improve efficiency through standardisation of routine audit tests and activities.

We understand that some concerns have been raised with such practices, in particular:

- Some audit firms and/ or engagement teams (or group engagement teams), when using work performed by other auditors or component auditors from the same firm or network, may be over-relying on the network's system of quality control (including monitoring policies and procedures covering responsibilities under ISQC 1); and

- The implications on a firm's system of quality control when using various ADMs are not appropriately covered by current requirements, particularly in regards to how the work is to be directed, performed, supervised and reviewed.

The IAIS is of the view that additional requirements or application material should be developed with respect to ISQC 1 in order to more explicitly address the extent to which audit firms should rely on shared network quality control and monitoring policies and procedures at the audit firm level. Further, such new material could include consideration of the results of external inspection findings of individual network firms and their implications on the network as a whole and the potential impact on the audit firm's own system of quality control, including its monitoring policies and procedures.

Firm level: transparency reporting

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

The IAIS believes that transparency reports issued by audit firms, highlighting particular aspects of their policies and approach to audits, provides an opportunity for audit firms to distinguish themselves on aspects of audit quality. Adding transparency reporting application material within ISQC 1 may provide audit firms with useful guidance for developing internal processes for producing consistent, relevant and supportable transparency reports.

Engagement level: engagement partner roles and responsibilities

The audit engagement partner is directly responsible for engagement audit quality. It is therefore essential to the public interest that the expectations of the engagement partner are sufficiently clear and well-articulated within the ISAs.

Firm and engagement level: engagement quality control reviews (EQCR) and engagement quality control reviewers

Given the importance of the role of the engagement quality control review (EQCR), related requirements and guidance need to be robust and clear, and consideration should be given to potentially expanding them beyond audits of listed entities to other entities that have a large number and wide range of stakeholders (such as insurance companies and pension fund), as this would serve the public interest.

The IAIS believes that strengthening the requirements and application material in ISQC 1 and ISA 220 related to EQCR should be considered, in particular the IAASB could develop new requirements to:

– Ensure integrity and independence of the engagement quality control reviewers; and

– Document the timing and substance of the EQCR procedures performed and any significant or substantive discussions between the engagement partner and reviewers;

Given the cross-cutting nature of the topic, consideration should be given to moving the requirements and guidance relating to EQCR into a new separate standard.

> **(b) Should we take other actions in the public interest to address the issues in paragraphs 67-83?**

Governance of an audit firm includes the responsibility to establish policies and procedures designed to support the performance of quality audits, monitoring compliance with the established policies and procedures, and instilling a culture of accountability for audit quality throughout the audit firm.

The areas the IAIS believes may need to be further addressed within the ISAs include:

Governance structure

Leadership responsibilities could be emphasized in ISQC 1 by highlighting the importance of audit firm leadership in setting an appropriate culture within the audit firm ("tone of the top") and being responsible for extending that culture throughout the audit firm.

Values, Ethics and Attitudes

As part of their human resource policies and procedures, how an audit firm compensates and rewards its staff is a key aspect of the 'tone at the top" and the attitude towards audit quality throughout the firm. It is important that audit quality considerations, including the need for staff to exhibit appropriate behaviours, are incorporated within appraisal and reward systems.

Knowledge, Time and Experience

It is important that policies and procedures supporting audit quality objectives are designed such that:

– Partners and staff have sufficient time and resources to deal with issues as they arise;

– Engagement teams are suitably qualified given the risk of the engagement;

– Performance appraisals are timely and appropriate coaching is given; and

– Adequate training is provided, including specialized industry training where appropriate.

> **(c) Should we take action now to tackle other issues? If yes, please describe the actions, why they need priority attention, and the action we should take.**

For the IAIS, the work that is underway to address ISA 540 issues is particularly important, especially to the extent it can help to enhance the quality of insurer audits generally and, perhaps in some cases, play a role in the effective monitoring of systemically important insurers.

> **Group Audits**

> **GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.**

The IAIS welcomes the particular attention given in this ITC to issues related to group audits. On the whole, the IAIS believes that the ITC proposals will help bring about an overall improvement in the quality of group audits.

> **(a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84-97)? If not, please explain why. What else could we do to address the issues set out in this consultation?**

Although the introduction to the ISA 600 states that "*The International Standards of Auditing (ISA) apply to group audits*" and the standard contains some direct references to other ISAs (ISA 220, 210, 300), the IAIS still believes it would be useful to emphasise that relevant principles required in the other ISAs should be applied when performing an audit of group financial statements. Also, application material could be strengthened to better illustrate how ISA 600 should be applied or adapted in practice.

The IAIS supports preserving the principles-based nature of the ISAs so they can continue to be fit for purpose in all situations and contexts encountered - in particular, for group audits.

> **(b) Would the actions we are exploring in relation to ISA 600 improve the quality of group audits? If not, why?**

While the IAIS supports the main actions explored in relation to ISA 600, the following specific aspects could be improved:

Acceptance and continuance process of the group audit engagement

IAS 600 should be clearer about the approach, the requirements to be followed, and the necessary documentation that should be developed by the group audit team when considering the acceptance or continuance of a group engagement.

The application material could be enhanced to better address:

− Restrictions on access, in particular to persons and information related to components; and

− Impairment of the group engagement team's ability to rely on, or to be involved in, the work of the component auditors.

The need for the group engagement partner to consider the competence and capabilities of the component auditors, when considering the competence and capabilities of the collective engagement team performing the group audit engagement, could be better reinforced.

The IAIS believes it would be appropriate for the terms of the engagement letter to include the group management's explicit agreement to provide the auditor with access to all information relevant to the group audit.

Communications between the group engagement team and component auditor

The IAIS is of the view that the requirements around communications within ISA 600 could be strengthened, in particular around the interactive communication required between the group engagement team and component auditor as the group engagement team plans, reviews and assesses the work performed by the component auditor.

Two-way communication at all stages of the audit would enable the group engagement team to better understand if the instructions provided to the component auditor are relevant and have been fully understood and complied with. It may also help the group engagement team better understand the results of the procedures performed and assist them in evaluating the sufficiency and appropriateness of the audit evidence obtained for the purposes of the group audit opinion.

Information sharing should be more than the group engagement team sending an instruction letter and the component auditor sending his/her clearance memo summarizing the work done and the overall conclusions at the end of the process. In the view of the IAIS, two-way dialogue and the exchange of information should take place throughout the audit process.

Using the work of the component auditors

According to the ISA 600, the group engagement team is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities, comply with ethics and independence and are subject to a regulatory environment ensuring quality control.

The IAIS is of the view that the standard should also require appropriate documentation and the application material should be made clearer about how to assess and document the required understanding by the group engagement team.

The IAIS believes that prerequisites regarding competence of component auditors should be emphasised in the case of international groups, for which group entities may have to report to

the parent company under an accounting framework different from the one used for local financial statements. Specific training of auditors may be necessary in certain cases.

The IAIS also believes that IAS 600 requirements should focus more on the significant judgments that need to be made about the timing, nature and extent of the involvement of the group engagement team in work done by component auditors, and even more, the need for adequate documentation of these significant judgments.

The standard should require the group engagement team to document how they have selected the forms of involvement among those listed in paragraph A55. Also regarding paragraph A55, it may be useful to add in a meeting with component management, the component auditor and group management to discuss the impact of the component auditor's findings on the component and the group audit.

Identifying and assessing the risks of material misstatement in a group audit

ISA 600 does not contain guidance relating to the understanding of a group's components and the identification of significant risks in group audit engagements, the requirements to do so are included within ISA 315, and those would also be applicable to group audits.

A more direct link to the other ISAs, and especially the relevant paragraphs in IAS 315, could be useful for reinforcing the importance of these requirements, as could the addition of application material to ISA 600 to help better support the application of the principles in ISA 315 in group audits.

Issues relating to component materiality and other aspects of materiality relevant to group audits

The determination of materiality in the context of the audit of group financial statements can be a difficult exercise given the need to design, apply and manage different materiality thresholds across the group. The IAIS believes the guidance on how component materiality and component performance materiality should be developed and applied could be strengthened, perhaps also introducing illustrative examples.

Responding to identified risks of material misstatement in a group audit (including issues relating to the group engagement team's involvement in the consolidation process)

The IAIS believes that it would be useful to make clearer the distinction of work done by the component auditor for the purposes of the group audit only and work done for stand-alone purposes, as this would provide more guidance on relevant considerations for the auditor in the different circumstances, in particular regarding the need to apply some or all ISAs. Considering the importance of the issue, it may be appropriate to develop a new standard specifically addressing the role of a component auditor.

Where some balances are audited centrally or in the aggregate and 'pushed' down to the component, it would be beneficial to introduce additional guidance about the implications for the work being performed by the component auditor, including when standalone opinions are also required at the component level.

In addition, it has been noted that the use of shared service centres also gives rise to other challenges in a number of areas, including how the audit procedures performed at the shared service centre can be integrated into the work performed by the group engagement team and

the component auditors, and the form and extent of communication between the engagement team responsible for the work being done at the shared service centre and the other auditors. The IAIS believes that further consideration is needed as to how to better address issues around the use of shared service centres, including consideration of enhancing requirements and providing additional guidance for such situations.

Also, the standard should make clearer that the group audit engagement team has to perform an assessment as to whether the remaining risks of material misstatement to the group financial statements related to 'residual balances' would be adequately addressed by work performed on significant components, selected non-significant components and through work performed at the group level. Although paragraph A53 of ISA 600 considers the situation where a group may be comprised of many components that are not significant, the guidance is not detailed enough regarding the approach and procedures to be performed.

Review and evaluation of the work of component auditors by the group engagement team

➢ **Review**

The IAIS believes that the judgments that led the group engagement team to define the level of review of the audit working papers of the component auditor, and the intensity of the effort and procedures deployed in this review, should be documented.

The IAIS agrees the extent of the review needs to be considered in light of the fact that the work of the component auditors is likely already reviewed by the engagement partner responsible for the work performed on the component, and that, all other things being equal, this review should not exceed the nature and extent of review by an engagement partner of another partner's work in a non-group situation. However, this view must be considered with some caution because it assumes that the component auditor uses common policies, procedures and methodologies with those of the Group's audit team and that there is some evidence of review by the engagement partner responsible for the work performed on the component. This implies also that the review is conducted by members of the team with a sufficient level of seniority and experience.

The IAIS also believes that additional guidance on the nature, timing and extent of the procedures that the group audit engagement team should perform on the work of the component auditor in different circumstances would be helpful.

➢ **Evaluation**

The IAIS believes that effective two-way dialogue is crucial for the group audit engagement team to obtain a full understating and all the necessary information to evaluate the findings of the component auditor, and their implications at the component level as well as the group level. These exchanges, and the judgment exercise in terms of the findings, should be appropriately documented.

➢ **The Impact of New and Revised Auditing Standards**

The IAIS agrees there is a need to focus more explicitly on relevant considerations about group financial statement disclosures and intensification of KAM, in the requirements or the application material of ISA 600, including giving consideration to the relevance of components and the involvement of the component auditor.

> **(c) Should we further explore making reference to another auditor in an auditor's report? If yes, how does this impact the auditor's work effort?**

Making reference to another auditor in a group auditor's report may be perceived by financial statement users as reducing the group auditor's responsibility for the group audit opinion, and may contribute to users' misunderstanding of the role of the group auditor with respect to assessing the adequacy and appropriateness of the component auditor's work.

However, in particular circumstances where the group auditor's access to either or both the component and the component auditor is restricted, the group auditor may have no choice but to use the component auditor's stand-alone report – and so making reference to another auditor in the auditor's report may be appropriate.

Consequently, the IAIS believes any reference to another auditor in a group auditor's report:

1) Should be strictly limited to unique circumstances; and

2) The group auditor's report should clearly explain those unique circumstances (e.g. restricted access to the component and/or to the component auditor) and the consequences resulting from the use of the component auditor's standalone report.

> **(d) What else could the IAASB do to address the issues highlighted or other issues of which you are aware? Why do these actions need priority attention?**

The IAIS would welcome future work focused on the following matters:

New auditing standard for component auditors

The IAIS supports the idea of creating a new auditing standard for component auditors, specifically to:

-   Facilitate the group auditor's understanding of the component, the component auditor and their operating environment;

-   Better deal with issues arising from the component auditor's environment, such as differences in culture, business customs, laws and regulations, professional oversight, educational and training background, independence requirements, etc.;

-   Allow earlier identification of the situations where there is no reasonable way of obtaining sufficient appropriate audit evidence from the component auditor;

-   Foster the group auditor's involvement in the work of component auditors;

-   Make the two-way communication in the course of the audit more fluid; and

-   Address specific issues related to SMPs acting as component auditors, as well as to the situations where the component is a non-controlled entity.

The group engagement team's involvement in the sub-consolidations performed at a regional or segmental level

In accordance to ISA 600, the group auditor should obtain an understanding of group-wide controls and of the consolidation process. However, the standard does not deal with situations where a part of the consolidation procedures and operations is performed at the regional or

segmental level (sub-consolidation). The standard does not cover various issues arising from sub-consolidation cases, in particular the:

- Group auditor's understanding of consolidation processes performed at the sub-consolidation level;

- Group auditor's involvement in the work of the component auditor acting at the consolidation level;

- Highly specific segmental sub-consolidations, especially challenging when reviewing and evaluating the work of the component auditor acting at the sub-consolidation level (e.g. insurance sub-group consolidated by an ultimate banking parent company);

- Complexity of information flows (between the ultimate parent, the sub-consolidation and the components); and

- Interactions between group / sub-group / component materiality.

These issues could be addressed by:

- Revisiting the ISA 600's requirements pertaining to the group auditor's responsibilities in relation to sub-consolidations; and

- Providing more application material to illustrate relevant issues and how those issues are expected to be addressed.

The group engagement team's involvement in the consolidation process

The IAIS is of the view that ISA 600 includes appropriate requirements and application material addressing the understanding and evaluation of the consolidation process at the overall group level. However, the IAIS notes the consolidation processes are increasingly reliant on sophisticated software and applications using complex and large data warehouses and data marts. In this context, it may be appropriate to consider strengthening the link between IAS 600 and the paragraphs in ISA 315 relating to the understanding of internal control relevant to the financial reporting process.