



CONSULTATION PAPER

**The publication and grading policy for
audit firms that carry out statutory audits of
public-interest entities**

30 April 2019

MISSION

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest

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1. Summary

In November 2018, the Irish Auditing & Accounting Supervisory Authority (“IAASA”) issued a consultation paper to obtain the views of stakeholders with regard to the proposal by IAASA to implement a publication and grading policy in the quality assurance review process relating to statutory auditors and audit firms that carry out statutory audits of public-interest entities.

Responses to the consultation paper were provided by seven audit firms and two recognised accountancy bodies. Although legislation requires Audit Committees to monitor the statutory audit of financial statements, taking into account any findings and conclusions by the Supervisory Authority¹, there was an absence of responses from Audit Committees and other users of the proposed public reports to the November 2018 consultation paper.

Following consideration of the responses to the November 2018 consultation paper, IAASA has revised the proposed publication and grading policy for audit firms that carry out statutory audits of public-interest entities.

The purpose of this consultation paper is to obtain an understanding of views from the intended users, other than practitioners, of the audit quality inspection reports with regard to the proposed publication and grading policy for audit firms that carry out statutory audits of public-interest entities.

2. Introduction and background

1. Quality assurance reviews

IAASA is designated as the competent authority in Ireland responsible for quality assurance reviews of statutory auditors and audit firms that carry out statutory audits of public-interest entities. The quality assurance review process is designed to assess the effectiveness of the statutory auditor or the audit firm’s internal quality control system through assessment of the design of the internal quality control system, compliance testing and review of individual audits of public interest entities.

The assessment of the design of the internal quality control system of the audit firm and compliance testing involves inspection of the firm’s policies and procedures and consideration of the impact of these policies and procedures on audit quality.

Further to this, a sample of audits of public-interest entities are selected for inspection using a detailed risk selection model. A number of audit areas are selected as part of each audit inspection, which are selected at the discretion of IAASA, taking into consideration specific risks pertaining to the entity as well as areas of interest to IAASA. Due to the application of a risk based approach in determining the audits selected for inspection and the areas reviewed within the selected audits, it would be inappropriate to infer that issues found within an individual audit inspected did, or would arise, on any other audit that has been, or would be, performed by the statutory auditor or audit firm.

¹ EU Regulation 537/2014, Article 16, 3(f)

2. IAASA's audit inspections unit

IAASA's audit inspections unit ('AIU') has an overall objective to inspect public-interest entity auditors' work and to promote improvements in the quality of auditing of public-interest entities. Public-interest entity auditors are required to be subject to the quality assurance review process at least every three years. IAASA has now completed fieldwork in each of the audit firms that carry out statutory audits of public-interest entities and has commenced its second cycle of quality assurance reviews. IAASA intends to perform quality assurance reviews throughout the year in each of the audit firms that carry out statutory audits of public-interest entities. The current inspection methodology used by IAASA identifies a number of elements of the firm-wide quality control systems. Each of the elements of the firm-wide quality controls system will be inspected over a three year cycle in all firms that carry out statutory audits of public-interest entities. IAASA will inspect the same elements of the firm-wide quality control systems across each of the audit firms during each calendar year to allow for comparability in reports, which will be published annually. Firms may or may not also have audits inspected in each year.

3. IAASA's reporting on quality assurance reviews

Following completion of a quality assurance review, IAASA issues to the audit firm an audit quality inspection report that provides a summary of all public-interest entity audits (if any) inspected as part of the quality assurance review and any findings arising in relation to the effectiveness of the design or implementation of the firm's quality control system. The audit quality inspection reports details weaknesses identified and recommendations. Recommendations include remediation of deficiencies and/or improvements going forward. Separate reports are issued to audit firms in respect of each public interest entity audit inspected detailing the matters arising and recommendations for remediation of deficiencies and/or improvements.

The quality assurance review process is not designed to identify all weaknesses, which may exist in the design and implementation of a statutory auditor or audit firm's policies and procedures. Although audit quality inspection reports may comment positively on certain items, these reports are not designed to give a balanced analysis of all areas. Where an inspection of an individual public-interest entity audit identifies an area where the firm did not obtain sufficient audit evidence, this does not necessarily indicate that the audit opinion is inappropriate or that the financial statements are misstated.

4. Follow-up process

Audit firms are required to implement recommendations made by IAASA within 12 months of the date of the audit quality inspection report.

Audit firms provide a written submission to IAASA within 12 months of the date of the audit quality inspection report, setting out the actions taken by the audit firm to implement IAASA's

recommendations for remediation of deficiencies and/or improvements going forward. Following review of the written submissions, the AIU may perform further procedures to verify that the audit firm has implemented the recommendations. To verify that audit firms have implemented the recommendations made in relation to individual public-interest entity audits, the AIU may also review the documentation supporting subsequent audits of the entity, this review is typically conducted on audits that have been completed following the date of the audit quality inspection report.

5. Publication and grading in other European member states

IAASA carried out a review to understand the publication and grading policies in 25 European countries. Of the 25 countries, 20 issue audit quality inspection reports on individual audits and at a firm level, similar to IAASA's process. Of the 20 countries that issue audit quality inspection reports on individual audits and at a firm level, three countries publish audit quality inspection reports on the firm publically and two countries publish audit quality inspection reports on the public-interest entity publically.

Of the 25 countries, twelve do not assign a grade to the internal quality control system of audit firms or to the inspections of public-interest entity audits. Five countries assign a grade to public-interest entity audits only. Three countries assign a grade to the internal quality control system of audit firms only. Four countries assign a grade to the internal quality control system of audit firms and to each of the inspections of public-interest entity audits. Three countries publically publish the grade assigned to the firm's internal quality control system.

Of the 25 countries, one country grades individual inspections of public-interest entities as pass or fail. One country applies three categories/grades and the remaining countries apply four categories of grade, which have broadly similar definitions.

6. Definition of findings within European and International fora

The Committee of European Auditing Oversight Bodies ("CEAOB") and the International Forum of Independent Audit Regulators ("IFIAR") both provide a platform for reporting and discussing findings relating to the effectiveness of the design or implementation of a firm's quality control system. The CEAOB has identified three indicators that must be satisfied for a matter to represent a significant firm-wide inspection finding, these are as follows: a relevant requirement in an auditing, quality control or ethical standard, or in a firm policy was not met; and circumstances indicate that there is a pervasive or systemic issue (rather than a one-time deviation or isolated issue); and there is not only a remote likelihood that the deficiency could affect the audit firm's independence or the quality of audits performed by the firm. IFIAR defines a finding as a significant failure to satisfy the requirements of auditing standards and further defines a quality control deficiency as a departure from auditing standards or requirements, including standards on quality control and ethics and

independence that may, or did, have an effect on audit quality, due to either the significance or systemic nature of the departure.

The CEAOB and IFIAR also both provide a platform for reporting and discussing findings relating to individual audits inspected. The CEAOB has identified three indicators that must be satisfied for a matter to represent a significant inspection finding in an audit, these are as follows: procedures of substance required by a standard have not been performed; and these relate to a material account balance, class of transaction or disclosure; and there has been failure to obtain sufficient and appropriate audit evidence for a key assertion. IFIAR defines a finding as a significant failure to satisfy the requirements of auditing standards with respect to a financial statement balance or disclosure. IFIAR further defines a deficiency as either a matter with respect to which a firm did not obtain sufficient audit evidence to support its opinion or a failure to identify or address a material, or likely potential material, error in the application of an accounting principle.

In both IFIAR and CEAOB, the focus is on compliance with auditing standards and the International Standard on Quality Control. In addition to these, IAASA assesses compliance with the following: the Ethical Standard for Auditors; the regulations of the audit firm's recognised accountancy body; and the audit firm's own policies and procedures. Accordingly, not all findings in IAASA reports will meet the definitions set out by either CEAOB or IFIAR.

3. Proposal

1. Proposed publication policy

(a) Audit quality inspection reports

It is IAASA's intention that audit quality inspection reports will be made available to the public from the second round of inspections forward for audit firms that carry out statutory audits of public-interest entities. IAASA does not intend to publish audit quality inspection reports on audit firms that carry out statutory audits of public-interest entities and are subject to the quality assurance review process for the first time.

The audit quality inspection reports will detail findings arising in relation to the effectiveness of the design or implementation of the firm's quality control system and will indicate the severity of each finding that has arisen along with IAASA's recommendation for remediation of deficiencies and/or improvements going forward. The audit quality inspection reports will also provide a summary of all public-interest entity audits inspected as part of the quality assurance review and will disclose the grading that has been assigned to each of the audits inspected. IAASA does not currently intend to disclose the names of entities whose audits have been inspected. This is because a finding in relation to audit procedures does not necessarily indicate any error in the financial statements.

Separate reports will continue to be issued to audit firms detailing the matters arising from each public interest entity audit inspection. The matters will be detailed along with IAASA's recommendation for improvements going forward and/or remediation of deficiencies. A schedule of other findings may also detail minor observations noted in the course of the inspection. These detailed reports will not be made publically available.

In IAASA's November 2018 consultation, input was sought from stakeholders as to whether publication should be in batches or whether reports should be issued as completed, balancing the interests of users of the reports while also applying the principles of due process. Following review of the November 2018 consultation responses, it is IAASA's intention to publish the audit quality inspection reports on completion of an inspection, with the first reports expected in early 2020.

(b) Statement of recommendation implementation

It is IAASA's intention to publish a statement, in reference to each audit quality inspection report, disclosing whether, or not, a firm has implemented IAASA's recommendations within 12 months of the date of the audit quality inspection report. IAASA intend to make the proposed statements of recommendation implementation available to the public following the completion of procedures to verify that an audit firm has implemented IAASA's recommendations.

2. Proposed grading policy

- Findings arising in relation to the effectiveness of the design or implementation of a firm's quality control system will have their severity indicated by way of a red-amber-yellow ("RAY") system.
 - **Red** indicates that a finding is a significant deficiency and will be included in IAASA's reporting of inspection findings to the CEAOB and IFIAR. A significant deficiency is a significant failure to meet the requirements of the ethical standards or ISQC 1; or, a pervasive failure to apply firm's processes or procedures where there is more than a remote likelihood that the deficiency could affect the audit firm's independence or the quality of audits performed by the firm. Failure to implement a recommendation and/or remediation set out in a prior finding in relation to the firm's quality control system, or, in relation to a matter arising from a public interest entity inspection would also be assigned a red grading.
 - **Amber** indicates that an improvement is required. This is less than a significant failure to meet the requirements of the ethical standards and ISQC 1; or, limited instances of failure have been found to apply the firm's processes or procedures.

- **Yellow** indicates that a finding is a minor deficiency. This is a minor or once off failure to apply a firm's procedures or processes; or, a low level deficiency that has the potential to develop into a significant or less than significant failure to meet the requirements of the ethical standards and ISQC 1.
- Each of the individual public-interest entity audits inspected as part of the quality assurance review will be assigned a grade.
 - A "1" grading is a good audit with no concerns regarding the sufficiency and quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. Any concerns in other areas are very limited in their implications (both individually and collectively). This grading is unlikely to be appropriate if there are any matters included in the report issued to the audit firm.
 - A "2" grading is an audit with limited improvements required. There will be only limited concerns regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. There may be some concerns in other areas but their implications (both individually and collectively) are limited.
 - A "3" grading is an audit with improvements required. There will be some concerns, assessed as less than significant, regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. There may be concerns in other areas, the implications of which (both individually and collectively) are less than significant.
 - A "4" grading is an audit with significant improvements required. There will be significant concerns regarding the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed. There may also be concerns in other areas, the implications of which are individually or collectively significant.
- For individual public-interest audits, three key factors will be considered in assessing "significance" of findings, these are as follows: the materiality of the area or matter concerned; the extent of any concerns regarding the sufficiency or quality of audit evidence (e.g. whether they relate to specific elements of the audit evidence only or are more pervasive to the overall sufficiency or quality of audit evidence in the areas concerned); and whether appropriate professional scepticism appears to have been exercised in forming audit judgments and the extent of any non-compliance with standards or the firm's methodology identified.

3. Guidelines for users of the audit quality inspection reports

IAASA intends to issue guidelines for users of the audit quality inspection reports. The proposed guidelines will include guidance on the following matters: interpretation of severity indicators assigned to findings arising in relation to the effectiveness of the design or implementation of a firm’s quality control system; interpretation of the grades assigned to each of the individual public-interest entity audits inspected as part of the quality assurance review; consistency of application; and interpretation of the risk factors considered in selecting individual public-interest entity audits for review.

4. Matters on which IAASA is consulting

In light of the above, a number of matters are set out below on which IAASA is seeking views from stakeholders and interested parties, other than practitioners, by 5pm on 31 May 2019.

No.	Matter on which views are sought
1.	Are the intended users of the audit quality inspection reports satisfied with the proposed mechanism of indicating the severity of findings in relation to the effectiveness of the design or implementation of a firm’s quality control system?
2.	Are the intended users of the audit quality inspection reports satisfied with the proposed mechanism of assigning a grade to the individual public-interest entity audits inspected as part of the quality assurance review process?
3.	<p>The proposed audit quality inspection reports will provide a summary of each finding that has arisen in relation to the effectiveness of the design or implementation of a firm’s quality control system and will detail IAASA’s recommendations for remediation of deficiencies and/or improvements going forward. The proposed audit quality inspection reports will also provide a summary of all public-interest entity audits inspected as part of the quality assurance review, the names of the individual public-interest entity audits inspected will not be disclosed.</p> <p>The proposed audit quality inspection reports will indicate the severity of each of the findings that have arisen in relation to the effectiveness of the design or implementation of the firm’s quality control system and will also disclose the grading that has been assigned to each of the individual public-interest entity audits inspected as part of the quality assurance review.</p> <p>Are the intended users of the audit quality inspection reports satisfied with the form and content of the proposed audit quality inspection reports?</p>
4.	Are the intended users of the audit quality inspection reports satisfied with the proposal to issue a report on completion of IAASA’s quality assurance review on each firm in addition to a statement, in reference to each audit quality inspection report, disclosing whether, or not, a firm has implemented IAASA’s recommendations?
5.	The proposed guidelines for users of the audit quality inspection reports will include guidance on the following matters: interpretation of severity indicators assigned to findings arising in relation to the effectiveness of the design or implementation of a firm’s quality control system; interpretation of the grades assigned to each of the individual public-interest entity audits inspected as part of

the quality assurance review; and interpretation of the risk factors considered in selecting individual public-interest entity audits for review.

Are the intended users of the audit quality inspection reports satisfied with the proposed content of the guidelines for users of the audit quality inspection reports?

5. Making your submission

IAASA invites comments on all proposals put forward in this Consultation Paper and, in particular, on the specific matters set out in section 4 above.

Stakeholders and interested parties, other than practitioners, are invited to provide responses to the above questions by e-mail only to submissions@iaasa.ie no later than **5pm on the 31st May 2019**.

Any submissions received after this time and all anonymous submissions will not be considered.

Comments are most helpful if they:

- (a) respond directly to the specific questions posed;
- (b) provide a clear rationale for the position adopted by the respondent;
- (c) provide supporting evidence underpinning the views expressed/rationale proposed; and
- (d) describe in detail any alternative option(s) you wish IAASA to consider.

All responses from identifiable individuals and organisations received by the deadline will be considered by IAASA. Depending on the nature and scale of responses, IAASA may publish a feedback statement summarising the content of the responses. Respondents should note that, in the interest of transparency, their responses may be published in full or in part (and may be attributed to the respondent) by IAASA in that feedback statement.