INTERNATIONAL FORUM OF INDEPENDENT AUDIT REGULATORS

Internationally Relevant Developments in Audit Markets

2021

In this report, released on July 20, 2021, IFIAR analyses Internationally Relevant Developments in Audit Markets as reported by its Members.

Established in 2006, the International Forum of Independent Audit Regulators (IFIAR) comprises independent audit regulators from 54 jurisdictions representing Africa, North America, South America, Asia, Oceania, and Europe. Dedicated to serving the public interest and enhancing investor protection, IFIAR provides a platform for dialogue and information-sharing regarding audit quality matters and regulatory practices around the world and promotes collaboration and consistency in regulatory activity.

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1. Executive Summary

The Internationally Relevant Developments in Audit Markets Task Force was established to monitor relevant developments in IFIAR Member jurisdictions. To do so, it conducted an extensive survey amongst IFIAR Members, in the beginning of 2020[1]. The responses from 50 IFIAR Members provide observations on five audit policy topics: auditor appointment and tenure, joint audits, combination of audit and non-audit services (NAS), transparency of audit related information and audit firms' governance and culture. This section summarizes these observations by highlighting – among other things – key facts and figures, which regulations and requirements generally apply and which reform measures have been implemented in the various jurisdictions, based on IFIAR Members' survey responses. This overview of practices across the IFIAR Membership may help in understanding international developments in audit markets, audit quality and related reforms and may inform debates around these topics.

- **A large majority of jurisdictions report the existence of audit firm tenure rules, driven largely by those in EU member states, particularly in respect of Public Interest Entities (PIEs)**[2]. At the same time, a quarter of the respondents to the IFIAR survey said that their jurisdiction has no rules limiting auditor tenure.

- **Although there is less consistency in rules which require rotation of audit partners, the most common formulation is for a maximum period of continuous audit partner tenure of 5-7 years with a 2-3 year cooling off period**. Most jurisdictions state that their audit firm tenure/partner rotation rules have an objective in mind to enhance audit quality through increased auditor independence.

- **A robust auditor selection/evaluation process may enhance audit quality and auditors' independence. The transparency of such a process contributes to understanding by users of the financial statements and auditor's report.** The survey results indicate few current frameworks/initiatives to enhance the transparency of the auditor selection/evaluation process across different jurisdictions, but provides some insight about disclosures when changing auditors.

- **56% of the IFIAR respondents indicate that their regulatory framework includes elements to facilitate access to the PIE audit market to a range of auditors.** These include targeted communication, an adaptation of the level of the fees charged by the regulator, specific procedures or a supply of audit IT tools. Also, targeted communication to audit committees, is seen by some IFIAR Members as a measure which can contribute to better market access.

- **In some jurisdictions, joint audits are in place, and the introduction of joint audits is under consideration in a number of other jurisdictions**. Joint audit requires the involvement of at least two auditors ("two sets of eyes" approach), and, subject to its regulation, may include a challenging approach between the audit firms through a cross review of the audit work.

[1] The survey was conducted before the outbreak of COVID-19. Impacts of COVID-19 are not reflected in the survey results or considered in the report.

[2] IFIAR did not seek to define Public Interest Entities for purposes of collecting data, as definitions vary between IFIAR Member jurisdictions. Public Interest Entities often, but not always, include listed entities and, whether or not listed, banks and insurance companies.

- **At the time of the survey, the regulatory mandates of only a few IFIAR respondents include competition in the audit market.** The TF's focus, therefore, was on gathering available data about audit service providers and observations from IFIAR Members.

- **The "Big Four" firms perform a prominent share of audits in many jurisdictions around the world.** In many jurisdictions, Deloitte, EY, KPMG and PwC (the "Big Four" firms) together hold a prominent market share in audit services.

- **The provision of NAS to audit clients is generally subject to limitations (in terms of nature and extent) that must be adhered to. Nearly all jurisdictions within the IFIAR Membership exercise restrictions on the provision of NAS, albeit varying in scope and strictness, addressing the threats to independence resulting from NAS**. Restrictions include not allowing auditors to provide any NAS to PIEs they audit; permitting only 'audit related' services; relatively short lists of specified allowed services; and blacklists of prohibited services.

- **Disclosure of the nature of and/or fees paid for NAS in the financial statements and or the audit report may address stakeholder concerns and affect trust in audit**. The survey identifies that there is significant variation in disclosure requirements among the IFIAR Membership.

- **Regulators in a few jurisdictions are considering much tougher restrictions.** They include not allowing audit firms to provide NAS to any entity, whether audited or not, with possible separation of the audit and non-audit operations of the firms; whilst others have implemented some of these measures.

- **In some IFIAR Member jurisdictions, the public trust in audit and auditors, and also in audit regulators in some cases, has been damaged following corporate scandals and failures**. Transparency and disclosure of the contents and processes of audit may contribute to users' understanding of audit, and may put direct or indirect pressure on the stakeholders to take action appropriate to their respective roles.

- **A number of initiatives have been or are being taken in IFIAR Member jurisdictions in the area of transparency and disclosure of audit related information.** These include the introduction of Audit Quality Indicators (AQI), Key Audit Matters (KAM)/Critical Audit Matters (CAM), reporting on Internal Control over Financial Reporting (ICFR) by auditors or companies, enhanced regimes for reporting on going concern matters, and other transparency reporting.

- **Audit Quality Indicators refer to potential portfolios of quantitative measures intended to provide insights for evaluating the quality of audits.** In 16 Member jurisdictions an AQI framework has been adopted, 8 of which include some mandatory features.

- **Key Audit Matters are defined in ISA701 as 'those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period'.** After almost 5 years since the launch of this international initiative, the survey results suggest that there are similar tendencies among jurisdictions regarding the number of selected KAMs/CAMs per audited entity and their contents.

- **Internal control over financial reporting refers to those procedures within a company that are designed to provide reasonable assurance of compliance with the company's policies that affect the reliability of financial reporting**. How IFIAR Member jurisdictions approach regulation, review and reporting of ICFR varies considerably with respect to both auditors and companies.

- **While all respondents apply ISA570 or an equivalent, in 8 Member jurisdictions initiatives to enhance going concern reporting regimes were recently implemented**. Some other respondents are considering the introduction of stricter reporting by auditors of going concern issues, but have not yet reached the point of developing a new regime.

- **The survey results indicate that transparency reporting and similar initiatives have been put in place across many different jurisdictions**: some in a mandatory fashion while others on a voluntary basis.

- **Governing bodies of audit firms play a key role in the firm's overall governance arrangements, setting the "tone at the top". Audit firms have a public interest role, and many also have significant consultancy and advisory practices, which increases the importance of firm governance that focuses on and supports audit quality.** Moreover, the International Standard on Quality Management 1 (ISQM 1) requirements expand upon audit firm governance and leadership requirements.[3]

- **While firm governance drives the tone at the top to support public interests and audit quality, sound firm culture is paramount for such governance to operate effectively.** About two-thirds of IFIAR Members indicate that audit firm culture is reviewed specifically as part of the audit regulatory inspection regime, although the vast majority of IFIAR Members indicate that there are no regulations or standards that require audit firms to address specifically behavior and the organizational culture of their audit practice beyond ISQC 1's provisions on Leadership Responsibilities for Quality within the firm.

[3] At the time of drafting of this report, ISQC 1 was the applicable standard for Quality Control at audit firm level. This standard includes limited requirements on audit firm leadership. ISQM 1, which is effective from late 2022 onwards, will expand on these requirements. This report does not elaborate on the changes resulting from this new standard.

2. Introduction

In May 2019, the IFIAR Board formed a Task Force on Internationally Relevant Developments in Audit Markets (hereafter: IRDAM TF). The objective of the TF was, among other things, to monitor relevant developments within IFIAR Member jurisdictions. This report provides a summary of internationally relevant developments in audit markets as reported by the IFIAR Membership. It should be noted that this report focuses on audits of Public Interest Entities, consistent with the mandates of many of IFIAR's members.

Sustainable and consistent high quality of audits is an important element of reliable financial reporting that contributes to a properly functioning financial system. In the period ahead, all stakeholders in the audit industry stand to gain from developing a better understanding of the relationship between reforms addressing the structure of the audit markets and/or audit firms and audit quality. Also, having independent data and evidence is key for decision makers. In preparing this report, IFIAR observed that research undertaken is generally case specific and fairly narrow. Hence, IFIAR would support academia's analysis and scrutiny of measures being implemented, their effects and impact, and their conditions for success.

❖ <u>Appointment and tenure of the audit firm and of the auditor</u>

Tenure of the audit firm and of the auditor may have an impact on audit quality in different ways. On the one hand, one can argue that the longer the relationship between the audit firm or the audit partner and the audit client has lasted, the better understanding the auditor has of the business model and the company. Therefore, one can argue, it is more likely that the quality of the audit will increase. On the other hand, one could also argue that the longer the relationship between the audit firm and the audited company, the closer the two parties become and it is more likely that the auditor's judgement will favor the company's management. This, one can argue, increases the chance that the quality of the audit will decline.

❖ <u>Joint audit</u>

Joint audit, required in some jurisdictions and allowed in others, involves more than one audit firm taking responsibility for the performance of the audit of a given entity. Depending on the regulation in place, this usually involves two audit firms working together to provide a joint opinion after challenging each other and cooperating to assess jointly the choices made by the entity's management when preparing the financial statements. The six IFIAR jurisdictions where joint audits are compulsory for certain categories of entities record lower market concentration levels than on average within the European Union, though this may be the result of factors other than, or in addition to, the use of joint audit.

❖ <u>Combination of audit and non-audit services</u>

Audit firms traditionally operate as multidisciplinary firms, with non-audit work becoming the main source of revenues and profits for the largest firms. Policy makers for many years have addressed the effect of the combination of audit and non-audit services on (the incentives for or the perception of) audit quality.

❖ Transparency and disclosure

Transparency and disclosure of audit related information by key stakeholders in the ecosystem is important to high quality audits. Transparency and disclosure of the contents and processes of audit contribute to the users' understanding of audit, and may put direct or indirect pressure on the stakeholders to take actions appropriate to their respective roles. These stakeholders include audited entities, audit committees, audit firms and audit regulators.

❖ Governance and organizational culture

A sound and healthy governance structure, and a sound organizational culture within audit firms influence the quality of statutory audits.

This list of audit policy topics analyzed by IRDAM TF is not exhaustive. Other relevant policy topics relate to the potential expectation gap regarding statutory audits (the "scope of audit"), the impact of technological developments on audit quality, regulatory and enforcement powers of audit regulators, and improving the public interest perspective in standard setting. Many of these topics are being addressed by other IFIAR work streams, including IFIAR's involvement in the Monitoring Group, the Technology Task Force and the Enforcement Working Group. Such developments are therefore not pursued in this report.

Working methods and governance

The survey covered the five audit policy topics with detailed questions on market developments, data and (potential changes in) current practices, regulations and requirements and their underlying rationale. In addition to the survey, the work of IRDAM TF has been based on recent publications from national audit supervisors, reports by national investigative committees in the field of audit markets and regulation, publications and data available from international organizations and academic literature on key selected topics within IRDAM TF's remit. Also, the report includes detailed case studies to better illustrate the set-up and impact of certain reform measures.

The IRDAM TF has been led by the Dutch Authority for the Financial Markets. The IRDAM TF further consists of 12 other IFIAR Members.

3. Audit policy topic 1: Appointment of the audit firm and of the auditor

The broad topic of auditor appointment covers a range of connected issues:

The auditor selection entails a number of challenges given the specific nature of the audit services, which requires that the auditor, after selection, needs to remain independent from the entity and its leadership in the opinions expressed.

Several regulatory measures are in place in a variety of jurisdictions that address the appointment of the auditor and the length of the auditor's engagement in a way that protects the independence of the auditor from the entities' management.

No IFIAR member country has been identified where the audited entities, which may include those charged with governance, have no say in the choice of its auditors. However, a number of rules are in place regarding minimum and maximum terms for audit firm tenure as the auditor for the same company. Other requirements deal with the rotation of individual audit partners, or other members of an audit team over the years for the same audited entity. Others address the transparency and openness of the auditor selection/evaluation process to enhance audit quality and auditors' independence, the involvement of audit committees in the appointment of auditors and arrangements for the appointment of auditors outside the normal course of business.

3.1 Audit engagement tenure

A large majority of jurisdictions, including all from EU member states, report the existence of audit firm tenure rules (37 out of 50), particularly in respect of PIEs. A very significant proportion of jurisdictions (24 out of 50) are EU member states and draw their audit firm tenure rules from the Audit Regulation (537/2014) and Directive (2006/43/EC) (ARD). The ARD sets maximum tenure for an audit engagement, whilst allowing member states to apply more stringent rules. The ARD also allows for longer tenure periods where there is a joint audit. Only 8 of the 24 ARD respondents appear to default to the maximum allowable rotation rules, a "10 + 10 years" approach which requires a mandatory tender after the initial 10 years with possible reappointment for up to an additional 10 years (for joint audits, the maximum combined tenure is 24 years).

Across all jurisdictions where audit firm tenure rules exist, rules covering maximum tenure for audit engagements focus predominantly on PIEs. Most jurisdictions set a maximum tenure, although many also set a minimum (often 3 years). Rules for non-PIEs are rare, and some of those which do exist relate to minimum tenure periods rather than maximums. A minority of jurisdictions have set rules only for specific market sectors – most commonly banks and/or insurance companies. Where rules are in force for other types of entities, those relating to banks and insurance companies are stricter and set shorter tenure periods. Another jurisdiction sets rules on auditor tenure for public companies other than financial institutions depending on whether or not the audited entity has an audit committee.

3.2 Audit Partner rotation

There is less consistency in rules which require rotation of audit partners or other members of audit teams. Many of the rules described in responses from IFIAR members are drawn from ethical codes and standards (for example the IESBA Code of Ethics) rather than having been set on a statutory basis. As with audit firm tenure, audit partner rotation rules for PIEs or larger listed entities appear generally more stringent than for other entities. The most common formulation is for a maximum period of continuous audit partner appointment of 5 to 7 years with a 2 to 3 year cooling off period.

The majority of respondents said no new changes to rules for partner rotation were planned in their jurisdictions. Those few that identified changes or proposals focused on rules covering audit partner rotation rather than audit firm tenure. One jurisdiction, Japan, reported that it was considering new rules for rotation covering other members of the engagement team in addition to audit partners.

3.3 Auditor selection/evaluation process

A robust auditor selection/evaluation process may enhance audit quality and auditors' independence. Enhancing the transparency of such a process could further add to a better understanding by the users of the financial statements and auditor's report. However, the survey results indicate that frameworks/initiatives to enhance the transparency of the auditor selection/evaluation process are less common across different jurisdictions.

Only 15 respondents have frameworks/initiatives to enhance the transparency of auditor selection/evaluation process, 12 of which are mandatory. Of the remaining 34, 7 indicated that initiatives are 'Under consideration'. 2 of those respondents are considering regulations to establish mandatory requirements.

The most commonly stated reason for changing auditors is the 'Expiration of the term' (8 responses), followed by 'Audit fees' and 'Securing consistency in the auditor between parent and subsidiary' (2 responses each). Some authorities do not require disclosure of the reasons except for early termination of the work.

Of 35 respondents, 34 do not necessarily find discrepancies between disclosures by auditors and those by audited companies on the disclosed changes of auditors. Only one jurisdiction noted that disagreement in fees and differences in opinion are mentioned more often by the firms.

3.4 The role of audit committees and appointments outside the normal course of business

The vast majority of jurisdictions report that audit committees play some role in the periodic evaluation and/or appointment of auditors. Within the EU, under the ARD audit committees have a specific statutory role in auditor appointment for PIEs.

18 of the 50 jurisdictions report a mechanism for the appointment of a statutory auditor outside the normal course of business, but no jurisdiction indicated having "specific" regulatory powers to intervene when faced with an audit firm failure or to prevent a related competition issue. In each case the appointment mechanism is a backstop power – vested in a government ministry, court or regulator. For example, if there are no statutory auditors or if all statutory auditors find it impossible to perform their duties, a jurisdiction has provided that the presiding judge of the commercial court can appoint a statutory auditor and set fees. Additionally various Members have set up crisis or contingency plans to help them in taking action in case of a failure of an audit firm. A limited number of Members mentioned that they have the capacity to activate, for instance, disciplinary proceedings, to stop crisis contagion or to facilitate the continuity of audit work.

4. Audit policy topic 2: Joint audit

4.1 Overview of current practices and requirements regarding joint audit in various jurisdictions

Joint audit is allowed in several jurisdictions, and required in some. 86% of the IFIAR jurisdictions do not have any regulation in place requiring joint audit in any circumstances. Some of these jurisdictions (17) allow joint audit but do not require it. In these cases, the use of joint audit remains marginal. In six IFIAR jurisdictions, legislation creating a compulsory joint audit regime for some categories of entities applies. These countries show a lower market concentration than average in the European Union, though this may be the result of a combination of factors other than, or in addition to, the use of joint audit.

Box 4.1: Joint audit in France

In France, a joint audit leads to a joint opinion on the financial statements. The joint auditors perform a joint examination of the financial statements. They communicate jointly with the entity and together sign a single audit report. They act together as a "college", and are jointly responsible for the audit opinion issued.

A specific professional standard deals with the organization of joint audits in order to avoid duplication of work and guarantee a balanced distribution of the audit work. External inspections are performed by the regulator to ensure proper collegiality and balance in the allocation of work, so that each auditor is able to form his own independent opinion and each of the two auditors sign the audit report.

Any audit firm can apply for an engagement as joint auditor, taking into account that joint auditors of an entity cannot be members of the same audit firm network. The audited entity selects each auditor separately and creates its pair of auditors. Apart from independence between them, there is no legal obligation regarding the composition of the pair of auditors in terms of size of market share.

The minimum duration of an audit engagement in France is six financial years. This provision protects the auditor's independence, especially against any attempts from clients to change the auditor in case of issuance of an adverse opinion. The six-year duration also incentivizes smaller firms to join the PIE market, with a longer perspective than just one year engagements.

Mandatory joint audit is required by law in all companies required to publish consolidated financial statements (PIE or non-PIE). In some financial institutions and companies, mandatory joint audit applies, even if no consolidated financial statements publications are required. 52% of PIEs publish consolidated financial statements and therefore have more than one auditor.

- ❖ In terms of market concentration, joint audit is one of the factors that has opened up the French audit market. In 2018, 331 different audit firms were involved in the audits of PIEs in France. Recent figures show that 55%[4] of the PIE engagements are held by the "Big Four". From an audit fees point of view, 28% of the PIE audit market is outside the "Big Four".

The introduction of new requirements for joint audit is under consideration in some jurisdictions. The suggestion for introducing mandatory joint audit has for instance been raised in 2020 in the Netherlands as one of the possible actions to prevent market vulnerability, though it is still under discussion and is not clear whether these recommendations will be considered for implementation.

On the other hand, some jurisdictions removed joint audit requirements that previously existed. As an example, a banking regulator decided in 1992 to remove the joint audit requirement that until then existed for federally regulated banks. Reasons cited to abolish this requirement at the time included harmonization with audit requirements for other financial institutions, and risks associated with the model.

Various reasons are provided by those requiring, allowing or considering joint audit. Some regulators indicate the increased impartiality vis-à-vis the audited entity due to the college of auditors, increases in the challenging approach of the auditors, due to mandatory cross review ("two sets of eyes" approach), an increase in technical competence of audit firms by sharing experience, an increased continuity of the audit when one of the auditors is replaced, and increased number and size of non-"Big Four" participants in the audit market.

In some cases, a specific obligations to appoint at least one joint auditor that is not among the "Big Four" was considered. In June 2020, the European Parliament called on the Commission to propose further measures to address what it referred to as the quasi monopoly of the "Big Four" firms auditing the largest listed companies, such as the setting up of mandatory joint audit to enable firms outside of the "Big Four" to develop the capacity needed to audit the biggest companies.[5] This follows a 2010 European Commission proposal and a 2019 French recommendation[6] that at least one of the two joint auditors should be a challenger audit firm.[7] In another jurisdiction, the concept of shared audits, whereby the component auditor is from a network other than the group auditor, is under consideration.

4.2 Joint audit and market monitoring considerations

While many IFIAR members (70%) have certain duties regarding audit market monitoring or related actions, the scope of these responsibilities varies considerably and few have responsibility for addressing competition in the audit market. However, two-thirds of the members having certain duties regarding audit market monitoring or related actions are European regulators.

[4] For a joint audited entity, each joint auditor holds one engagement.
[5] *European Parliament resolution on competition policy – Annual report 2019*, European Parliament, June 2020
[8] *Report on audit market monitoring*, Haut Conseil du Commissariat aux Comptes, June 2019
[7] *Green paper – Audit Policy: Lessons from the Crisis*, European Commission, October 2010

Market monitoring assists in understanding developments with respect to the audit firms participating in PIE audits. In addition to providing general information, statistics about market participants provide insight into the extent of concentration in audit services, which in turn may affect competition.

In most jurisdictions, the "Big Four" firms together hold a prominent market share in audit services. For instance, a recent study showed that, in the European Union, the "Big Four" firms together had an average market share of almost 70% in the number of statutory audits of PIEs[8]. Taking turnover as the reference, the market share of the "Big Four" was calculated around 80%. IRDAM TF did not address market concentration in detail as competition generally falls outside of our members' mandates, but noted the challenge in assessing data about concentration given variations across its members' jurisdictions in audit requirements and in the types and sizes of companies that access capital markets.

A consideration regarding the level of market concentration is the implication for auditor choice. Concentration may affect competition and may limit choice for audited companies, and some regulators note implications for the soundness of the audit market as a whole as well. Another potential consideration is whether lack of competition may make audit firms complacent, possibly lowering audit quality. At the same time, there is not enough (academic or practical) evidence on the nature of the relationship between concentration levels and audit quality (see box 4.2).

Box 4.2: Overview of academic studies on market concentration, audit quality and choice

Academic studies dealing with audit market concentration provide a mixed picture of positive as well as negative consequences on the audit services provided. It should be noted that there is no single definition of audit quality or commonly accepted measures of audit quality. The absence of a point of reference makes it challenging to draw a correlation between a given level of audit market concentration and the quality of audit services provided in this market. Separately, a recurring consideration with respect to market concentration is the number of options if there are a limited number of audit firms, which is a topic within the remit of competition authorities.

The following benefits of market concentration have been highlighted in academic literature:

- Higher market concentration and larger audit firms are logically connected. Larger firms may have, compared to smaller firms, more financial resources likely to devote to human capital development. As such, they are able to invest to expand the knowledge and technical skills of their staff.
- More staff in larger audit firms inherently implies more auditors with specialized knowledge. Larger firms with specialized expertise in given topics allows them to address a larger range of audit engagements.
- Larger audit firms, through pooling greater resources, may invest more in information technology, which is likely to lead to operational efficiency.
- Larger audit firms depend less on a single client than smaller or medium-sized audit firms and they are less likely to become lenient with their clients, as the temptation to please them by compromising audit procedures is lowered.
- A concentrated audit market with larger firms creates economies of scale, enabling auditors to

[8] Report on Audit Market Monitoring 2020, European Commission, January 2021, based on data collected in 2019.

reduce costs and fees.

- ❖ As competition is lower in a concentrated market, there may be less downward pressure on audit pricing. Higher audit fees are likely to allow an increase the audit time spent, and as such the depth of the audit effort.

Other academic studies raise the following potential downsides of market concentration:

- ❖ Specialization of skills may concentrate high expertise in some few large audit networks, creating a gap between the large networks and the remaining smaller firms.
- ❖ In a concentrated market, fewer firms lead to a more constrained choice. Audit firms with significant market power may reduce the level of their services, as the lack of alternative solutions would limit their clients' ability to obtain audit services elsewhere.
- ❖ If big firms purge their portfolio of the riskiest audit clients, those clients have fewer alternative auditors to choose from. Also comments are being made of whether the small firms have access to the necessary capabilities for auditing such risky clients.
- ❖ In the absence of competition, large firms may not have an interest in investing in IT innovations that lead to operational efficiency as they may not have to differentiate themselves to gain new clients.
- ❖ Due to the reduced probability of the client switching auditors, auditors' long association with clients could result in a familiar relationship, leading to potential auditor complacency.

The weight of positive and negative impacts of concentration on audit quality or choice may depend on the market segments. In the large-client segment, multinational entities may benefit from large audit firms able to provide them with technology- and resource-intensive audits. On the other hand, smaller entities and businesses acting on a national basis, whose less complex audits involve less resources, may see a higher benefit in a larger variety of audit firms.

Lastly, some academic studies have highlighted that concentrated audit markets can remain price and quality competitive if audit clients are sufficiently mobile. The reduced competition, as long as the market share instability remains high, may not be concerning. Only a stable market with reduced mobility would be detrimental to audit "captive" clients.

Apart from joint audit used in some countries, 56% of the IFIAR respondents indicate that their regulatory framework includes some elements which facilitate access to the PIE audit market to a wider range of auditors. A regulation in the European Union protects audit firms which have less than a 15% market share from being eliminated from tendering in the PIE market. The goal of the legislation is to ensure that the PIE audit sector remains open to all registered statutory auditors. Under the legislation, no company is entitled to issue audit tenders restricting eligibility to the main players in the market, based on a given market share held (or "Big Four" firms in particular).

Some IFIAR members take other actions to facilitate access by a range of players in the audit market. Examples of such actions include targeted communication to smaller audit firms, and an adaptation of the level of the fees charged by the regulator.

5. Audit policy topic 3: Combination of audit and non-audit services

5.1 Overview of the extent of combining audit and non-audit services in various jurisdictions

The provision of NAS to audit clients is generally subject to limitations (in terms of nature and extent) that must be adhered to. A broad majority of the IFIAR Membership signals that threats to, for example, auditor objectivity and independence are relevant to general market perception and consideration about NAS. The provision of certain NAS to audit clients is generally accepted in a significant majority of jurisdictions (42 out of 50). However, there can be consequences resulting from NAS, including reduced competition if firms are unable to tender for audits because of independence issues.

All jurisdictions have provisions established by laws and regulations and / or ethical codes to address threats to independence. A significant majority apply the IESBA Code either in full (22), with additions (16) or in part (4). EU member states, and others that chose to align with them, have to comply with the ARD which have significant requirements in relation to NAS. Some of these requirements are more restrictive than the IESBA Code, in particular the percentage cap on the amount of fees that can be earned from NAS that are not required by law to be provided by the auditor.

Transparency and disclosure

One means of addressing stakeholder concerns and promoting trust in audit is to require disclosure of NAS. If stakeholders have an understanding of the nature and amount of NAS fees, they are better positioned to make judgments about the appropriateness of the auditor providing those NAS.

The survey identifies that there is variation in disclosure requirements. 18 jurisdictions report no disclosure requirements; some only require disclosure of the fees and others also require some disclosure of the nature of the NAS.

Restrictions on NAS

Nearly all jurisdictions within the IFIAR Membership exercise restrictions on the provision of NAS, albeit varying in scope and strictness. Restrictions include not allowing auditors to provide any NAS to PIEs they audit; permitting only 'audit related' services; relatively short lists of specified allowed services; and blacklists of prohibited services. Eight jurisdictions apply restrictions only for the audited entity, but others apply them more widely with some variation in extent. As noted above, EU member states, and others that choose to align with them, have to comply with a percentage cap on the amount of fees that can be earned from NAS that are not required by law to be provided by the auditor. Only one jurisdiction reported that NAS are allowed unconditionally.

These differences in regulation of NAS across jurisdictions require careful consideration by audit firms leading audits of global groups. Some members reported that some firms voluntarily apply tighter restrictions than required in their jurisdiction to avoid the provision of services that could cause issues in relation to group audits.

5.2 Measures addressing the combination of audit and non-audit services

Regulators in some jurisdictions, notably the UK, are considering or have put in place much tougher restrictions, including restricting the types of NAS audit firms can provide to any entity, whether audited or not, alongside separation of the audit and non-audit operations of the firms. The purpose of such measures is to ensure that the audit firms are focused on the public interest. Also it would mean that firms are not restricted by independence issues from tendering for audits.

In July 2020 the FRC published a set of principles, which were updated in February 2021,[9] to guide the implementation of operational separation. Key objectives are to enhance audit quality by ensuring that those working in the audit practice are focused on the public interest; and to enhance audit market resilience by ensuring that no material structural cross subsidy persists between audit practices and the rest of the firms. 22 Principles have been agreed with the firms, covering Governance, Scope of the Audit Practice, Financial, Remuneration of Partners, Transparency, Accountability and Transitional arrangements. Whilst these principles have been agreed with the largest UK firms, the FRC will also seek backstop statutory powers to achieve the desired outcomes.

There may, however, be downsides to audit only firms. In the responses to this survey 10 jurisdictions reported that acceptance of NAS was associated with perceived benefits, in particular enhanced knowledge and expertise of audit staff. More generally, when proposals to prohibit all NAS are mooted, audit firms typically claim that there will be negative effects such as reduced knowledge and expertise, and also the audit profession being less attractive as a career making it harder to recruit staff with high capabilities.

[9] *Principles for Operational separation of audit practices*, UK FRC, July 2020 (updated in February 2021)

6. Audit policy topic 4: Transparency and disclosure

6.1 Overview of current practices and requirements regarding transparency and disclosure in various jurisdictions

In some Member jurisdictions, the public trust in audit and auditors, and also in audit regulators in some cases, has been damaged following corporate scandals and failures. Transparency and disclosure of the contents and processes of audit may contribute to users' understanding of audit, and may put direct or indirect pressure on the stakeholders to take action appropriate to their respective roles. These stakeholders include audited entities, audit committees, audit firms and audit regulators.

This chapter focuses on a number of initiatives currently being taken in IFIAR Member jurisdictions in the area of improving transparency and disclosure of audit related information, which reflect their own situation and/or international or regional agreements. The following sections look at facts and figures of five areas that are relatively widely seen across different jurisdictions, including AQI, KAM/CAM, ICFR, enhanced regimes for reporting of going concern, and transparency reporting, as well as other initiatives.

In general, since these measures are rather new, situations among IFIAR Members appear to vary. It would therefore take some more time to see any visible impacts they might have on audit quality. However, some Members are reporting indications of positive effects, particularly in the areas of AQIs and KAM/CAM.

6.2 Audit Quality Indicators

AQIs are a potential portfolio of quantitative measures that may provide new insights about how to evaluate the quality of audits. They are mainly used by audit firms as measures in their system of quality control, but some audit firms make them public in the context of their disclosure and transparency initiatives and/or disclose them to audit committees to facilitate bilateral dialogues.

Regulatory approaches relating to AQIs vary among jurisdictions in a number of aspects, and the same can be said about the approaches towards the publication of AQIs. Some authorities have published mandatory lists of AQIs while others follow principles-based approaches. The results of the survey suggest that competitively sensitive information appears less frequently on a voluntary basis.

State of AQI implementation

Out of 50 respondents, 16 Members have adopted an AQI framework, of which 8 have mandatory regimes and 7 voluntary[10]. Another 18 respondents are currently considering the adoption of the AQI framework, of which 5 Members plan implementation in a few years' time. The remaining 16 respondents are not considering the AQI framework at this point.

[10] A few responses where the AQIs are voluntarily implemented by audit firms as their own initiatives are counted as "voluntary." One respondent answered "other" because the Member published a report related to AQIs but does not necessarily encourage auditors to adopt those AQIs due to the limitations acknowledged.

The number and content of AQIs

Out of 14 respondents that provided information on the number of indicators[11] included in the AQIs in their jurisdiction, 9 use less than 10 indicators, while 5 respondents use 10 or more. The most widely used AQIs relate to 'Availability (e.g., workload, resources, and experts)' with 13 responses, followed by 'Focus (e.g., audit hours and risk areas)' with 12 responses. 'Competence,' 'Independence,' and 'Governance within the firm (e.g., quality control, internal and external inspection results)' are used in 11 jurisdictions, ranking third.

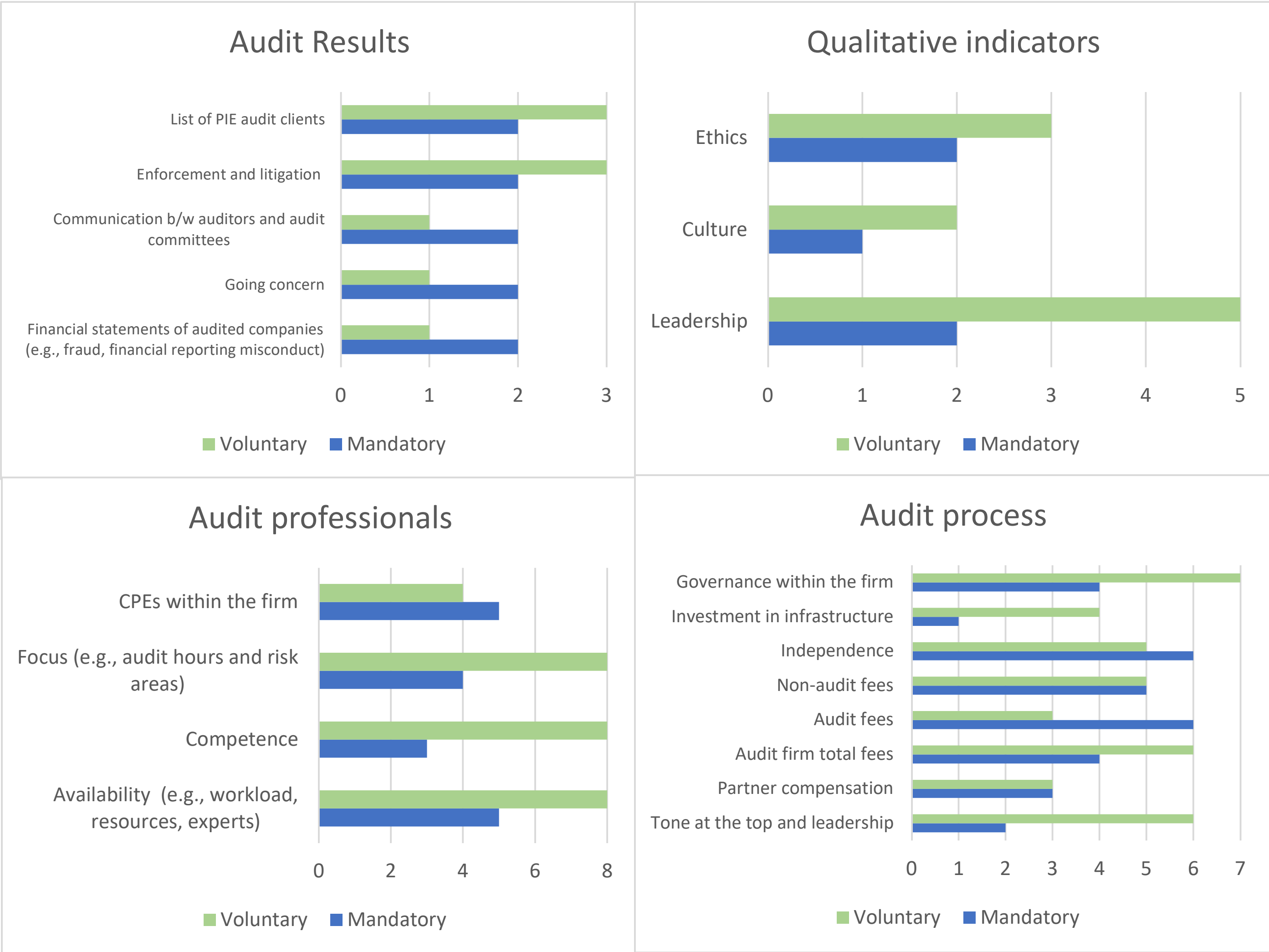
When separating responses between mandatory versus voluntary reporting of AQIs, some differences can be observed. Under mandatory frameworks, 'Audit fees' and 'Independence' are most frequently used (6 responses), followed by 'Availability,' 'CPEs within the firm' and 'Non-audit fees' (5 responses). On the other hand, 'Availability,' 'Competence' and 'Focus' are used the most (8 responses), followed by 'Governance within the firm (e.g., quality control, internal and external inspection results)' (7 responses) when it is voluntary.

Regarding the use of qualitative information, 9 out of 16 respondents indicate that they use such information as part of AQIs while 2 recommend to use it but not as AQIs. Some firms have included qualitative information in the set of AQIs on their own initiatives. Of those using qualitative indicators, either on a mandatory or voluntary basis, 7 respondents use 'leadership', 5 respondents 'culture', and 5 respondents 'ethics.' Even when qualitative indicators are not included in AQIs, firms' selection of indicators reflects in part the different business models, internal structures and cultures of the firms.[12] See figure 6.1 on the next page.

[11] To collect data on the types of information collected as AQIs, IFIAR determined certain categories based on known data reported. IFIAR does not suggest that these categories necessary are indicator with causal relationships to audit quality.

[12] *AQR Thematic Review, Audit Quality Indicators*, UK FRC, May 2020

Figure 6.1: Use of specific measures (mandatory vs voluntary)



6.3 Key Audit Matters

KAM are defined in ISA701 as 'those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period'.[13] ISA701 expects the communication of KAMs to 'enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed,' which would enhance the users' understanding of both audits and audited entities themselves.

After almost 5 years since ISA701 and ISA700 introduced the KAM framework, the survey results suggest that there are similar tendencies among jurisdictions regarding the number of selected KAMs/CAMs per audited entity and their contents.

[13] Many jurisdictions apply ISA701 or local/regional standards similar to ISA 701. For example the US uses CAM (Critical Audit Matters, PCAOB Staff guidance). They are collectively defined as "KAM/CAM" in this report.

State of KAM/CAM implementation

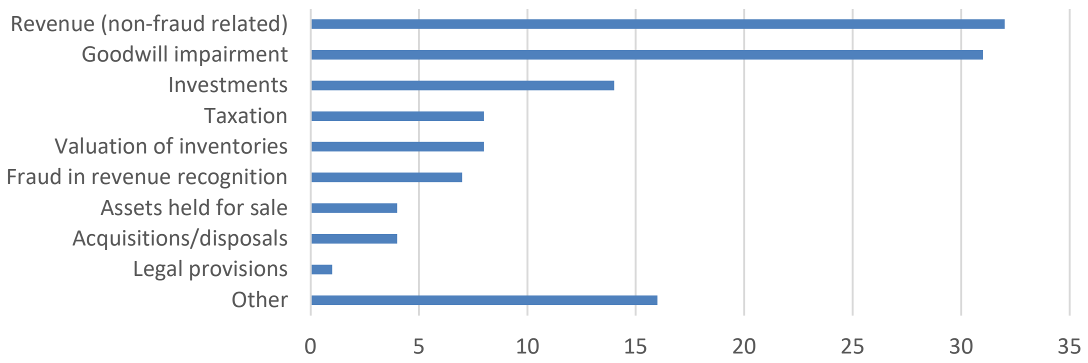
All respondents have adopted (including partially adopted and awaiting implementation) ISA701 and ISA700 or the equivalents. 21 respondents provide guidance on the application of KAM/CAM. The United States for example provided guidance and educational webinars to help firms implement the standard.[14] Turning to the audited entities, while ISA701 is applied to the audit of PIEs, which usually include large companies, listed companies and financial institutions, 18 out of 46 respondents apply the standard only to listed companies, whereas one includes state-owned companies as well.

The number of KAM/CAM and their contents

As for the average number of selected KAM/CAM per audited entity, 30 out of 44 respondents answered '1-3,' and the other 14 answered '3-6.' No one answered 'More than seven,' whereas 6 respondents did not give any answers.

The most common areas of KAM/CAM in respective jurisdictions relate to 'Revenue (non-fraud related)' - 32 Members – closely followed by 'Goodwill impairment,' observed by 31 Members. Those respondents that did not select 'Goodwill impairment' tended to be from relatively small economies with some exceptions. See figure 6.2.

Figure 6.2: Common areas of KAM/CAM



[14] *Implementation Resources for PCAOB Standards and Rules- Auditor Reporting,* updated October 2020
The United States also released in October 2020 an *Interim Analysis Report with evidence on the initial impact of CAM requirements*, along with a CAMs data set. These documents include information about numbers and types of CAMs disclosed as well as initial audit firm and investor experiences with CAM reporting.

6.4 Internal Control over Financial Reporting

Internal control over financial reporting refers to those procedures within a company that are designed to reasonably ensure compliance with the company's policies and procedures that affect the reliability of financial reporting. Management's responsibility for financial reporting, including for reliability and compliance with standards, is generally accepted and a key premise on which an audit is conducted. Strong ICFR is often associated with more reliable reporting.[15] How IFIAR Member jurisdictions approach regulation, review and reporting of ICFR varies.

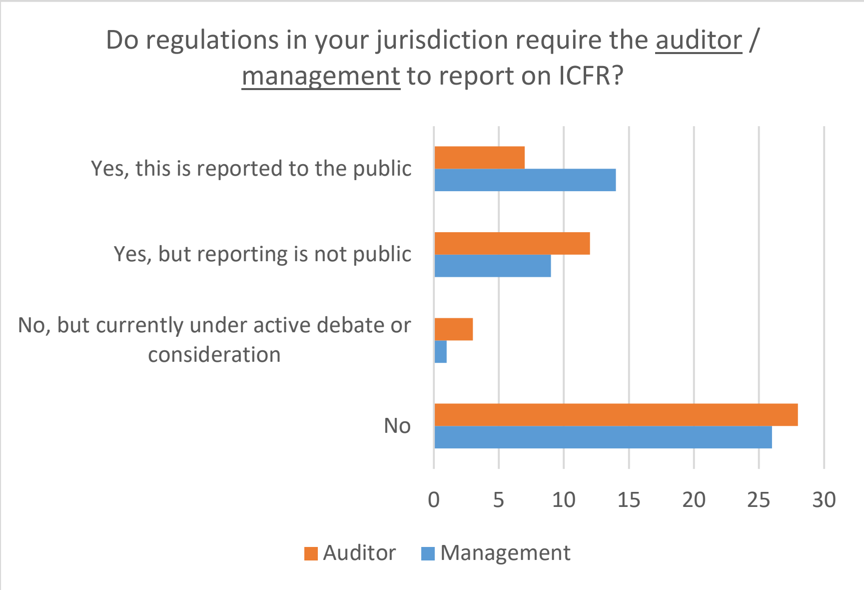
Of the respondents, less than half (46%) currently have regulations in their jurisdiction that require companies' *management* to report on ICFR. For those jurisdictions with regulations, whether or not this reporting is public is also split – 61% (14 respondents) have public reporting while 39% (9 respondents) do not. See figure 6.3.

With the growing demands for effective ICFR as a background, fewer but still over one third (38%) of respondents indicated that regulations or standards in their jurisdiction require ICFR reporting by the *auditor*. Similar to the above, whether this required reporting is public or not is varied; in these jurisdictions, 37% (7 respondents) have public reporting while 63% (12 respondents) do not. See figure 6.3.

While 19 respondents indicated that auditors have a requirement to report on ICFR, only 9 (or 18%) of the survey respondents indicated that the external auditor's responsibility is to *issue an opinion* on ICFR. One of the jurisdictions in which the external auditor has a responsibility to issue an ICFR opinion is the United States. As required by the Sarbanes-Oxley Act and implementing regulations, the principal executive and financial officers of publicly listed companies must certify that, among other things, they are responsible for establishing and maintaining ICFR. In addition, the officers must evaluate and report publicly on the effectiveness of the company's disclosure controls and procedures. For companies over a certain size, the auditor must opine on ICFR effectiveness.

[15] In a *2019 proposal to amend regulatory requirements*, the U.S. Securities and Exchange Commission noted the following (see page 88 of the proposal for studies cited): "Some studies have found that a failure to maintain effective ICFR has been associated with a higher rate of future restatements and lower earnings quality, a higher rate of future fraud revelations, more profitable insider trading, and less accurate analyst forecasts. Generally, ICFR auditor attestations also have been found to be directly associated with financial statements that are more reliable than in the absence of these attestations."

Figure 6.3: Do regulations in your jurisdiction require the auditor / management to report on ICFR?



While increased responsibilities for ICFR for either management or the auditor have been raised in a number of IFIAR Member jurisdictions, the survey responses indicate that this topic is under active debate or consideration in only a few jurisdictions. The case studies below provide further examples thereof:

Box 6.1: Ongoing Consideration of ICFR

Abu Dhabi – Resolution No.1, 2017 of the Chairman of the Abu Dhabi Accountability Authority ("ADAA"), "Effectiveness Test of Internal Control": In October 2017, the ADAA issued a resolution requesting reporting entities to engage their external auditors to issue an opinion on the effectiveness of ICFR, with a gradual approach to enable adequate investing in required skills and systems towards building an effective ICFR and addressing of issues relating to scoping, level of assurance, management roles, and responsibilities versus the auditors' roles and categorization of deficiencies.

In early 2019, ADAA ran a survey to understand the level of compliance by entities and their external auditors, which highlighted a disparity in application among the firms and entities. One lesson learned was that practitioners in audit firms and at entities need consistent follow up and guidance from ADAA to ensure consistency.

Australia – Parliamentary Joint Committee on Corporations and Financial Services: In February 2020, this Australian parliamentary committee issued an interim report as part of its inquiry into the regulation of auditing in Australia. Along with nine other recommendations, the committee recommended that the "Corporations Act 2001 be amended such that entities required to have their financial reports audited under the Act must establish and maintain an internal controls framework for financial reporting. In addition, such amendments should require that:

- management evaluate and annually report on the effectiveness of the entity's internal control framework; and
- the external auditor reports on management's assessment of the entity's internal control framework."

In its final report issued in November 2020, the committee did not change its support for this recommendation, but observed that the current economic situation will require the government to consider timing and thresholds for any new requirements. [16]

Netherlands – Future of the Audit Industry Committee: As part of its study into the measures necessary to sustainably improve the quality of statutory audit in the Netherlands, the Future of the Audit Industry Committee has also considered the financial reporting ecosystem. In doing so, the Committee has suggested to further study whether making management's responsibility for the financial statements more explicit, for instance via including an 'in control statement' would contribute to audit quality. It is anticipated that such study will be conducted in the near future.

United Kingdom – Restoring trust in audit and corporate governance consultation: Following a series of reviews relating to audit, the United Kingdom government (Department for Business, Energy and Industrial Strategy or BEIS) is proposing new reporting and attestation requirements covering, amongst others, internal controls. Under these proposals, auditors could also be engaged to provide a formal opinion about the internal control attestation, possibly limited to key internal controls over financial reporting.

6.5 Enhanced regime for reporting of going concern

While all respondents apply ISA570 or an equivalent, in 8 Member jurisdictions initiatives to enhance auditors' going concern reporting regimes were recently implemented. For example, Ireland and the United Kingdom revised their rules in 2019 with a view to increasing the work effort and reporting requirements on auditors in respect of the going concern assumption. In January 2020, Canada published a consultation paper[17] on going concern to prompt dialogue with a broader range of stakeholders. Samples of audit files were reviewed to understand the auditors' approach to evaluate managements' assumption of going concern risks and identify the needs for improvement. In France, auditors are required to inform management when they are aware of facts that would compromise the continuity of operations and shall notify a commercial court in case management does not take appropriate action to prevent the company's failure. Some other respondents are considering the introduction of stricter reporting of going concern, but have not yet reached the point of developing a new regime.

6.6 Transparency reporting

A transparency report is a publication issued on a regular basis, often annually, by audit firms to provide stakeholders with disclosure of the initiatives taken by firms for the enhancement of audit quality. While contents and titles of the reports can vary between different jurisdictions, they generally contain information related to governance and commitments of each firm including but not limited to:

[16] More information about the inquiry, including the joint committee's interim and final reports, can be found at Parliament of Australia - Regulation of auditing in Australia.
[17] *Going concern project*, CPAB, January 2020

legal/governance structure; relationships with an audit firm network; quality control system and outcomes; tone at the top; development of qualified professionals; financials; and responses to relevant regulations.

State of implementation of transparency reporting

Out of 50 respondents, 36 have already adopted transparency reporting by audit firms. Another 11 indicated they have not adopted transparency reporting because they already have other frameworks fully or partially serving the same function, or are waiting evidence of the effect of such reporting before taking action. Among 3 respondents considering a transparency reporting regime,' one Member mentioned that audit firms in that jurisdiction already voluntarily release transparency reports.

Out of 36 respondents with the transparency reporting regime in place, 27 made it mandatory by laws or regulation and another 1 through a guideline by self-regulatory organizations. Those jurisdictions with a mandatory framework also have rules on the contents of the reports. On the coverage, 20 out of 24 respondents apply the framework to PIE auditors following the EU regulation, while some others target either all audit firms or auditors of 10 or more listed entities.

6.7 Other initiatives

There are a number of jurisdictions where authorities are discussing enhancement of transparency and disclosure related to audit and audit regulation in response to their local needs. For example, one respondent is exploring amendments to the relevant act to require auditors to disclose inspection outcomes to those charged with governance (e.g., audit committees) in instances of severe audit deficiencies. Another authority is considering the introduction of initiatives for more transparency, which include publishing enforcement cases with the name of the audit firm, while promoting open and close dialogue with audit committees. The case study on Japan (Box 6.2) describes some of their unique approaches to deepening the existing disclosure requirements to enhance transparency and the provision of more substantive information.

Box 6.2: Japan - Enhancement of Auditors' Accountability

In an effort to regain public trust in audit after prominent audit failure cases in 2015, JFSA introduced an 'Audit Firm Governance Code' in 2017 and 'KAM' in 2018. While they were significant steps forward, further calls remained. They included the calls for more information from auditors on individual audits—especially, the background to modified opinions that potentially impact users' decisions—as well as disclosure on the replacement of auditors.

In January 2019, JFSA's advisory council (AC) published a 'Report on Enhancement of Auditor's Accountability' (JFSA, 2019). The major points of this report are as follows:[i]

Previous situation	AC's proposal
Accountability for auditor's opinion	
A) Enhancement of accountability in audit reports—basis for modified opinions	

Auditors are required to explain the grounds for modified opinions, but… • Audit reports tended not to fully explain reasons for modified opinions and how much impact the misstatement/limitation might have on financial reports, falling short of user expectations.	• Auditors should meet user expectations by providing specific, understandable explanation, especially for qualified and disclaimer opinions: - Reasons for issuing qualified opinions and not adverse opinions due to misstatements. - Reasons for the highly exceptional situation which precludes issuance of any opinions.
B) Additional explanations other than via audit reports—alternative/complementary channels	
Auditors are required to explain audit opinions primarily via audit reports, but... • It is difficult at times for auditors to include all the information in audit reports when opinions of the auditors and management (or audit committees) differ. • While GSMs[ii] are appropriate venues for the auditors to explain, these are rarely used.	• Auditors should use GSMs more effectively. They should further create alternative opportunities even in the absence of GSMs (e.g., on quarterly results) to explain their views. • Companies also should make better use of GSMs as an opportunity for auditors to explain financial reports. • On professional secrecy concerns, presenting auditors' opinions at GSMs should be well within the perimeter of 'justifiable grounds' for waiver.
Accountability for auditor nomination	
Companies are required to disclose reasons for the change in auditors, and details of the new auditors, but... • More than half of the disclosed reasons are just 'end of tenure,' which provides little value.	• Auditors should be responsible for explaining the reasons for the change. • Companies as well are encouraged to disclose the specific reasons for the change (*e.g.*, disagreement on accounting treatment/audit fees between the management and auditors.).

JFSA revised audit standards in September 2019 following the AC's proposals, to be applied to FY ending March 2020 and onwards. JICPA set up a project group to discuss the appropriate interpretation of 'justifiable grounds' for waiving professional secrecy requirements in their Code of Ethics to make it not overly risk-averse (JICPA, 2019).

The progress in improving transparency and disclosure is already seen albeit gradual. JICPA states that there has been some improvements in disclosed descriptions of auditor changes as a result of JICPA's initiatives including issuing a notice and revising guidelines based on the AC recommendations (JICPA, 2019).

It is still difficult at this stage to assess the impact of these initiatives on audit quality, in part because the initiatives have just been put in place, and also due to the continued difficulty in defining audit quality. However, enhanced transparency and disclosure should serve well in reducing the asymmetry of information and supporting informed decision by investors and other stakeholders in the market.

[i] Advisory Council on Enhancement of Auditors' Accountability
[ii] General Shareholders Meetings

7. Audit policy topic 5: Governance and organizational culture

The soundness of a business entity's governance and organizational culture affect the quality of that business's operations. This applies to audit firms as well as to the companies they audit. This chapter examines practices and requirements in certain IFIAR Member jurisdictions that are relevant to audit firm governance and culture / behavior. The key facts and figures presented on these topics reflect an array of approaches taken. Case studies illustrate distinct initiatives within certain Member jurisdictions.

7.1 Audit Firm Governance

As noted in the introduction to this chapter of the report, the principle discussed above – namely, that sound controls to govern financial reporting affect the quality of such reporting – also would seem to apply to the effect good governance within an audit firm may have on the general quality of that firm's audits. Governing bodies of audit firms play a key role in the firm's overall governance arrangements, setting the "tone at the top". The public interest role of audit firms, also including sizable advisory practices, elevates the importance of firm governance that supports audit quality. Moreover, the future International Standard on Quality Management 1 (ISQM 1) requirements expand upon audit firm governance and leadership requirements. Through its survey of IFIAR Members, IRDAM TF sought to better understand developments in two aspects of governance: the involvement of individuals outside of the firm in governance to provide an independent perspective and audit regulators' roles regarding governing bodies' composition or arrangements.

In the course of an inspection, audit regulators assess various aspects of an audit firm's compliance with standards on firm-wide systems of quality control, which include, among other things, governance arrangements (see also section 7.2 below on culture and behavior). In two jurisdictions, the United Kingdom and Japan, audit regulators have taken the additional step of introducing audit firm governance codes. The case study below compares those two examples in some more detail:

Box 7.1: A Comparison of two IFIAR Members' Audit Firm Governance Codes

United Kingdom	**Japan**
Context	

• Launched in 2010, with a revised version issued in 2016
• Applies to firms auditing 20 or more listed companies
• Operates on a "comply or explain" basis
• Principal objectives:
  ➢ To promote audit quality
  ➢ To help the firm secure its reputation more broadly, including its non-audit businesses
  ➢ To reduce the risk of firm failure
	• Launched in March 2017
	• Intended for large-sized audit firms that conduct audits of major listed companies but other audit firms can voluntarily implement the Code.
	• Operates on a "comply or explain" basis
	• The audit firm governance code was introduced to encourage audit firms to disclose and explain the state of their governance and efforts to ensure the quality of accounting audits.

Contents	
• Arranged around a total of twenty Principles under six headings: Leadership, Values,	• The Code consists of five principles and related guidance for effective implementation of the

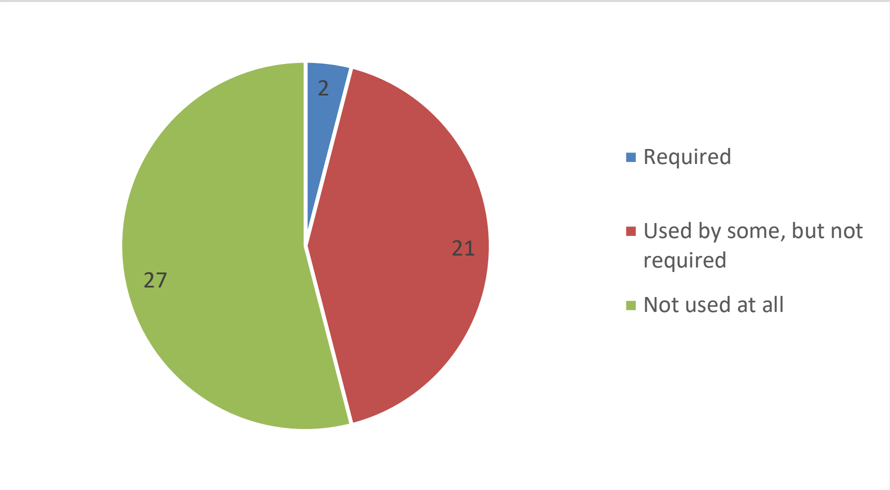
Independent Non-executives (INEs), Operations, Reporting and Dialogue • Under the Principles there are a number of provisions which provide specifics on how the Principles' application might look in practice • The INEs Principles include probably the most significant changes to audit firms' existing governance arrangements; stipulating that firms should appoint INEs to their governance structures • The Dialogue Principles also introduced a new requirement for firms to have dialogue with listed company shareholders and the audit committees of those companies • The other Principles draw out and expand on aspects of firms' existing policies and procedures • The Reporting Principles include a provision for firms to report in their annual Transparency Report on how they have applied each of the Code's Principles in practice	principles for ensuring audit quality: ➢ Principle 1: Role to be accomplished by an audit firm. ➢ Principle 2: Organizational structure (management functions) ➢ Principle 3: Organizational structure (oversight/assessment of firms management functions including appointment of independent third persons) ➢ Principle 4: Operation (human resources management, whistle blowing etc.) ➢ Principle 5: Ensuring transparency • Each principle is accompanied with an explanation of concepts and guidance which suggest what the audit firms should do to achieve the principle.
Response from Firms	
• Firms' responses have been broadly positive. All firms within the target group have adopted the Code, along with at least two which audit fewer than 20 listed companies • Firms have applied the INEs Principles in a variety of different ways. ➢ INEs may sit on the firm's main Board ➢ INEs may sit on a separate Public Interest Committee or similar body ➢ Where firms have an international or regional structure in addition to the UK partnership INEs may sit within that structure as well as fulfilling their UK role • Firms report on their application of the Code in their annual Transparency Reports; many also include details of this in their annual reports • The FRC considers the firms' application of the Code as part of its regular audit quality monitoring program	• 17 firms, including small sized firms which adopt only part of the Code, have adopted the Code as of July 2019. • Firms have applied Principle 3 in different ways. ➢ Bringing in independent third persons as outside committee members to existing oversight/assessment bodies. ➢ Setting up separate, independent bodies such as a public interest committee. • The Code encourages audit firms to explain their application of the Code and most firms report on their application in their Transparency Reports. JFSA/CPAAOB monitor the application of the Code and publish a list of firms which have adopted the Code on the FSA websites.

In other jurisdictions, even without audit firm governance codes in place, certain firms voluntarily adopt corporate governance practices to strengthen the board and executive tone at the top, as indicated in the survey insights reflected in the charts below. Practices that have emerged in some IFIAR jurisdictions include appointing INEs to the governing board (which may involve participation by INEs in a separate public interest committee or as voting or non-voting members of a firm's governing board); involvement of INEs in ethics, quality and reputational risk committees; and audit regulator involvement in director appointments. As audit firm boards are largely comprised of partners, INEs often diversify the perspectives of the board by bringing incremental experience in regulation, corporate governance, business, public service and academia. In addition, INEs may offer objectivity that can help mitigate conflicts of interest among other directors that also are partners in the firm.

More recently, the UK FRC published principles for operational separation of the Big Four firms (refer to section 5.2 of the report for more detail). Related to firm governance, the FRC listed among its desired outcomes that "audit practice governance prioritises audit quality and protects auditors from influences from the rest of the firm that could divert their focus away from audit quality.[18]

In 82% (40) of respondents' jurisdictions, the audit regulator has no role with respect to selection of individuals to serve on audit firm governing bodies. For those jurisdictions where the audit regulator does play a role, three (6%) conduct a suitability (or fit and proper) assessment, two (4%) have approval, and the remaining four jurisdictions indicated "other" responses.

Figure 7.1: In your jurisdiction, does the governance structure for audit firms involve any outside bodies

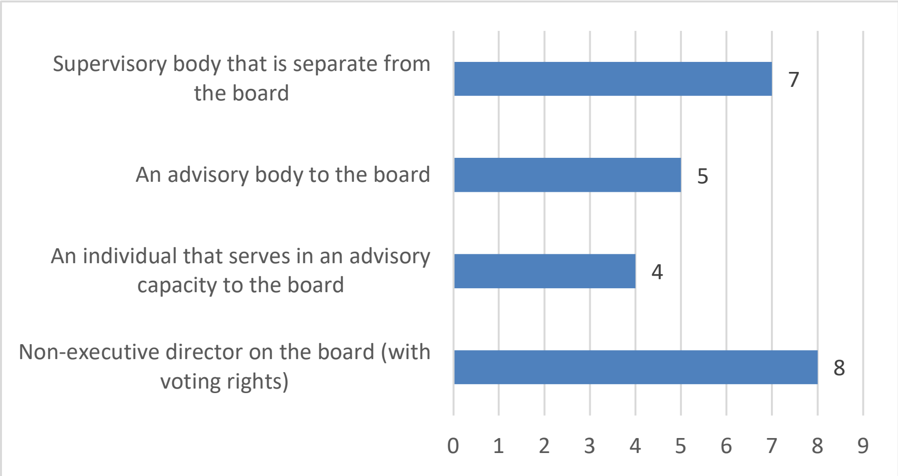


In 54% (27) of respondents' jurisdictions, the governance structure for audit firms does not involve any outside bodies (for example, an advisory group or supervisory board) or individuals (for example, non-executive directors or advisors). See figure 7.1.

In the remaining jurisdictions where outside bodies or individuals are required (4%, 2 respondents) or used by some but not required (42%, 21 respondents), the form that this governance takes varies. These include a supervisory body that is separate from the board, an advisory body to the board, an individual that serves in an advisory capacity to the board, or a non-executive director on the board (with voting rights). See figure 7.2.

[18] For additional information, *see* the related FRC press release, which links to the principles.

Figure 7.2: Forms of outside governance



For those audit firms that are part of a global network, the "Global" function and processes can have both direct and indirect effects on the audit firm's governance arrangements. A brief summary of the network structure and its implications for firm governance are described in IFIAR's Information Paper.[19]

7.2 Audit Firm Culture and Behavior

While firm governance drives the tone at the top to support public interests and audit quality, sound firm culture is paramount for such governance to operate effectively. Additionally, despite the advancements in technology tools for audits, high quality audits continue to require the application of expertise and judgment by trained professionals. The cultural and behavioral norms and expectations within an audit firm thus can play an important role in developments in audit quality.

How these norms and expectations are communicated and actualized by different firms in different jurisdictions can vary. As noted in a research synthesis related to accounting firm culture and governance, "[t]he auditing profession has historically viewed firm culture as unique and proprietary, the very essence of the firm. Moreover, firms have established and nurtured their cultures more or less freely within the boundaries set by the marketplace and regulators."[20]

Additionally, as audits happen at a local level, expectations around a culture of quality need to be reinforced and managed locally. Research shows that office-level culture, the aforementioned "norms and expectations", is important. The findings in a recent study on firm mergers and acquisitions "support the culture of the local office as a key determinant of audit quality, especially during times of change and stress".[21]

Currently, the main source for an international standard related to culture is the International Standard on Quality Control 1 (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial*

[19] See also IFIAR Information Paper: Facilitating Oversight of Global Audit Networks (September 2020).

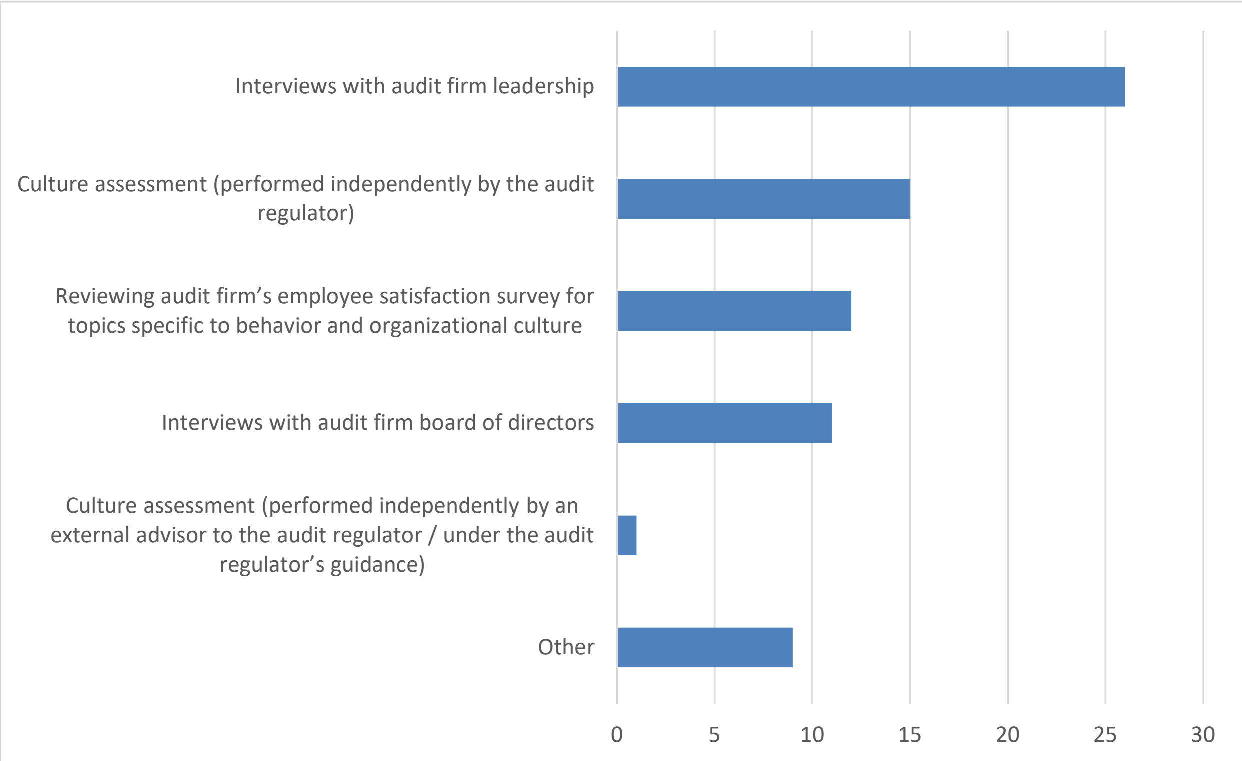
[20] J. Gregory Jenkins, Donald R. Deis, Jean C. Bedard, and Mary B. Curtis (*2008*) Accounting Firm Culture and Governance: A Research Synthesis. Behavioral Research in Accounting: Spring, Vol. 20, No. 1, pp. 45-74. 48.

[21] *The Spillover Effect of Audit Firm Office Acquisition on the Audit Quality of the Existing Client Base*, Sllers, R. Drew and Zimmerman, Aleksandra and Moeini Chaghervand, Amirali and Fogarty, Timothy J., October 23, 2019.

Statements, and Other Assurance and Related Services Engagements.[22] While all six key elements of ISQC 1 involve behaviors and cultural consideration to some degree, the first element "Leadership Responsibilities for Quality within the Firm" focuses on firm leadership setting examples for the firm's internal culture, providing guidance on promoting an internal culture of quality.

Aside from ISQC 1's provisions on Leadership Responsibilities for Quality within the Firm, 80% of IFIAR Member respondents indicated that they do not have regulations or standards that require audit firms to address specifically behavior and the organizational culture of their audit practice. However, 64% of respondents indicated that audit firm culture is reviewed specifically as part of the audit regulatory inspection regime. The inspection methods employed include a wide range. See figure 7.3. The "other" responses include initiatives at both the regional and jurisdictional levels. For instance, the body of European Union member state audit regulators ('CEAOB') conducted a specific survey of the "Big Four" firms. Respondents noted additional methods including interviews with audit firm staff other than leadership or asking questions specifically related to firm culture.

Figure 7.3: Common audit firm culture inspection methods



Certain audit regulators have taken additional actions related to the subject of culture and behavior. Of those IFIAR Members who responded to the survey, 38% noted that culture assessments and/or related actions have formed part of the response to address more systemic audit firm inspection findings. The following box provides insights of how two different regulators approach culture and behavior in their work.

[22] At the time of the Survey, ISQC 1 was the standard in effect. However, at the time of writing of this report, the International Auditing and Assurance Standards Board (IAASB) has recently replaced this standard through ISQM 1 effective late 2022.

Box 7.2: A Tale of Two Firm Culture Assessments

The Netherlands

As part of a broader set of responses to the AFM's 2014 inspection findings, the audit profession in the Netherlands has actively started working on the culture within the firms. Also, as part of these responses, the AFM has included activities in its inspection program to drive the firms to adapt their culture and have more focus on a culture of delivering high quality audits. More specifically, the AFM has established assessment criteria regarding that audit firms:

- Increase their own awareness of the importance of culture and behaviour for their quality objectives
- Define their desired culture in light of their quality objectives
- Understand the gaps between their existing culture and their desired culture
- Implement measures aimed at closing the gap between the existing and desired culture
- Adjust measures based on their assessment and measurement of the effectiveness of the measures taken, and potential adjustments to the desired culture

The AFM has been in ongoing dialogue with the firms on their improvement programmes, and has issued a number of reports addressing the progress made by the firms:

- In 2015, the AFM concluded[23] that firms generally better understood the importance of culture and behavior for achieving their quality objectives and as a basis for a sound system of quality control
- However, the AFM also concluded that firms needed to further define and identify steps to change their culture, including defining their desired cultures and understanding their existing cultures as a basis for measures necessary to amend their cultures.
- In its subsequent report[24] on the topic (relating to the Big Four firms only), in 2017, the AFM concluded that some progress was made, but that the firms generally had not taken sufficient measures to stimulate behaviors to support quality. More specifically, the AFM found that
  - Staff didn't recognize the measures taken by the firm's leadership to improve quality, and in most firms staff weren't made aware of the urgency to change
  - Most interventions by the firms related to systems and processes, and more focus on leadership and competences was necessary
- A survey amongst partners and staff of the Big Four showed that, in their perception, firms focused more on quality in their teams, and that partners took ownership thereof. Key factors mentioned included
  - Timely sharing of information within teams
  - The ability to be able to professionally critical of someone else's work
  - Time to reflect on matters
- In its report[25] on the non-Big Four PIE firms, in 2019, the AFM observed that

[23] https://www.afm.nl/en/professionals/nieuws/2015/okt/dashboard-accountantsorganisaties
[24] https://www.afm.nl/en/professionals/nieuws/2017/juni/kwaliteitslag-oob
[25] https://www.afm.nl/~/profmedia/files/doelgroepen/accountantsorganisaties/2019/report-quality-other-pie-firms.pdf?la=en

- Partners and staff generally understood what a quality oriented culture entails, and recognized efforts being undertaken. They also were willing to take part therein.

However, it was also observed that decisions by the boards did not always clearly relate to the quality oriented culture, and also that time constraints prevented them from delivering quality.

Canada

Cultural assessments - delving beyond the root cause analysis

An emerging practice has been the utilization of cultural assessments by some audit firms and as a formal recommendation from CPAB, for example, in a situation where the root cause analysis and corresponding action plans have not resulted in consistent improvements to audit quality. It is a mechanism for identifying underlying beliefs and behaviours that may be impacting audit execution and quality.

Drawing from experience in the banking sector, these assessments will often be conducted by external consultants who have developed benchmark databases. The assessments are distinct and quite different from the more common employee engagement or employee satisfaction surveys. Areas of focus include:

- Exploring public interest mindset of audit professionals (as contrasted with other behavioural motivations such as profitability or client service).
- Gauging ethical perspectives.
- Understanding the extent to which audit quality and professional skepticism is perceived to impact performance evaluation and compensation.
- Assessing gaps between the tone at the top and staff experiences.
- Querying challenges to independence such as client service and selling other firm services.

The firms and external consultants analyzed the results of the assessments and developed plans to address the findings. The results and proposed action plans were reviewed by CPAB. The intended benefits of the use of cultural assessment include:

- Quality action plans that incorporate the behavioural changes that may be required to drive sustainable improvement.
- Increased focus on the effectiveness of leadership communications in influencing culture.

ANNEX: LIST OF TERMS AND ABBREVIATIONS

AQI - Audit Quality Indicators

ARD - Audit Regulation (573/2014) and Directive (2006/43/EC)

Big Four – Deloitte, EY, KPMG, PricewaterhouseCoopers

CAM - Critical Audit Matters

CEAOB – Committee of European Audit Oversight Bodies

CMA - Competition and Market Authority

CPE – Continuous Professional Education

ICFR - Internal Control over Financial Reporting

IESBA – International Ethics Standards Board for Auditors

INEs - Independent Non-Executive directors

IRDAM TF – International Relevant Developments in Audit Markets Task Force

ISA – International Standard on Auditing

ISQC 1 – International Standard on Quality Control 1

ISQM 1 - International Standard on Quality Management 1

KAM - Key Audit Matters

NAS - non-audit services

PIE – Public Interest Entity

TCWG - Those Charged With Governance