

Association of Accounting Technicians response to “Enhancing audit quality in the public interest – a focus on professional scepticism, quality control and group audits”

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## 1. Introduction

- 1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to IAASB’s invitation to comment on “Enhancing audit quality in the public interest - a focus on professional scepticism, quality control and group audits” (ItC), published December 2015.
- 1.2. AAT is submitting this response on behalf of our membership and from a wider public benefit perspective.
- 1.3. AAT has entered into comment in order to add value or highlight aspects that need to be considered further.
- 1.4. AAT has focussed on the operational elements of the proposals and has provided opinion on the practicalities in implementing the measures outlined.
- 1.5. AAT is not offering comments on the detailed proposals or individual questions set out in the consultation document but wishes to draw attention to some overarching general principles in the following response.
- 1.6. AAT has considered the achievement of the objectives set out in the ItC that the primary output of an audit is an auditor’s opinion that provides users with confidence as to the reliability of the audited financial statements and the need to apply and demonstrate professional scepticism, the need for quality control and the specific considerations of group audits.

## 2. Executive summary

- 2.1. AAT recognises that to enhance public confidence in audits it is essential to establish the highest ethical practices as well as procedures for ensuring audits are carried out effectively and efficiently. While appropriate auditing procedures can be codified within Auditing Standards, the practice of high ethical standards by auditors is dependent upon an attitude of mind and is therefore difficult to fully codify.
- 2.2. In recent times public confidence in audits has declined due to business failures and financial crises which have had no forewarnings from the auditors concerned, with users of financial statements being provided with inadequate information to make their own evaluation of risks reflected in those financial statements and, in particular, an inadequate level of prudence being applied in the preparation of those financial statements.
- 2.3. AAT concludes that the public interest is best served by requiring auditors to provide detailed informative opinions in their published reports.
- 2.4. It should not be expected that auditors would issue what is traditionally considered to be a “clean” report (see 3.3 and 3.4 below). This approach to formal audit reporting will in itself create the application of greater professional scepticism in audits and provide evidence of such, as well as promoting control over the quality of audits.

- 2.5. AAT considers it important that only suitably skilled audit personnel with a proper sceptical attitude of mind should be those drawing conclusions from the output from audit procedures (see 3.6 below).
- 2.6. AAT is of the view that quality control procedures applied within audit firms should be appropriate to the entity being audited, particularly “Public Interest Entities” which require higher levels of quality control than other entities (see 3.8, 3.9 and 3.10 below). The suggestions as regards more informative audit reporting (section 6, ItC) would result in the quality control exercised by audit firms being more readily apparent.
- 2.7. AAT firmly believes that audits of subsidiaries should meet the same criteria employed for standalone entities (see 3.12-3.15, below). Furthermore, users of subsidiaries financial statements would benefit from more informative audit reporting (as suggested in 3.2 and 3.3 below).
- 2.8. AAT considers that analytical review of financial statements by suitably experienced audit personnel is the most effective audit tool in recognising professional scepticism and demonstrating quality control (see 3.5 below).

### **3. AAT response to the consultation paper on Enhancing audit quality in the public interest**

#### **Professional Skepticism<sup>1</sup> and Judgement**

- 3.1. The need for auditors to apply and demonstrate appropriate professional scepticism can be problematic, as it depends totally upon an attitude of mind which is difficult to document and evidence. AAT considers, however, that even where appropriate scepticism has been applied there is a difficulty for auditors to objectively demonstrate such due to the primary objective of an audit being to report whether the auditor supports the financial statements presented by the entity, or not. In practice it is likely that in all cases an auditor will have some doubts or concerns with the financial statements of the entity, although would not have sufficient grounds to qualify the audit report. It is only where there is a situation of total disagreement that an auditor’s opinion might be published in detail.
- 3.2. AAT is of the view that appropriate professional scepticism can be demonstrated to the public by requiring audit reports to provide more detailed information as regards the auditor’s opinion on the detailed contents of financial statements, particularly those matters which are based on the preparer’s estimates, judgement and subjective evaluations. Scepticism is best reflected if the audit objective is to produce an audit report which reflects the auditor’s doubts and uncertainties.
- 3.3. The auditor should, in addition, express their opinion as to the degree of prudence applied to such matters in the preparation of the financial statements.
- 3.4. AAT recognises that such a change of approach is likely to result in higher costs but, this is a necessary outcome of providing stakeholders with sufficient information from, and confidence in, financial statements. It also has to be recognised that under current conditions pressures on audit costs may lead auditors to take unjustifiable risks in the evaluation of possible misstatements in financial statements so that, while costs may increase, more informative audit reports will result in demonstrably improved audits and benefits for the users of financial statements.

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<sup>1</sup> Where AAT is reproducing text from the IAASB invitation to comment the spelling used in the source document will be used

- 3.5. While the invitation to comment sets out factors influencing professional scepticism and possible ways forward (sections 23 to 44), AAT is of the view that the most important aspect has not been addressed, that of a basic analytical review of the financial statements, ensuring that the information presented makes sense and is fully understood by the auditor.

### **Quality Control**

- 3.6. Apart from ensuring that the appropriate techniques and mechanics of audit testing are deployed during the auditing process the principal element of quality control is reflected in the evaluation of the audit evidence obtained and as such, is the outcome and documentation of the professional scepticism applied in that evaluation process (and referred to in section 3 above).
- 3.7. Training audit personnel in audit skills is a long term process, particularly as regards attitude of mind, taking several years of exposure to practical situations, as well as theoretical training on both technical accounting matters and procedures. It is important that only skilled and experienced personnel with the required professional scepticism are those reaching conclusions on the outcomes of audit work, particularly on matters of subjectivity and judgement.
- 3.8. The need for, and nature of, formalised quality control procedures within audit firms tends to vary according to the size of the entities subject to audit and consequently the numbers of staff involved in the audit, the geographical spread of audit locations, the use of other audit firms (whether in a network or independent), supporting specialist advisers and completion deadlines.
- 3.9. As a result of the factors referred to in 3.8 (above), small audit firms will not have the need for complex quality control procedures and possibly can more easily demonstrate the use of professional scepticism than a larger firm.
- 3.10. AAT is of the view that there is a need for a more stringent approach to the quality control of the audits of public interest entities (PIE's) to cover all entities which are substantially dependent upon public monies, including listed entities, providers of public utilities and public services, entities funded by public monies (both by grants and commercial contracts) and charitable entities in all forms.
- 3.11. The oversight of such audits needs to be open and transparent to the public at large, whereas the oversight of other entities needs to focus on the needs of the users of their financial statements.

### **Group Audits**

- 3.12. AAT is concerned that there is a general ethos that the audits of subsidiary entities do not require the same level of care and attention as is expected of standalone entities, because they are under the control of another entity and their financial results are incorporated into the ultimate controlling entity's financial statements, and are likely to have an immaterial impact on the overall consolidated position.
- 3.13. AAT considers that subsidiaries' financial statements require greater attention from the auditors as regards the potential impact of the influence of other group entities on the results of each individual subsidiary and the likelihood of subjectivity being applied to inter group transactions.
- 3.14. The users of the individual subsidiary's financial statements need to be aware of any such significant factors in order to understand the financial statements and it is suggested that the audit report should include details of the auditor's opinion on such matters.

- 3.15. It is considered particularly relevant in the case of group audits for the audit reports on individual subsidiaries to contain full information as to the auditor's opinion on the elements of the financial statements based on estimates, or subjective evaluation so as to provide the controlling entity's auditor with a basis for determining the risks of relying on the subsidiary's financial statements as an element of the consolidated financial statements

#### **4. Conclusion**

- 4.1. AAT concludes that what has been set out in the ItC falls short of achieving the IAASB's overall objective that the primary output of an audit is an auditor's opinion that provides users with confidence as to the reliability of the audited financial statements.
- 4.2. There is an over reliance on public perceptions of the auditor's integrity, objectivity and independence but with audit reports only containing adverse comments on an exceptional basis, the users of financial statements can never know when their confidence has been well placed but will know only when an unexpected disaster arises, that it is misplaced. In reality there are rarely examples where a disaster is preceded by an audit report containing appropriate warnings due primarily to an expectation that an audit report will be "clean" except in the most extreme situations.
- 4.3. AAT considers that achieving confidence in the integrity, objectivity and independence of auditors can best be achieved through a requirement for there to be more information in audit reports as regards the risks attaching to significant elements of the financial statements which are based on subjectivity, uncertainty, judgement or bias contained in financial statements. This is of greater benefit to users than the statement that the financial statements represent "a true and fair view" allowing users to then understand the degree of any uncertainties as well as the margins of subjectivity inherent in the financial statements and form their own opinions as to the degree of prudence reflected in the financial statements (see 3.2 and 3.3, above).
- 4.4. AAT believes that such principles should be applied to subsidiary entities as for standalone entities (see 3.12-3.15, above).
- 4.5. Quality control procedures within audit firms need to be appropriate to the nature of the entities subject to audit and entities in which the public at large have an interest should necessitate more stringent quality controls (see 3.8, 3.9 and 3.10 above).
- 4.6. Emphasis should be placed on the need for auditors to apply the basic principles of analytical review to the audit of financial statements (see 3.5, above) as well as audit conclusions being reached only by suitably skilled personnel (see 3.7, above).

#### **5. About AAT**

- 5.1. AAT is a professional accountancy body with over 49,800 full and fellow members<sup>2</sup> and 80,900 student and affiliate members worldwide. Of the full and fellow members, there are over 4,200 members in practice who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.
- 5.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

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<sup>2</sup> Figures correct as at 31 March 2016

## 6. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact AAT at:

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