

PRELIMINARY COMMENTS ON THE DISCUSSION PAPER, *PROMOTING AUDIT QUALITY*

We are pleased to have the opportunity to comment on the above Discussion Paper issued by the Auditing Practices Board (APB) of the Financial Reporting Council (FRC).

The purpose of this comment letter is to provide the FRC with a brief background to measures taken in South Africa to promote audit quality, as well as preliminary responses to the specific questions.

A more detailed comment letter in response to the questions posed by the FRC in the Discussion Paper concerning the drivers of audit quality, threats to those drivers and suggested courses of action that may contribute to the achievement of audit quality will be submitted before the comment date of 31 March 2007.

audits and reviews of historical financial information, and other assurance and related services engagements.

RESPONSE TO SPECIFIC QUESTIONS

THE CULTURE WITHIN AN AUDIT FIRM

Question 1: Are there important indicators of an audit firm's culture that are not referred to above?

Although the paper refers to staff development systems, we believe that specific mention should be made of a culture which will ensure effective Continuous Professional Development (CPD) in both auditing and accounting disciplines for all audit partners and staff.

We further recommend that the paper include as an indicator a culture of embracing robust reviews performed by external quality control reviewers, internal reviewers and regulatory reviewers (inspection units).

Question 2: Are there pressures that could compromise the culture of audit firms that have not been identified above?

Other pressures that might compromise a culture of quality in a firm include undercharging of audit fees and audit firms that are understaffed.

Question 3: Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?

Further steps that could be taken to enhance a culture of quality in a firm could include:

- Communication of incidents of non-compliance to other staff;
- Action against staff who do not comply with quality requirements;
- Recruitment procedures (ensuring that the right staff is recruited);
- Monitoring of compliance with a culture of quality; and

- Publishing information about a firm's internal governance and quality control processes. The information should, however, be publicly available and easily accessible. Regulators could then also confirm the published information during quality control reviews.

THE SKILLS AND PERSONAL QUALITIES OF AUDIT PARTNERS AND STAFF

Question 4: Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?

We agree.

Question 5: Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there?

In a country such as South Africa, the political and socio-economic history has resulted in different skills levels. Although the results of these policies are being corrected through Employment Equity legislation and Affirmative Action policies, it will take a substantial period of time and investment in training to provide the required skills to the previously disadvantaged communities, which are in the majority.

Furthermore, once employees have been skilled in the auditing field, the issue of staff retention becomes a problem given the income earning differential between the profession and Commerce and Industry. This problem is exacerbated by firms having an obligation to transform (race and gender representation) and the challenges to retain skilled staff from the previously disadvantaged groups (which are in demand) and attracted by the higher compensation offered in Commerce and Industry.

Question 6: Should there be a fundamental review of the qualification and training requirements for auditors?

We believe that this should be an ongoing process, given the continuously changing environment referred to in the paper, the increased focus on ethics, legislative changes and the need for

auditors to demonstrate a greater balance between technical skills and other (soft) skills, which presumably would include the personal qualities referred to in the paper.

THE EFFECTIVENESS OF THE AUDIT PROCESS

Question 7: Are there other factors that determine when an audit process is effective?

The factors listed in the paper to ensure an effective audit process is largely input driven. Possibly consideration could be given to measure the effectiveness of an audit by outputs and results, e.g., the number of audit failures, clients' (audit committees) perception of the effectiveness of audits, etc.

Question 8: Are there threats to the effectiveness of the audit process that have not been identified above?

The following may pose additional threats to the effectiveness of the audit process:

- In addition to the threats listed which result from the increased use of computerized audit methodologies, there is also the increased risk that auditors no longer apply their minds to the objectives to be achieved by the prescribed procedures, the assertions which need to be addressed and the possibility that the procedures may not be appropriate for the particular circumstances.
- Although ethical standards may be prescribed and even legislated, ethical behaviour remains largely dependent on the individual and their personal attributes.
- Technical support is often lacking in smaller audit firms and more so in South Africa, where firms of previously disadvantaged individuals have emerged on a large scale without the required technical infrastructure to support their technical needs.

Question 9: Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?

In the case of smaller firms, consideration could be given to the technical support being obtained from Professional bodies and larger firms which may have the necessary structures to provide technical support.

Some smaller firms also use academics to provide technical opinions on certain complex matters of a technical nature.

THE RELIABILITY AND USEFULNESS OF AUDIT REPORTING

Question 10: Are there other factors that determine whether audit opinions command confidence?

Confidence in audit opinions is also required by inspection and disciplinary units at audit regulators.

Question 11: Are there other reasons why users may not have confidence in the audit opinion?

There exists a perception that auditing standards have become too prescriptive and that auditors are more focused on compliance with standards and quality control. In this process they lose sight of the objective of the audit and may therefore arrive at an incorrect audit opinion.

Question 12: Are there further steps that could be taken to reinforce confidence in the audit opinion? In particular, what changes to the form and content of the audit report should be considered?

The audit report does not require any changes but it might be useful to educate the public on the auditor's responsibilities and the mandate of audit regulators.

FACTORS OUTSIDE THE CONTROL OF AUDITORS AFFECTING AUDIT QUALITY

Question 13: Are there other external factors that have the potential to adversely affect audit quality?

No.

Question 14: Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?

The contribution by audit committees may not be at the expected level. Such contribution is affected by various factors (refer to attached article published in one of South Africa's legal journals).

Question 15: Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?

Yes, that would be advisable should there be insufficient guidance. However, we recommend that the FRC consider similar guidance which might have been developed by other bodies, e.g., in South Africa, the Institute of Directors issued various guides on Corporate Governance.

Question 16: Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?

Yes, this could form part of the Statement on Corporate Governance.

Question 17: Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?

Where possible, certain factors may be written into legislation, such as the Companies Act.

Should you wish to discuss the above, please do not hesitate to contact the writer.

Yours faithfully

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The Role of Audit Risk Management in Audit Quality Control

The Financial Reporting Commission (FRC) in the UK issued a discussion paper on "Promoting Audit Quality". Its objective was the promoting and maintaining of confidence in the audit process and the resulting audit report.

It did not specifically deal with the risks inherent in the various stages of the audit process and the need to manage these risks as a factor in improving audit quality. Only passing reference was made to risk management. In my view, managing audit risks could become an important step in reducing the risk of audit failure. The purpose of the paper is to promote discussion on this topic.

The FRC paper identified a number of threats to audit quality, some of which in turn translate into risks in the audit process. I have selected from this well researched FRC paper some of the concerns and my suggestions regarding the sort of the risks these concerns give rise to. These are listed under the same headings as the paper, the headings being those used in the paper being the main drivers of audit quality.

THREATS	EXAMPLES OF ASSOCIATED RISKS
The culture within the firm	
Over emphasis on winning and retaining audit clients	Reduced or inadequate audit procedures. Failure to stand up to client resulting in lack of independence in reporting.
Excessive cost cutting in economic downturns	Inadequate audit procedures. Inexperienced staff lacking competence to perform work assigned to them.
Insufficient importance placed on technical training	Inexperienced staff as above.
The skills and personal qualities of audit partners and staff	
Failure to develop the necessary personal characteristics through effective monitoring	All these result in the risks of assigning people with inadequate competence to carry

Failure to retain staff with the necessary experience and expertise.

Allocating more capable staff on the basis of client prestige rather than audit risk.

Insufficient or ineffective training

The effectiveness of the audit procedures

Increased use of computer audit methodologies

Over-prescriptive auditing standards, regulation and methodologies

Client capture

out the various steps in the audit process.

This in turn increases the risk of not:

- planning the audit properly
- carrying out the procedures properly
- reviewing the work performed properly
- identifying misstatements where they exist, in the financial statements

Auditors distanced from companies they audit, reducing flexibility and inappropriate allocation of time coping with technology at the expense of evidence gathering. This in turn gives rise to the risk of inadequate or insufficient procedures, adopting a tick box approach, and reviews of work becoming remote.

Insufficient emphasis on tailoring audit procedures to specific circumstances.

Inhibiting the exercise of judgment.

A focus on producing documentation at the expense of performing audit procedures properly.

Impairment of objectivity.

The above examples, which are by no means exhaustive, indicate the risks in carrying out the audit process especially the risk of people at all levels of the audit team not performing at the required level. How could this and other factors affect the audit process? The primary processes are planning, executing and reviewing the audit. The risks involved are impacted by many factors in addition to the performance of the audit team.

For example, at the planning stage, inadequate knowledge of the business, the propensity to enhance performance for management bonus or share price purposes, the ability for management to collude with third parties or override controls are some of the more important factors which could impact on audit quality.

At the execution stage the risks lie primarily with the adequacy of the experience and competence of the audit team. But during this stage more is found out about the business and related risks but this may not be reacted to and the plan modified appropriately. If the audit team is compartmentalised the risk is that knowledge gained by one part of the team, that affects the work of another, is not communicated.

At the review stage the risk is that the review concentrates on what work has been done and not on what should have been done but was omitted. If the review is remote, the danger is that it is not carried out within the context of a holistic view of the audit risk of the specific business being audited.

These examples are given only for illustrative purposes but highlight the dangers of not identifying and managing audit risk holistically. Investigation into audit failure, in my experience, discloses that a more formal approach to managing the audit risks of that audit may have helped to avoid the lapse.

The point is that each major audit presents different combinations of risks. These require that risk is managed on an individual basis for each audit. So far as I am aware, however, risk is not specifically managed as part of the audit process, let alone on an audit by audit basis.

Significant progress has and is being made in risk management by clients and these techniques could be adopted to mitigate audit risk. The questions that therefore arise are:

1. Should a more formal approach be adopted for audit risk identification and management?
2. If such an approach was adopted, would it improve audit quality?
3. Should such an approach be codified in an audit pronouncement?
4. Who should manage audit risk, a risk manager independent of the team or a member of the team? The former approach could reduce the need, or at least the frequency, for partner rotation because the risk of a partner whose

independence is impaired could be managed in other ways. The latter approach would involve a new dimension to the role of the engagement partner or some other member of the team.