STAFF AUDIT PRACTICE ALERT 7

August 2022

CONTENT OF A TRANSPARENCY REPORT

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Additionally, **this publication is not meant to be exhaustive**. Reading this publication is not a substitute for reading the abovementioned pronouncements, as they are the authoritative texts.

ISQM 1 requires that a firm communicates relevant and reliable information to external parties. This is informed by an increased need for external parties to understand a firm's system of quality management.

Further, it is in a firm's interest to be transparent, and for the audit industry to further embrace the attitude of disclosure and transparency that generates confidence among users.

This IRBA staff audit practice alert serves to provide auditors with a framework describing the content of a transparency report that may be used to communicate relevant and reliable information to external parties, as envisioned by ISQM 1.

INTRODUCTION

The International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (ISQM 1), deals with the firm's responsibilities to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements. It also covers the firm's responsibilities to establish policies or procedures that address engagements that are required to be subject to engagement quality reviews.

Applicability of this IRBA Staff Audit Practice Alert

1. This IRBA staff audit practice alert applies to all firms[1], as defined in terms of the Auditing Profession Act 26 of 2005, as amended (APA).

2. Further, this IRBA staff audit practice alert supersedes the IRBA communiqué issued on 27 July 2018 titled *"Transparency reports will strengthen confidence in audit firms*".

System of Quality Management – Information and Communication

3. ISQM 1 is effective as follows:

   - Systems of quality management in compliance with ISQM 1 are required to be designed and implemented by 15 December 2022; and
   - The evaluation of the system of quality management required by paragraphs 53-54 of ISQM 1 is required to be performed within one year following 15 December 2022.

4. ISQM 1 defines quality objectives as the desired outcomes in relation to the components of the system of quality management to be achieved by the firm.[2]

5. Also, ISQM 1 states that the firm shall establish quality objectives that address obtaining, generating, or using information regarding the system of quality management, and communicating information within the firm and to external parties on a timely basis to enable the design, implementation and operation of the system of quality management.[3]

6. Paragraph 33(d) of ISQM 1 requires that a firm establish quality objectives that address communicating relevant and reliable information to external parties.

7. ISQM 1 in paragraph 33(d)(ii) expands on the above and states that:

   "Relevant and reliable information is communicated to external parties, including:

   > Information is communicated externally when required by law, regulation or professional standards, or to support external parties' understanding of the system of quality management."

8. In explaining paragraph 33(d)(ii) in ISQM 1, paragraph A114 (Communication with Others External to the Firm) puts forward an example where law or regulation requires the firm to publish a transparency report, and specifies the nature of the information that is required to be included in the transparency report.

9. To that end, the IRBA has prepared the framework described hereunder to assist firms to comply with ISQM 1, paragraph 33(d).

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[1] A firm means a partnership, company or sole propriety, as referred to in Section 40 of the APA.

[2] ISQM 1, paragraph 16(q).

[3] ISQM 1, paragraph 33.

Transparency Reports

10. A transparency report, whether voluntary or prescribed or recommended by a regulator, is a report issued periodically by a firm to disclose a variety of information about the firm and the environment in which it operates, and where such information is considered relevant to external parties. These reports may be in a format that is prescribed or recommended by a regulator.

11. A transparency report allows external parties, such as audited and prospective clients (including audit committees and shareholders), regulators and other stakeholders, to appropriately understand a firm's system of quality management.

12. South Africa currently has no law or regulation that requires firms to publish transparency reports. As a result, firms presently prepare these reports on a voluntary basis. While communication is required by ISQM 1 (refer to paragraph 5 above), a transparency report is not currently mandatory but may become mandatory for certain firms in terms of the IRBA exposure draft published on 14 June 2022 and in government gazette 46649 (Board Notice 302 of 2022), and this staff alert should be read in conjunction with that, and any future final rule. Refer to the following link for a sample of transparency reports issued by firms in South Africa:

    https://www.irba.co.za/guidance-for-ras/technical-guidance-for-ras/transparency-reporting-and-audit-quality-indicators-aqis.

13. A transparency report serves the purpose of providing insight into a firm's:
    - Structures and governance processes;
    - System of quality management and its operating effectiveness;
    - Quality risks[4] and responses to those risks; and
    - Other relevant information that will assist external parties to understand a firm's system of quality management.

14. Further, transparency reports are a firm's reflection of its audit quality initiatives. Such reports provide users with the information that will help them understand the firm's approach to:
    - Governance and leadership;
    - Culture and ethics;
    - The firm's risk management practices;
    - Its relationship with staff and service providers;
    - Independence; and
    - Addressing its external and internal inspection and monitoring results.

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[4] ISQM 1 defines a quality risk as a risk that has a reasonable possibility of:

(i) Occurring; and

(ii) Individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.

Timing of the Transparency Report

15. ISQM 1, paragraph 53, requires that the individual(s) assigned the ultimate responsibility and accountability for the system of quality management shall evaluate, on behalf of the firm, the system of quality management. The evaluation shall be undertaken at a point in time, and performed at least annually.

16. It is thus recommended that a firm issues its transparency report at the conclusion of the abovementioned ISQM 1 evaluation, or no later than two months thereafter, to ensure that it communicates relevant information to external parties.

17. In instances where the evaluation of the system of quality management, as per ISQM 1, coincides with the firm's financial year-end, the aforementioned two months' recommendation will apply to the financial year-end.

Name of the Transparency Report

18. It is recommended that a firm clearly names or titles the report referred to in this alert as a transparency report, so that external parties can easily identify and refer to it.

19. A transparency report is not primarily a marketing[5] tool; therefore, its information should be presented in a neutral, complete and factual manner, without exaggeration.

Relevance and Reliability of the Disclosures in a Transparency Report

20. It is recommended that a firm explains in its transparency report the controls and system(s) used to develop the report, so as to ensure that the report is relevant and reliable in its communication to external parties, as required by ISQM 1.

21. Information in a transparency report may be forward looking, as in the case of that which pertains to remedial actions. Ordinarily, such forward-looking information should be separately identifiable.

Accountability for the Transparency Report

22. It is recommended that the individual(s) assigned ultimate responsibility and accountability for the system of quality management in compliance with ISQM 1 should also take ultimate responsibility and accountability for the transparency report.

23. This responsibility and accountability for the transparency report may be evidenced through signing the transparency report or a statement to such effect in the report.

[5] Also refer to Section R115.2 of the IRBA Code of Professional Conduct for Registered Auditors, as amended (the IRBA Code).

Content of a Transparency Report

24. In complying with the ISQM 1 requirement for firms to communicate relevant and reliable information to external parties, firms may develop transparency reports for the South African marketplace that include, for example, a relevant discussion and disclosures about the firm's:

- Legal structure (relating to how a firm is structured in terms of the APA, including whether the firm is a partnership, company or sole proprietor);
- Governance (describing the role of the person(s) or organisations with responsibility for overseeing the strategic direction and obligations that are related to the accountability of the firm);
- Leadership;
- Risk assessment processes;
- Resources;
- Engagement-related information, such as a firm's approach to client acceptance and retention;
- Results of the monitoring and remediation process, detailing the outcome of internal and external inspections, root causes and remedial actions to address deficiencies or findings; and
- Audit Quality Indicators (AQIs).

25. The table below expands on the abovementioned disclosures and is not exhaustive.

The firm's risk assessment process ➢ The firm's risk assessment methodology, including: • How the firm establishes quality objectives; • How it identifies quality risks; • What factors the firm considers in determining its quality risks and the significance thereof; • How it designs and implements responses to its quality risks; and • The frequency of review of the appropriateness of the identified quality risks.
Legal structure, leadership and governance ➢ The legal arrangements/structure of the firm; ➢ Governance structures, their authorities and relationships within the firm; ➢ Voting rights and special voting rights; ➢ Rights and benefits of retired partners; ➢ The firm's funding arrangements, where relevant; ➢ The process and/or requirements to appoint the firm's leadership;

- Where a firm is a member of a network[6], a description of the network as well as the legal and structural arrangements of the network;
- The network as well as associations and similar structures, and how the firm ensures a consistent approach to audit quality from all members of the structure; and
- The firm's reporting on performance against key performance indicators for assessing the effectiveness of the system of quality management.

Resources

Human resources

- The firm's selection, recruitment and retention, including:
  - The number of candidates on the Audit Development Programme.
- The firm's approach and goals for Continuing Professional Development or education.
- The firm's policy concerning the rotation of key audit partners[7] and, where relevant, staff.
- The firm's basis for the incentives and the remuneration of partners and/or directors, including in relation to key performance indicators.
- The firm's transformation policies and statistics, including its:
  - B-BBEE scorecard;
  - Policy on partner promotions;
  - Number of female partners and/or directors, including as a percentage of the firm's total partners and/or directors; and
  - Number of African, Coloured and Indian partners and/or directors, including as a percentage of the firm's total partners and/or directors.
- The firm's sponsorship and gifts policy.
- Its internal whistle-blowing mechanisms and statistics.
- The firm's consultative or resolutions structures for internal differences of opinion.

[6] As defined in ISQM 1 and the IRBA Code.

[7] As defined in the IRBA Code.

Other resources

- A description of financial resources in relation to the firm's investment in maintaining and/or improving its system of quality management;
- A description of the firm's technological resources (for example, IT applications, including their impact on audit, as well as aspects pertaining to cyber-security);
- A description of the firm's intellectual resources (for example, written policies or procedures, a methodology or guides); and
- A description of the firm's service providers.

Engagement-related information

- The firm's approach to client acceptance and retention, as well as how the related risks are addressed;
- The firm's formation of audit engagement teams i.e., what factors are considered when assigning staff to an audit team;
- The criteria to identify Public Interest Entities (PIEs) within the firm;
- The firm's criteria to identify engagements with entities other than PIEs, where it applies the elevated independence requirements as applicable to these entities;
- A list of PIE clients won and lost, including where an engagement is terminated or accepted as a result of the IRBA's Mandatory Audit Firm Rotation rule;
- A list of PIEs for which the firm has carried out an audit of financial statements;
- The firm's independence practices, including the independence assessment process with respect to providing non-audit services to audit clients;
- The audit fees earned from PIE engagements versus non-PIE engagements and their relationship to fees earned from non-audit services[8];
- The firm's audit fees earned from private sector versus public sector engagements, including as a percentage of total audit fees; and
- The firm's audit fees from key clients[9], including as a percentage of total audit fees.

[8] Also refer to the IRBA Code regarding fee-related provisions.

[9] Audit clients where such audit fees exceed 5% of total audit fees.

The monitoring and remediation process

- A description of the firm's monitoring and remediation process;
- The firm's external inspection and monitoring results;
- Its internal monitoring results, including in relation to non-audit service engagements;
- The firm's root cause analysis results on internal and external review findings; and
- A description of its remedial actions to address deficiencies or findings.

The firm's audit quality indicators (AQIs)

- The firm may disclose AQIs that are considered useful to external parties as well as its own targets with respect to those AQIs. For examples of AQIs, refer to the following links:
  - https://www.irba.co.za/upload/IRBA%20AQI%20Survey%20report%202020.PDF.
  - https://www.irba.co.za/upload/IRBA%20AQI%20Feedback%20report%20-%202019.pdf.

Other topics for a firm's transparency report

- The firm may disclose the following additional matters[10]:
  - The evaluation of the system of quality management per ISQM 1, including how it was arrived at;
  - In instances other than where the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved, the reasons accompanying such instances (refer to ISQM 1, paragraph 54(b) and (c));
  - How the firm responded to economic events and situations that impacted it over the period;
  - The firm's investment in technology and training;
  - Outcomes of litigation involving the firm (i.e., cases won/lost);
  - The firm's pending litigation;
  - Regulatory disciplinary matters[11];
  - The firm's interactions with the IRBA (for example, at a firm leadership level, with the IRBA's Investigations and Inspections departments, etc.);
  - The value of any subsidies provided by the network firm(s) to the firm;
  - Fees paid by the firm to network firm(s); and
  - The firm's funding of political parties.

26. A description of the impact of the activities described in the above table on the firm's financial resources, if that is relevant, may also be necessary.

27. Where applicable, firms may also use trends and comparatives with respect to the information in the above table. Further, firms may also cross-reference to other reports where relevant, for example, a firm may decide to cross-reference to their network's international or global transparency report.

Firms Merging or Separating Before a Periodic Transparency Report is Issued

28. In the event that firms separate before the publication of a periodic transparency report, it is recommended that such an event be clearly disclosed in the report. This alert will then apply to each new firm for the period during which they are firms, as defined in the APA.

29. In the event that firms merge before a periodic transparency report is published, it is recommended that such an event be clearly disclosed in the report. This alert will therefore apply to the new firm for the period during which it is a firm, as defined in the APA.

Publication of the Transparency Report

30. It is recommended that a firm publishes its transparency report, as a minimum, on its website. It is further recommended that where a firm publishes its report on its website, that it do so in the "about us" section of the firm's website. The firm may also publicise or distribute its report to external parties.

31. Further, it is recommended that the transparency report be available on the firm's website for at least five years from the day of its first publication.

32. When a firm updates its published transparency report, it is recommended that it indicates or states that the latter is an updated version of the report, while the original version should remain available on the firm's website.

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[10] The firm applies professional judgment as to what is a material disclosable item to include in a transparency report.

[11] May include for example disciplinary matters with the IRBA, the Johannesburg Stock Exchange, the Public Company Accounting Overnight Board or other regulators.