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CONTACTS

Phone: **+998 50 737 87 88**

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CRITERIA FOR ASSESSING THE QUALITY OF THE AUDIT OF COMMERCIAL BANKS' FINANCIAL STATEMENTS AND THE FORMATION OF KEY AUDIT MATTERS (ISA 701)

Ibragimov Nodirbek Baxodir o'g'li

Independent Researcher,

Tashkent State University of Economics

E-mail: nodirbek.ibragimov.96@mail.ru

Abstract. The article develops criteria for assessing the quality of the audit of commercial banks' financial statements and recommendations for forming key audit matters (ISA 701). The research problem is the absence of a unified system of criteria for objectively assessing bank audit quality and of a methodology for forming KAMs tailored to banks' specifics. Based on the IAASB audit-quality framework, a four-group system of criteria, audit quality indicators (AQI) and typical KAMs for banks are proposed and tested on the example of JSCB 'Xalq Bank'. As a result, the transparency of the audit report is increased.

Keywords: audit quality, key audit matters, KAM, ISA 701, bank audit, audit quality indicators (AQI), ISQM, audit report, transparency, audit committee.

Аннотация. В статье разрабатываются критерии оценки качества аудита финансовой отчётности коммерческих банков и рекомендации по формированию ключевых вопросов аудита (ISA 701). Проблема исследования — отсутствие единой системы критериев объективной оценки качества банковского аудита и методики формирования КАМ с учётом особенностей банков. На основе концепции качества аудита IAASB предложены четырёхгрупповая система критериев, индикаторы качества аудита (AQI) и типичные КАМ для банков, апробированные на примере АКБ «Халк банк». В результате повышена прозрачность аудиторского заключения.

Ключевые слова: качество аудита, ключевые вопросы аудита, КАМ, МСА (ISA) 701, банковский аудит, индикаторы качества аудита (AQI), ISQM, аудиторское заключение, прозрачность, аудиторский комитет.

INTRODUCTION

The ultimate value of audit activity lies in its quality: no matter how advanced the methodology applied, if the quality of the audit itself remains uncontrolled, the reliability of the auditor's opinion becomes questionable. In the audit of commercial banks, this issue is of particular importance, since bank financial statements are used by a wide range of stakeholders, including depositors, investors, and regulatory authorities. Any deficiency in the quality of bank audit may therefore lead to systemic consequences.

Two key mechanisms for ensuring quality stand out in modern audit practice. The first is the objective and systematic assessment of audit quality through a set of criteria covering factors ranging from the auditor's competence and independence to the quality of the auditor's report. The second is increasing the transparency of the auditor's report by disclosing Key Audit Matters (KAM), as required by ISA 701. However, a unified system of criteria adapted to the specific characteristics of bank audit, as well as a methodology for identifying typical KAMs for banks, has not yet been fully developed.

The practical relevance of this problem is clearly reflected in real cases. The error in measuring expected credit losses (ECL) in the 2021 financial statements of JSC "Xalq Banki" — which resulted in the restatement of equity by approximately UZS 1,333.7 billion, or nearly one-third — demonstrates in practice how critical audit quality control and the in-depth examination of ECL as a Key Audit Matter can be in bank audit. If this issue had been disclosed as a KAM and subjected to quality control during the initial audit, the likelihood of such an error could have been reduced.

The purpose of this article is to develop recommendations for assessing the quality of audits of commercial banks' financial statements and for identifying Key Audit Matters in accordance with ISA 701. The object of

the study is the process of assessing bank audit quality and forming the auditor's report, using JSC "Xalq Banki" as a case study. The subject of the study is the methodological relationships arising in this process. The subsequent sections of the article are structured as follows: literature review, methodology, analysis and results, and conclusions and recommendations.

LITERATURE REVIEW

The theory of audit quality has been extensively developed in the academic literature. L. DeAngelo defined audit quality as the joint probability that an auditor will both detect a misstatement in the financial statements and report it objectively (DeAngelo, 1981). This classical definition highlights two key components of audit quality: competence, which refers to the ability to detect misstatements, and independence, which refers to the willingness to report them. These components are particularly important in bank audits, since threats to auditor independence may be stronger in banks with state participation.

J. Francis proposed a comprehensive framework for understanding and studying audit quality, arguing that quality should be assessed through input factors, the audit process, and audit outcomes (Francis, 2011). Building on this approach, the IAASB, in its *Framework for Audit Quality*, demonstrated that audit quality is formed through inputs, processes, outputs, and the interactions among them (IAASB, 2014). This framework serves as the basis for developing the system of criteria for assessing the quality of bank audits in the present study.

The issue of enhancing the transparency of the auditor's report is regulated by ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (IAASB, 2023). This standard requires that, in the audit of listed entities, including banks, the auditor disclose in the report the most significant matters selected from those communicated with the Supervisory Board — that is, the matters that were of greatest significance in the audit of the current period. Mautz and Sharaf, who laid the philosophical foundations of audit theory, also substantiated the principles of reliability and integrity in the auditor's report (Mautz and Sharaf, 1961).

The management of audit quality has been further developed in modern standards, particularly in the International Standards on Quality Management, namely ISQM 1 and ISQM 2, as well as in the requirements for engagement quality review (IAASB, 2023). In international practice, Audit Quality Indicators (AQIs) are used as a system for the quantitative measurement of audit quality. Modern audit textbooks also address audit quality and the transparency of the auditor's report as central issues in audit practice (Arens et al., 2017; Hayes et al., 2014).

The introduction of ISA 701 in 2016 marked a significant reform in the auditor reporting model. It enriched the traditional binary "pass/fail" audit opinion by requiring auditors to provide information on the most significant matters identified during the audit. The main purpose of this reform was to reduce the information gap between auditors and users of financial statements and to increase the value of the auditor's report. Studies have shown that the introduction of KAMs has improved the informativeness of auditor's reports; however, the quality and informational value of KAM disclosures vary across sectors and companies. For banks, the standardisation of KAMs can help reduce such variation.

RESEARCH METHODOLOGY

The study is based on a qualitative and case-study paradigm. Its core objective is to design a system of audit quality assessment criteria and a methodology for identifying Key Audit Matters (KAMs), and to apply them to a real banking case. The development of the criteria system is based on the IAASB's *Framework for Audit Quality* (2014) and the theory of audit quality (DeAngelo, 1981; Francis, 2011), while the methodology for identifying KAMs is grounded in the requirements of ISA 701.

To demonstrate the practical relevance of the proposed model, JSC "Xalq Banki" was selected as the case study. The choice of this bank is justified by its systemic importance, state participation, extensive branch network, and the ECL measurement error identified in 2021. These factors make the bank a relevant case for testing the audit quality assessment criteria and the KAM identification methodology. The study also employs grouping, a systems approach, and expert assessment methods.

The reliability of the study is ensured by its reliance on official sources and international standards, while its validity is supported by the consistency of the proposed criteria and KAMs with ISA 701, ISQM 1, ISQM 2, and the IAASB's *Framework for Audit Quality*. The sample KAMs were developed on the basis of the bank's actual risk profile.

ANALYSIS AND RESULTS

Audit quality is a multidimensional concept and cannot be represented by a single indicator. Based on

the IAASB's *Framework for Audit Quality*, this study proposes a four-group system of criteria for assessing the quality of bank audits: input factors, including auditor competence and independence; process factors, including compliance with ISA requirements and risk-oriented audit procedures; output factors, including the quality of the auditor's report and KAM disclosures; and interaction factors, including communication with the audit committee and supervisory authorities. For each group of criteria, specific indicators and assessment methods are defined, as presented in Table 1.

Table 1
Criteria for Assessing the Quality of Bank Audits (proposed)¹

Group of criteria	Indicator	Assessment method
Input factors	Auditor independence and competence, including compliance with the IESBA Code and possession of a bank audit certificate	Review of documents and qualification certificates
Process factors	Compliance with ISA requirements and application of a risk-oriented approach	Assessment of the quality of working papers through peer review
Output factors	Quality of the auditor's report and transparency of KAM disclosures	Analysis of the auditor's report
Interaction factors	Communication with the audit committee and supervisory authority	Review of communication records

The advantage of the proposed system is that it assesses audit quality not only through the final outcome, namely the auditor's report, but also through input factors and the audit process. This is particularly important in bank audits, since quality deficiencies often arise not in the auditor's report itself, but at the stage where sufficient audit evidence has not been obtained or auditor independence has been compromised. The system enables both the audit firm and the audit committee to assess and improve audit quality in an objective manner.

One of the key indicators of audit quality is the transparent disclosure of Key Audit Matters (KAMs) in the auditor's report in accordance with ISA 701. The identification of KAMs is a systematic process that involves selecting the most significant matters from those communicated with the Supervisory Board, particularly those associated with high risk, significant professional judgement, or material events. For banks, Key Audit Matters usually cover areas that require a high degree of professional judgement. The most common KAMs in the audit of commercial banks and the related audit approaches are presented in Table 2.

Table 2
Typical Key Audit Matters (KAMs) in the Audit of Commercial Banks²

Key Audit Matter (KAM)	Reason	Audit approach
ECL and provisions for loans	High uncertainty and professional judgement	Risk-oriented audit programme, model validation, and independent recalculation
Fair value of financial instruments	Complexity of valuation	Review of valuation methods and hierarchy, use of the work of an expert (ISA 620)
Transactions with related parties	Risk of conflicts of interest	Identification of transactions and review of terms and disclosures
Information systems and data integrity	Operational and IT risks	Testing of IT controls and use of CAATs

As can be seen from the table, most Key Audit Matters in bank audits are related to areas involving estimates and significant uncertainty. Defining a clear audit response for each KAM improves audit quality and enhances the informational value of the auditor's report. Transparent disclosure of KAMs in the auditor's report increases the value of the audit for users of financial statements, including investors, depositors, and regulatory authorities, and is consistent with the recommendations of the Basel Committee on Banking Supervision on enhancing transparency in bank audits (Basel Committee on Banking Supervision, 2024).

In the case of JSC "Xalq Banki", the assessment of expected credit losses (ECL) under IFRS 9 may be considered a Key Audit Matter, since it involves a high level of uncertainty, depends heavily on management judgement, and was precisely the area in which a measurement error occurred in 2021. In the auditor's report,

¹ Source: Author's development based on the IAASB Framework for Audit Quality.

² Source: Author's development based on ISA 701 and the bank's actual risk profile.

the auditor may explain why ECL was considered a Key Audit Matter and what audit procedures were performed to address it. Such a KAM provides users with clear information about the area that received the auditor's most significant attention and the work performed in response. This, in turn, substantially increases the transparency of the auditor's report and strengthens users' confidence.

For example, ECL may be presented as a Key Audit Matter in the auditor's report as follows: "The assessment of expected credit losses (ECL) on loans to customers requires a high degree of professional judgement, a complex model, and forward-looking assumptions. Due to the significant uncertainty involved in this assessment, we considered it to be a Key Audit Matter. As part of our audit, we examined the ECL methodology, model parameters, and the staging of loans, and independently recalculated ECL for selected loan samples." The ECL measurement error identified in 2021 and its subsequent restatement in the following year provide practical evidence of the need to disclose ECL in detail as a KAM. Therefore, the KAM mechanism not only enhances transparency but also serves as a preventive tool for improving audit quality.

To quantitatively assess the quality of bank audits, this study proposes the introduction of a system of Audit Quality Indicators (AQIs). These indicators make it possible to measure audit quality objectively and monitor it over time. In bank audits, indicators such as the resources allocated to ECL testing and the coverage of independent recalculations are particularly important, as they show whether sufficient attention has been paid to high-risk areas. The main indicators are presented in Table 3.

Table 3
System of Bank Audit Quality Indicators (AQIs) (proposed)³

Audit Quality Indicator (AQI)	Description	Measurement
Share of experienced staff	Highly qualified auditors assigned to the engagement	%
Time spent on ECL testing	Resources allocated to a high-risk area	hours / %
Independent recalculation coverage	Share of the portfolio tested using CAATs	%
Identified adjustments	Number and amount of errors identified during the audit	number / UZS billion
Independence breaches	Number of identified threats	number

These indicators will serve as a practical tool for audit firms and audit committees in assessing and improving audit quality. For example, a low level of independent recalculation coverage increases the risk that errors similar to those identified in 2021 may remain undetected. Therefore, monitoring this indicator helps ensure that sufficient attention is paid to high-risk areas in bank audits. The AQI system transforms audit quality from a matter of subjective judgement into a set of quantitative and observable indicators.

All the proposed instruments — audit quality criteria, AQI indicators, and the KAM mechanism — are integrated into a comprehensive system within the framework of the international standards on quality management, namely ISQM 1 and ISQM 2. This system provides for quality control at the level of the audit firm and engagement quality review at the level of individual audit assignments. For high-risk engagements such as bank audits, it is advisable to apply engagement quality review procedures, whereby an experienced independent partner reviews conclusions related to ECL and provisions. Such a multi-layered system of quality control may play an important role in reducing the risk of material misstatements similar to those identified in 2021.

The proposed quality system is closely linked to other elements of the bank audit methodology. Areas identified as high-risk by the Bank Risk Factor Index (BRFI) are determined as KAMs; the ECL audit programme forms the audit response to the relevant KAM; and CAATs ensure the coverage of independent recalculations, which is one of the AQI indicators. Thus, audit quality criteria, KAMs, and AQIs serve as the final connecting and controlling element of the overall audit methodology. This integration ensures a comprehensive approach to audit quality.

Transparent disclosure of Key Audit Matters also reflects the quality of communication between the auditor and those charged with governance. Since KAMs are discussed with the audit committee before being disclosed in the auditor's report, they serve as an indicator of effective cooperation between corporate governance bodies and the auditor. In banks, a strong audit committee directly contributes to the proper identification of KAMs and the improvement of audit quality. In this sense, the KAM mechanism is not only a means of informing users but also a tool for strengthening the culture of quality within the bank.

The expected effect of introducing audit quality criteria, AQI indicators, and the KAM mechanism is reflected in the increased informativeness of the auditor's report and greater user confidence. The quality system may help reduce the risk of material misstatements and lower the likelihood of restatements similar to

3 Source: Author's development based on the IAASB audit quality indicators approach.

those identified in 2021. From an economic perspective, a reliable audit can strengthen confidence in a bank's financial statements, improve the quality of financial information for investors, and support more informed decision-making.

The practical implementation of the proposed system requires institutional support. First, it would be appropriate for the audit regulator and the Chamber of Auditors to incorporate audit quality criteria and AQI indicators into national standards. Second, certification bodies and higher education institutions should strengthen the training of auditors in IFRS 9, ECL validation, and digital audit. Third, the introduction of an information exchange mechanism between the Central Bank and external auditors would improve the quality of bank audits.

The group of input factors forms the foundation of audit quality. In bank audits, auditor independence — both actual and perceived — is of particular importance, since banks with state participation may face specific independence-related risks arising from governance arrangements, long-term cooperation, or the provision of non-audit services. The IESBA Code of Ethics requires such threats to be identified and appropriate safeguards to be applied (IESBA, 2023). The competence factor, in turn, requires auditors to possess specialised certification in bank auditing, as well as knowledge of IFRS 9 and ECL validation. This is an important prerequisite for conducting a reliable audit of bank-specific high-risk areas.

Process factors reflect the quality of audit execution. In this regard, the assessment focuses on the extent to which the audit was conducted in accordance with ISA requirements, whether the risk-oriented approach was applied, and whether sufficient and appropriate audit evidence was obtained. The main method for assessing process quality is the independent review of working papers, through peer review or inspection, where an experienced auditor evaluates the sufficiency of the work performed and its compliance with ISA requirements. In bank audits, particular attention is paid to working papers related to ECL and provisions.

Output factors are reflected in the audit product, namely the auditor's report. Under ISA 700, the auditor's report must have a clear structure and include the auditor's opinion, the basis for the opinion, Key Audit Matters, and the responsibilities of management and the auditor. The quality of the report is expressed through its correctness, clarity, and informativeness, particularly through KAM disclosures. In bank audits, the quality of the auditor's report requires particular attention because it directly influences users' decision-making.

Interaction factors cover the auditor's communication with those charged with governance under ISA 260 and with the supervisory authority. During the audit, the auditor discusses significant matters identified, material weaknesses in internal control under ISA 265, and KAMs with the Supervisory Board or the audit committee. In bank audits, the existence of an effective and independent audit committee is an important factor of audit quality, as it ensures balance between the auditor and management and supports auditor independence.

ISA 701 establishes a two-stage logic for identifying KAMs. First, the auditor identifies, from the matters communicated with the Supervisory Board, those that required the most significant auditor attention. Second, from these matters, the auditor selects those that were of greatest significance in the audit of the current period and designates them as KAMs. The selection criteria include assessed significant risks, areas requiring a high degree of professional judgement, and significant events that occurred during the period. In banks, these criteria usually lead to areas such as ECL, fair value measurement, and IT systems.

In addition to KAMs, other elements are also important for enhancing the transparency of the auditor's report. The auditor reviews other information published together with the financial statements, such as management's analysis in the annual report, in accordance with ISA 720 and assesses its consistency with the financial statements. In addition, the auditor's conclusion on the bank's going concern assumption under ISA 570 is important information for users. Taken together, these elements increase the informativeness and reliability of the auditor's report.

In ensuring audit quality, it is also necessary to consider the issue of the expectation gap. The public often expects the auditor to detect all errors and fraud, whereas an audit provides reasonable, not absolute, assurance. Transparent disclosure of KAMs and a clear explanation of the auditor's responsibilities in the auditor's report help reduce this gap and make users' understanding of audit more realistic. This is particularly important in bank audits, since confidence in banks is closely linked to the stability of the entire financial system.

Audit quality assessment criteria and AQI indicators are integrated with the internal quality control system of the audit firm. Under ISQM 1, an audit firm must implement a risk-based quality management system that includes quality objectives, risk assessment, and responses to those risks. AQI indicators serve as a tool for monitoring the effectiveness of this system. Thus, the proposed criteria and indicators are organically integrated into international quality management standards.

Another aspect of the proposed quality system is its connection with external quality assurance. External quality assurance reviews may be conducted periodically to assess the quality of bank audits, including the quality management systems of audit firms and the quality of individual engagements. AQI indicators and audit quality criteria provide an objective basis for such external inspections, thereby ensuring systematic monitoring

and consistent improvement of bank audit quality.

In assessing the quality of bank audits, it is also necessary to take into account the specific features of group audits under ISA 600. In banks with an extensive branch network and subsidiaries, the quality of the audit of consolidated financial statements depends on coordination between the group auditor and component auditors. The group auditor must identify significant components and monitor the quality of their audits. In the case of JSC "Xalq Banki", with its extensive network, the quality of such coordination may be monitored as a separate AQI indicator, since deficiencies at the component level can affect the quality of the audit of the entire consolidated financial statements.

The audit quality system is also linked to the periodic self-assessment cycle of the audit firm. Under ISQM 1, the firm must assess its quality management system at least once a year and take measures to address identified deficiencies. The dynamics of AQI indicators, such as the number of identified adjustments or changes in the coverage of independent recalculations, provide an objective basis for such assessment. In this way, the quality system functions not as a static set of criteria, but as a continuously improving mechanism.

Finally, the quality of bank audits is closely connected with the overall state of the national financial reporting infrastructure. International financial institutions, such as the World Bank, assess audit quality and external oversight systems in their Reports on the Observance of Standards and Codes (ROSC) as important elements of national financial transparency. Therefore, the introduction of the proposed audit quality criteria and AQI system at the national level would contribute not only to improving the audit of individual banks but also to strengthening the reliability of the country's financial reporting system as a whole.

At the same time, certain limitations of the proposed system should be taken into account. First, AQI indicators and audit quality criteria should be adapted to the specific characteristics of the bank and the audit firm. Second, quality assessment, such as peer review of working papers, depends on the auditor's professional judgement and therefore cannot be entirely free from a degree of subjectivity. Third, transparent disclosure of KAMs requires the auditor to maintain an appropriate balance with the bank in terms of confidentiality. Despite these limitations, the proposed system represents an important step toward the objective assessment of bank audit quality and the enhancement of the transparency of the auditor's report.

CONCLUSION AND RECOMMENDATIONS

As a result of the study, recommendations were developed for assessing the quality of audits of commercial banks' financial statements and for identifying Key Audit Matters in accordance with ISA 701. The proposed four-group system of audit quality assessment criteria, comprising input, process, output, and interaction factors, makes it possible to assess audit quality comprehensively on the basis of the IAASB's *Framework for Audit Quality*. In addition, a system of Audit Quality Indicators (AQIs) was proposed as a tool for the quantitative measurement of audit quality.

Typical Key Audit Matters for banks were identified, including ECL and provisions, the fair value of financial instruments, transactions with related parties, and information systems. For each of these matters, an appropriate audit response was defined. Using the case of JSC "Xalq Banki", the study presented an example of transparent disclosure of ECL as a KAM in the auditor's report. The ECL-related restatement identified in 2021 illustrates the practical relevance of disclosing ECL as a KAM and highlights the role of the KAM mechanism in improving audit quality.

Based on the findings, the following recommendations are proposed: (1) the audit regulator and the Chamber of Auditors should incorporate bank audit quality criteria and AQI indicators into national standards; (2) audit firms should transparently disclose ECL, financial instruments, and IT systems as Key Audit Matters in bank audit reports; (3) it is advisable to apply engagement quality review procedures to high-risk engagements such as bank audits in accordance with ISQM requirements; and (4) the activities of audit committees in commercial banks should be strengthened, and procedures for communication with the supervisory authority should be clearly established.

It should be emphasised that the audit quality system serves as the final and controlling element of the overall bank audit methodology. It ensures the quality execution of all key components, including risk assessment, ECL testing, and the use of digital audit tools. In this sense, audit quality criteria, AQI indicators, and the KAM mechanism logically complete the integrated system for improving bank audits and support its ultimate objective: ensuring the reliability and transparency of the auditor's report.

The theoretical significance of the study lies in the enrichment of the methodological foundations for assessing bank audit quality and enhancing the transparency of the auditor's report. Its practical significance is reflected in the fact that the developed system of criteria, AQIs, and KAM recommendations can be used by audit firms, commercial banks, and regulatory authorities. Future research may focus on statistically validating AQI indicators using a large empirical sample and developing a unified national system for assessing the

quality of bank audits.

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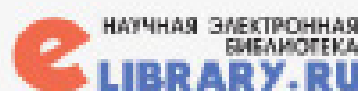
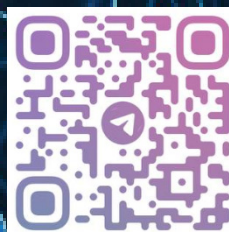
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