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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)

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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

Audit quality represents the ultimate value of the auditing profession. Regardless of how sophisticated the audit methodology may be, if the quality of the audit itself is not properly controlled, the reliability of the auditor’s opinion becomes questionable. This issue is particularly significant in the audit of commercial banks, as bank financial statements are relied upon by a wide range of stakeholders—including depositors, investors, and regulatory authorities—and deficiencies in audit quality may lead to systemic consequences.

In modern auditing, two key mechanisms are fundamental to ensuring audit quality. The first is the objective and systematic assessment of audit quality through a comprehensive set of criteria encompassing auditor competence, independence, audit procedures, and the quality of the audit opinion. The second is enhancing the transparency of the auditor’s report by disclosing Key Audit Matters (KAMs) as required by ISA 701.

The practical significance of this issue is evident in real-world cases. The 2021 Expected Credit Loss (ECL) measurement error at JSC *Xalq Banki*, which resulted in the restatement of shareholders’ equity by approximately UZS 1,333.7 billion (nearly one-third), clearly demonstrated the critical importance of audit quality control and the thorough examination of ECL as a Key Audit Matter. Had this issue been identified and disclosed as a KAM during the initial audit and subjected to rigorous quality control procedures, the likelihood of such a material error would have been substantially reduced.

The objective of this article is to develop recommendations for establishing audit quality assessment criteria and formulating Key Audit Matters (KAMs) in accordance with ISA 701 for the audit of commercial banks’ financial statements. The object of the study is the process of evaluating audit quality and preparing the auditor’s report, using JSC *Xalq Banki* as a case study. The subject of the research comprises the methodological relationships arising within this process. The remainder of the article is organized into the following sections: 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. Linda Elizabeth DeAngelo defined audit quality as the joint probability that an auditor will both detect a material misstatement in the financial statements and report it objectively (DeAngelo, 1981). This classical definition distinguishes two fundamental components of audit quality: competence (the ability to detect errors) and independence (the willingness to report them). These attributes are particularly important in bank auditing, where auditor independence may be subject to greater threats, especially in state-owned banks.

Jere R. Francis proposed a comprehensive framework for understanding and evaluating audit quality, arguing that it should be assessed through audit inputs, processes, and outcomes (Francis, 2011). Building upon this perspective, the International Auditing and Assurance Standards Board introduced its *A Framework for Audit Quality*, which explains that audit quality is determined by the interaction of input factors, audit processes, audit outputs, and contextual factors (IAASB, 2014). This framework serves as the theoretical basis for developing the bank audit quality assessment criteria proposed in this study.

The issue of enhancing the transparency of the auditor's report is governed by ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (IAASB, 2023). The standard requires auditors of listed entities, including commercial banks, to communicate the matters that were discussed with those charged with governance and that were of the greatest significance during the audit of the current reporting period. Robert K. Mautz and Hussein A. Sharaf, who established the philosophical foundations of audit theory, likewise emphasized the principles of reliability and integrity in the auditor's report (Mautz & Sharaf, 1961).

Audit quality management has been further developed through the International Standards on Quality Management (ISQM 1 and ISQM 2), together with the requirements for Engagement Quality Reviews (IAASB, 2023). To facilitate the quantitative assessment of audit quality, international practice increasingly employs Audit Quality Indicators (AQIs). Contemporary auditing textbooks also identify audit quality and the transparency of the auditor's report as central issues in modern auditing (Arens et al., 2017; Hayes et al., 2014).

The introduction of ISA 701 in 2016 represented a significant reform of the traditional auditor's reporting model. Rather than providing only a conventional "pass/fail" opinion, the revised reporting framework requires auditors to communicate information about the most significant matters encountered during the audit. The principal objective of this reform was to reduce the information gap between auditors and users of financial statements while increasing the informational value of the auditor's report. Previous studies indicate that the introduction of Key Audit Matters (KAMs) has enhanced the informativeness of audit reports, although the quality and usefulness of KAM disclosures vary considerably across industries and companies. Developing a standardized approach to KAM reporting for commercial banks may help reduce these inconsistencies.

RESEARCH METHODOLOGY

The study adopts a qualitative research paradigm and a case study approach, focusing on the development of a bank audit quality assessment framework and a methodology for identifying and reporting Key Audit Matters (KAMs), followed by their conceptual application to a real commercial bank. The proposed audit quality assessment criteria were developed based on the IAASB's *Framework for Audit Quality* (2014) and the audit quality theories of DeAngelo (1981) and Francis (2011), while the KAM methodology was designed in accordance with the requirements of ISA 701.

To demonstrate the practical relevance of the proposed model, JSC *Xalq Banki* was selected as the case study. The selection was justified by the bank's systemic importance, state ownership, extensive branch network, and the Expected Credit Loss (ECL) measurement error identified in 2021, which makes the bank an appropriate case for evaluating audit quality and validating the proposed KAM methodology. In addition, grouping, systems analysis, and expert evaluation methods were employed throughout the research.

The reliability of the study is supported by the use of official sources and internationally recognized auditing standards, while its validity is ensured through the consistency of the proposed audit quality criteria and Key Audit Matters with the requirements of ISA 701, ISQM 1, ISQM 2, and the IAASB *Framework for Audit Quality*. The proposed KAM examples were developed based on the actual risk profile of the selected commercial bank.

ANALYSIS AND RESULTS

Audit quality is a multidimensional concept that cannot be adequately measured by a single indicator. Drawing upon the IAASB's *Framework for Audit Quality*, this study proposes a four-dimensional framework for assessing audit quality in commercial bank audits. The framework comprises: input factors (auditor competence and independence), process factors (compliance with the International Standards on Auditing and a risk-based audit approach), output factors (the quality of the auditor's report and the transparency of Key Audit Matters), and interaction factors (communication with the audit committee and regulatory authorities). Specific indicators and assessment methods are defined for each category, as presented in Table 1.

Table 1. Proposed Criteria for Assessing Audit Quality in Commercial Bank Audits[1]

Criteria Group	Indicator	Assessment Method
Input factors	Auditor independence and professional competence (IESBA Code and bank audit certification)	Review of documentation and professional qualifications
Process factors	Compliance with ISAs and application of a risk-based audit approach	Peer review of audit working papers
Output factors	Quality of the auditor's report and transparency of Key Audit Matters (KAMs)	Analysis of the auditor's report
Interaction factors	Communication with the audit committee and regulatory authorities	Review of meeting minutes and communication records

The principal advantage of the proposed framework is that it evaluates audit quality not only through the final audit opinion but also through the quality of audit inputs and audit processes. This is particularly important in bank auditing, where deficiencies in audit quality often arise not from the auditor's report itself but from insufficient audit evidence or compromised auditor independence. The framework provides both audit firms and audit committees with an objective basis for evaluating audit quality and identifying opportunities for continuous improvement.

One of the most important indicators of audit quality is the transparent communication of Key Audit Matters (KAMs) in the auditor's report, as required by ISA 701. Identifying KAMs is a systematic process that involves selecting, from the matters discussed with those charged with governance, those of the greatest significance during the audit—typically matters involving high audit risk, significant professional judgment, or major events. In commercial bank audits, Key Audit Matters generally relate to areas requiring substantial professional judgment. The most common KAMs in bank audits and the corresponding audit approaches are presented in Table 2.

Table 2. Typical Key Audit Matters (KAMs) in Commercial Bank Audits[2]

Key Audit Matter (KAM)	Reason	Audit Approach
Expected Credit Losses (ECL) and loan loss allowances	High estimation uncertainty and significant professional judgment	Risk-based audit program, model validation, and independent recalculation
Fair value measurement of financial instruments	Complexity of valuation	Evaluation of valuation methodologies and hierarchy; use of an auditor's expert (ISA 620)
Related-party transactions	Risk of conflicts of interest	Identification of transactions; verification of contractual terms and disclosures
Information systems and data integrity	Operational and IT risks	Testing of IT controls and application of CAATs

As shown in Table 2, most Key Audit Matters in commercial bank audits relate to estimates and areas characterized by significant uncertainty. Defining an appropriate audit response for each KAM enhances audit quality while improving the informational value of the auditor's report. Transparent disclosure of Key Audit Matters provides investors, depositors, and regulatory authorities with meaningful insight into the most significant issues addressed during the audit and is consistent with the recommendations of the Basel Committee on Banking Supervision regarding greater transparency in bank auditing (Basel Committee on Banking Supervision, 2024).

1 **Source:** Developed by the author based on the IAASB Audit Quality Framework.
2 **Source:** Developed by the author based on ISA 701 and the bank's actual risk profile.

In the case of JSC *Xalq Banki*, the assessment of Expected Credit Losses (ECL) under IFRS 9 clearly constitutes a Key Audit Matter because it involves substantial estimation uncertainty, depends heavily on management judgment, and was the area in which a material measurement error occurred in 2021. Accordingly, the auditor's report should explain why ECL was considered a Key Audit Matter and describe the audit procedures performed to address it. Such disclosure provides users of the financial statements with a clear understanding of the area that received the greatest audit attention and the procedures undertaken by the auditor, thereby significantly enhancing both the transparency of the audit report and stakeholder confidence.

For example, the ECL-related Key Audit Matter could be presented in the auditor's report as follows: *"The measurement of Expected Credit Losses (ECL) on loans and advances to customers involves significant professional judgment, complex modeling techniques, and forward-looking assumptions. Due to the high level of estimation uncertainty associated with this area, we determined it to be a Key Audit Matter. Our audit procedures included evaluating the ECL methodology, assessing the model parameters, reviewing loan stage classifications, and independently recalculating the ECL for selected loan exposures."*

The ECL measurement error identified in 2021 and the subsequent restatement of the financial statements provide practical evidence of the importance of comprehensive KAM disclosure. This demonstrates that the KAM mechanism not only enhances transparency but also serves as a preventive instrument for improving audit quality.

To facilitate the quantitative assessment of audit quality, this study proposes the implementation of a system of Audit Quality Indicators (AQIs). These indicators enable objective measurement and continuous monitoring of audit quality over time. In particular, indicators such as the resources devoted to ECL auditing and the extent of independent recalculation provide evidence of whether sufficient attention has been devoted to high-risk audit areas. The proposed AQIs are presented in Table 3.

Table 3. Proposed Audit Quality Indicators (AQIs) for Commercial Bank Audits[3]

Audit Quality Indicator (AQI)	Description	Measurement
Proportion of experienced audit staff	Share of highly qualified auditors assigned to the engagement	%
Time devoted to ECL auditing	Resources allocated to the highest-risk audit area	Hours / %
Coverage of independent recalculation	Percentage of the loan portfolio examined using CAATs	%
Audit adjustments identified	Number and monetary value of misstatements detected during the audit	Number / UZS billion
Independence breaches	Number of identified threats to auditor independence	Number

These indicators provide both audit firms and audit committees with practical tools for evaluating and improving audit quality. For example, limited coverage of independent recalculation increases the likelihood that material errors—such as the ECL measurement error identified in 2021—may remain undetected. Consequently, monitoring this indicator helps ensure that sufficient audit attention is directed toward high-risk areas. The proposed AQI framework transforms audit quality from a largely subjective assessment into a system of measurable and observable performance indicators.

The proposed audit quality assessment criteria, Audit Quality Indicators (AQIs), and the Key Audit Matter framework are designed to operate as an integrated quality management system consistent with the requirements of ISQM 1 and ISQM 2. At the audit firm level, the system supports comprehensive quality management, while at the engagement level it incorporates an Engagement Quality Review (EQR). For high-risk audit engagements such as commercial bank audits, an independent engagement quality review should be mandatory, whereby an experienced engagement quality reviewer independently evaluates the auditor's conclusions regarding Expected Credit Losses and loan loss allowances. Such a multilayered quality management system is essential for preventing significant audit deficiencies similar to those observed in 2021.

The proposed audit quality framework is closely integrated with the other components of the bank auditing methodology. Areas identified as high risk by the Bank Risk Factors Index (BRFI) are designated as Key Audit Matters (KAMs); the Expected Credit Loss (ECL) audit program provides the corresponding audit response for those KAMs; and Computer-Assisted Audit Techniques (CAATs) ensure comprehensive independent recalculation, which is measured through the relevant Audit Quality Indicator (AQI). Consequently, the audit quality assessment criteria, KAMs, and AQIs collectively serve as the final integrative and supervisory component of the overall audit methodology, ensuring a comprehensive approach to audit quality.

3 **Source:** Developed by the author based on the IAASB Audit Quality Indicators approach.

The transparent communication 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 external auditor. In commercial banks, a strong and independent audit committee directly contributes to the appropriate identification of KAMs and the overall enhancement of audit quality. Therefore, the KAM framework functions not only as a means of communicating information to stakeholders but also as an instrument for strengthening a culture of quality within the bank.

The expected benefits of implementing the proposed audit quality criteria, AQIs, and KAM framework are reflected in the increased informativeness of the auditor's report and greater confidence among users of financial statements. The proposed quality management system helps prevent audit deficiencies and reduces the likelihood of restatements similar to the one resulting from the 2021 ECL measurement error. From an economic perspective, high-quality auditing enhances confidence in banks' financial statements, reduces the cost of raising capital, and strengthens investor confidence during privatization processes.

The practical implementation of the proposed framework requires institutional support. First, the national audit regulator and the Chamber of Auditors should incorporate the proposed audit quality assessment criteria and Audit Quality Indicators into national auditing standards. Second, the national higher education and professional certification systems should strengthen auditor training in IFRS 9, Expected Credit Loss validation, and digital auditing. Third, establishing an effective information-sharing mechanism between the Central Bank and external auditors would further enhance the quality of commercial bank audits.

The input factors constitute the foundation of audit quality. In commercial bank audits, auditor independence—both in fact and in appearance—is of particular importance because state-owned banks may face threats arising from political or administrative influence, long-term auditor-client relationships, or the provision of non-audit services. The IESBA Code of Ethics requires auditors to identify such threats and implement appropriate safeguards (IESBA, 2023). Professional competence is equally important, requiring auditors to possess specialized qualifications in bank auditing together with expertise in IFRS 9 and Expected Credit Loss validation. These competencies are essential for effectively auditing the high-risk areas specific to commercial banks.

The process factors reflect the quality of audit execution. These include compliance with the International Standards on Auditing, the effective application of a risk-based audit approach, and the collection of sufficient and appropriate audit evidence. The principal method of evaluating audit processes is an independent review of audit working papers through peer review or regulatory inspection, whereby experienced auditors assess whether the audit procedures performed are adequate and consistent with ISA requirements. In commercial bank audits, working papers relating to Expected Credit Losses and loan loss allowances require particularly careful examination.

The output factors are reflected in the auditor's report, which constitutes the primary product of the audit engagement. In accordance with ISA 700, the auditor's report should follow a clearly defined structure, including the auditor's opinion, the basis for that opinion, Key Audit Matters, and the respective responsibilities of management and the auditor. The quality of the report is reflected in its accuracy, clarity, and the informational value provided through the communication of KAMs. Since the auditor's report directly influences the decisions of investors, depositors, and regulatory authorities, its quality is of particular importance in commercial bank auditing.

The interaction factors encompass communication between the auditor, those charged with governance (ISA 260), and regulatory authorities. During the audit, the auditor communicates significant findings, material deficiencies in internal control (ISA 265), and proposed Key Audit Matters to the supervisory board or audit committee. In commercial banks, the existence of an effective and independent audit committee represents an important determinant of audit quality because it maintains an appropriate balance between management and the external auditor while reinforcing auditor independence.

ISA 701 establishes a two-stage process for identifying Key Audit Matters. First, the auditor identifies, from the matters discussed with those charged with governance, those requiring the greatest audit attention. Second, the auditor selects from these matters those that were of the greatest significance in the audit of the current reporting period and reports them as Key Audit Matters. The principal selection criteria include significant risks of material misstatement, areas involving substantial professional judgment, and significant events occurring during the reporting period. In commercial bank audits, the application of these criteria most commonly results in the identification of Expected Credit Losses, fair value measurements, and information technology systems as Key Audit Matters.

In enhancing the transparency of the auditor's report, elements other than Key Audit Matters (KAMs) also play a significant role. In accordance with the requirements of ISA 720, the auditor reviews other information published together with the financial statements (for example, the management discussion and analysis included in the annual report) and evaluates its consistency with the financial statements. In addition, the auditor's conclusion regarding the bank's ability to continue as a going concern (ISA 570) constitutes important information for users. Collectively, these elements improve the informativeness and credibility of the auditor's report.

When ensuring audit quality, it is also necessary to consider the issue of the expectation gap. The public often expects auditors to detect all errors and fraud, whereas an audit provides reasonable, rather than absolute, assurance. Transparent disclosure of KAMs and a clear explanation of the auditor's responsibilities in the auditor's report help reduce this expectation gap and provide users with a more realistic understanding of the audit. This is particularly important in bank audits, as confidence in banks is closely linked to the stability of the entire financial system.

The criteria for assessing audit quality and the Audit Quality Indicators (AQIs) are aligned with the audit firm's internal quality management system. In accordance with ISQM 1, audit firms are required to establish a risk-based system of quality management that incorporates quality objectives, risk assessment, and responses to identified risks. AQIs serve as a monitoring tool for evaluating the effectiveness of this system. Consequently, the proposed criteria and indicators are organically integrated into international quality management standards.

Another important aspect of the proposed quality framework is its linkage with external quality assurance. The audit oversight authority periodically inspects bank audits and evaluates both the quality management systems of audit firms and the quality of individual audit engagements. AQIs and audit quality criteria provide an objective basis for such external inspections, thereby ensuring systematic oversight and continuous improvement of bank audit quality.

The assessment of bank audit quality should also take into account the specific characteristics of group audits (ISA 600). In banks with extensive branch networks and subsidiaries, the quality of the audit of consolidated financial statements depends on effective coordination between the group auditor and component auditors. The group auditor is responsible for identifying significant components and overseeing the quality of their audits. In the case of JSC "Xalq Banki," with its extensive branch network, the quality of such coordination can be monitored as a separate AQI, since deficiencies at the component level may adversely affect the quality of the audit of the consolidated financial statements as a whole.

The audit quality system is also closely associated with the audit firm's periodic self-assessment cycle. Under ISQM 1, an audit firm is required to evaluate its quality management system at least annually and implement corrective actions to address identified deficiencies. Trends in AQIs (such as the number of identified adjustments or changes in the coverage of independent recalculations) provide an objective basis for this evaluation. Thus, the quality management system functions not as a static set of criteria but as a mechanism for continuous improvement.

Finally, the quality of bank audits is closely linked to the overall condition of the national financial reporting infrastructure. International financial institutions, such as the World Bank, assess audit quality and external oversight systems as key components of national financial transparency in their Reports on the Observance of Standards and Codes (ROSC). Therefore, implementing the proposed audit quality criteria and AQI framework at the national level would enhance not only the quality of individual bank audits but also the reliability of the country's entire financial reporting system. This is consistent with the objective of the *Uzbekistan–2030 Strategy* to align the financial sector more closely with international standards.

At the same time, certain limitations of the proposed framework should be acknowledged. First, AQIs and audit quality criteria should be tailored to the specific characteristics of both the bank and the audit firm. Second, quality assessments (for example, peer reviews of audit documentation) depend on the auditor's professional judgment and therefore cannot be entirely free from subjectivity. Third, transparent disclosure of KAMs requires auditors to maintain an appropriate balance between transparency and confidentiality in their relationship with the audited bank. Despite these limitations, the proposed framework represents an important step toward the objective assessment of bank audit quality and the enhancement of transparency in the auditor's report.

CONCLUSIONS AND RECOMMENDATIONS

As a result of the study, a set of audit quality assessment criteria for the financial statement audits of commercial banks and recommendations for the formulation of Key Audit Matters (KAMs) in accordance with ISA 701 were developed. The proposed four-dimensional audit quality assessment framework—comprising input, process, output, and interaction factors—draws upon the IAASB Audit Quality Framework and enables a comprehensive evaluation of audit quality. In addition, a system of Audit Quality Indicators (AQIs) was proposed as a quantitative tool for measuring audit quality.

The study identified the key audit matters that are most typical for commercial banks, including expected credit losses (ECL) and loan loss provisions, the fair value measurement of financial instruments, related-party transactions, and information systems, while specifying the corresponding audit responses for each area. Using JSC "Xalq Banki" as a case study, the research presents an example of transparent disclosure of ECL as a KAM in the auditor's report. The actual ECL misstatement identified in 2021 confirms the preventive value of the KAM mechanism.

Based on the findings, the following recommendations are proposed: (1) the audit regulatory authority and the Chamber of Auditors should incorporate bank audit quality assessment criteria and AQIs into national auditing standards; (2) audit firms should transparently disclose ECL, financial instruments, and information systems as key audit matters in bank audit reports; (3) mandatory engagement quality reviews based on the requirements of ISQM should be introduced for high-risk engagements such as bank audits; and (4) the role of commercial bank audit committees should be strengthened, with formal communication procedures established between audit committees and regulatory authorities.

It should be emphasized that the audit quality system serves as the concluding and supervisory component of the entire bank audit methodology, ensuring the proper execution of all its elements, including risk assessment, ECL auditing, and the application of digital audit tools. In this sense, audit quality criteria, AQIs, and the KAM mechanism collectively provide a coherent and comprehensive framework for improving bank audits, ultimately ensuring the reliability and transparency of the auditor's report.

The theoretical contribution of this research lies in enriching the methodological foundations for assessing bank audit quality and enhancing the transparency of auditor's reports. Its practical significance stems from the applicability of the proposed quality assessment framework, AQIs, and KAM recommendations by audit firms, commercial banks, and regulatory authorities. Future research should focus on the statistical validation of AQIs using large empirical datasets and on the development of a unified national framework for assessing the quality of bank audits.

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