

Audit Quality—Preliminary Matters for Consideration**Background***IAASB Strategy and Work Program, 2009-2011*

1. Following extensive consultation with stakeholders in 2007, the IAASB determined that the topic of audit quality should be included in its strategy and work program for 2009-2011. The IAASB noted that while the term “audit quality” has become widely used in the communications of the IAASB and those of its stakeholders, there is no universally agreed definition for it. The lack of a basic agreement as to the meaning of the concept of audit quality may in turn foster an expectations gap between what the public expects and what the profession believes it can and should deliver. In addition, the IAASB recognized that ISAs are by no means the only ingredient to audit quality and that are other equally important contributing factors.
2. Accordingly, the strategy for 2009-2011 envisions the IAASB considering whether to develop a consultation paper on audit quality. The IAASB noted that, if developed, such a consultation paper might also highlight key conceptual matters such as materiality, audit evidence and professional judgment that may need to be further developed as part of the IAASB’s initiatives on implementation of the ISAs.
3. While audit quality has been, and remains, a major driver in the IAASB’s efforts in developing high quality ISAs, the topic of audit quality itself has never been the subject of specific debate at the IAASB. However, IFAC broached the topic briefly in January 2007 through the release of a 4-page brief titled *Audit Quality and International Standards on Auditing*, highlighting the importance of audit quality and the value of contributions to it by the ISAs and IAASB’s processes that underpin their development.¹

Prior Research and Analysis on Audit Quality

4. A large volume of research, thought-leadership and policy analysis work on audit quality and its related aspects and ramifications has already been undertaken by various parties over the years, including IFAC, regulators, professional accountancy bodies, and academia. Appendix 1 provides an overview of some of the different perspectives on, and approaches to, audit quality from sources including:
 - Academic research
 - The UK Financial Reporting Council’s (FRC’s) Audit Quality Framework
 - The U.S. Department of the Treasury’s Advisory Committee on the Auditing Profession
 - The Public Company Accounting Oversight Board’s (PCAOB’s) Standing Advisory Group (SAG)
 - The European Union’s (EU’s) Eighth Directive’s transparency report

¹ The IFAC Audit Quality brief can be accessed at:
http://www.ifac.org/MediaCenter/files/Audit_Quality_Fact_Sheet.pdf.

- The Basel Committee on Banking Supervision’s work on external audit quality and banking supervision
 - International Organization of Securities Commissions’ (IOSCO’s) Audit Quality roundtable and consultation on auditor communications
 - The Institute of Chartered Accountants in England and Wales’s (ICAEW’s) Audit Quality Forum
 - The IFAC Transnational Auditors Committee’s (TAC’s) work on the tone at the top and audit quality
 - IFAC’s report on the financial reporting supply chain
5. In addition, the importance of audit quality continues to be highlighted at various discussions of the IAASB Consultative Advisory Group. Also, other groups, such as the Center for Audit Quality of the American Institute of Certified Public Accountants, continue to actively monitor and develop policy responses to audit quality issues.

Objective and Scope of Discussion

6. The objective of this session is to generate open discussion on the topic of audit quality.
7. It is understood that there is a range of perspectives and considerations associated with this topic and, equally, a wide range of potential courses of action that may be pursued. Accordingly, IAASB members are invited to share their views, experiences and perspectives on the topic of audit quality to help inform IAASB’s considerations.
8. This Paper is not intended to prejudge a decision by the IAASB about whether it should undertake the development of a consultation paper on audit quality or otherwise embark on a project on the topic, nor is it aimed at identifying immediate solutions to the many issues concerning audit quality.

Matters for Discussion

9. In the context of the various perspectives on, and approaches to, audit quality as set out in Appendix 1, the following includes some possible generalities that may be drawn.
- Audit quality may mean different things to different people, whether regulators and oversight bodies, analysts, investors, auditors or academics.
 - Irrespective of the meaning that may attach to it, it is generally acknowledged that audit quality is fundamental to economic growth and financial stability. Stakeholders and IAASB all have a vested interest in promoting it, pursuing it, investing in it, and supporting efforts to achieving it.
 - There are many facets to audit quality. As an outcome, audit quality rests not only on the quality of auditing standards but also on various other factors such as:
 - The quality of application of the standards (or, more generally, the “audit process”);

- Relevant elements of the financial reporting supply chain, including the quality of the financial reporting process and corporate governance;
- The capabilities and competence of auditors;
- The culture within audit firms;
- The nature and extent of the auditor's communications with stakeholders; and
- The legal and regulatory environment, including litigation risk and oversight of the profession.

The issues concerning audit quality are equally varied and interrelated.

- The degree of interest and the extent of work that has already been undertaken by various parties on audit quality suggests a significant opportunity to leverage relevant work and potentially to collaborate with interested groups that are engaged in discussion on audit quality.
 - A number of current IAASB projects and initiatives are of direct relevance to the audit quality question. For example, in the auditor communications and reporting project, a number of questions that may be explored impinge directly on the matter of audit quality because the quality of audits is judged as much by outputs achieved as it is by inputs applied in the audit process.²
10. While all comments are welcome, the IAASB is asked for its views on the following three broad questions in particular:
- (a) **Are there one or more perspectives on, or approaches to, audit quality outlined in Appendices 1-4 that resonate with the mandate and work of IAASB more so than the others?**
 - **For example, does the UK FRC's Audit Quality Framework (see Appendix 4) provide a useful and appropriate frame of reference when thinking about the interplay of audit quality with the IAASB's work? If so, would members broadly agree to the list of five drivers and corresponding indicators of audit quality in the UK FRC's Framework? If not, why?**
 - (b) **From the perspective of users of audits, to what extent can audit quality be assessed or measured, and how?**
 - (c) **If the IAASB were to engage in a project on Audit Quality, what should the scope of such a project be? In particular:**
 - **Where should IAASB best place its efforts to enhance and promote audit quality?**

² Such questions might include, for instance:

- What is the extent of users' appetite for more information to be communicated about the "black box" of the audit process?
- Is there a need for a different auditor reporting model – and if so, what are the key issues?
- What is the impact of litigation risk on the possibilities for developing alternative auditor communications?

- **Can the objective(s) and scope of such a project be clearly identified and, if so, what should they be? What might be appropriate short, medium and long term goals in this regard?**
- **How might IAASB best leverage work done by others and collaborate with relevant stakeholders?**
- **Are there aspects of audit quality that have particular bearing on, or relationship with, current IAASB projects and initiatives?**

Appendix 1

Perspectives on, and Approaches to, Audit Quality from Various Research, Thought-Leadership and Other Initiatives or Forums

A. Academic Research

1. A large body of academic research has been done on the subject of audit quality. Appendix 2 provides an overview of some research approaches to audit quality issues that the UK FRC prepared as part of its project to develop an audit quality framework (see Section B below).
2. More recently in September 2009, in his inaugural lecture at Maastricht University, Prof. Robert Knechel laid out eight propositions to explore when rethinking audit quality. Appendix 3 includes relevant excerpts that challenge thinking about audit quality.

B. The UK FRC's Audit Quality Framework

3. In November 2006, the UK FRC issued a Discussion Paper titled *Promoting Audit Quality*³ seeking views as to whether, within the existing UK legal and regulatory framework, all appropriate steps were being taken to maintain and enhance the quality of audits and, if not, what more could or should be done. The paper addressed the FRC's objective of promoting and maintaining confidence in the audit process and the resulting audit report as a key component of the corporate reporting and governance regime and the effective operation of the capital markets.
4. The paper noted that there is no single agreed definition of audit quality that can be used as a "standard" against which actual performance can be assessed. An auditor's opinion on the financial statements is subjective, and different views may be held as to the nature and extent of audit evidence required to support the opinion. Further, limited transparency makes an assessment of audit quality difficult by those who rely on it.
5. To facilitate the discussion, the paper identified four main drivers that, in the FRC's view, are central to achieving a high quality audit:
 - The culture within an audit firm
 - The skills and personal qualities of audit partners and staff
 - The effectiveness of the audit process
 - The reliability and usefulness of audit reporting

The paper also identified indicators for each driver and possible threats that weaken its effective operation.

6. In October 2007, the FRC published a document summarizing the comments received and its approach to the issues raised in response to the discussion paper. The FRC also added a fifth

³ The Discussion Paper can be accessed at:
<http://www.frc.org.uk/images/uploaded/documents/Promoting%20Audit%20Quality%20paper%20web%20optimised1.pdf>.

audit quality driver: factors outside the control of auditors (e.g., corporate governance, audit committee effectiveness, reporting deadlines, etc.).

7. These five drivers and their indicators constitute the FRC's Audit Quality Framework,⁴ which is intended to complement existing UK regulations and guidelines, and support effective communication among auditors, audit committees, preparers, investors, and other stakeholders. Appendix 4 lists the drivers and indicators that constitute the FRC's Audit Quality Framework.

C. U.S. Department of the Treasury: Advisory Committee on the Auditing Profession

8. In October 2007, the U.S. Department of the Treasury established the Advisory Committee on the Auditing Profession (Advisory Committee) to “examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics.” In October 2008, the Advisory Committee issued its final report setting out 31 recommendations derived from the deliberations of three subcommittees, each of which focused on one of three key areas: human capital, firm structure and finances, and concentration and competition.⁵
9. Among its various recommendations, the report notes the following:
 - The Subcommittee on Firm Structure and Finances also focused on improving the usefulness of the auditor's report, the auditor's primary means of communication with investors. The Subcommittee recommended that the PCAOB undertake standard-setting initiatives to:
 - Consider improving the content of the auditor's report beyond its current pass/fail model; and
 - Require that the engagement partner sign the auditor's report.
 - The Subcommittee on Concentration and Competition discussed enhancing audit quality as a key element in improving the viability and resilience of the auditing profession. The Subcommittee learned that auditing firms provide limited information on audit quality to the public, particularly to audit committees and investors. The Subcommittee recommended that the PCAOB consider the feasibility of developing and disclosing audit quality indicators so that more of such information can be developed and communicated.
 - The Subcommittee on Concentration and Competition also noted the increasing globalization of the capital markets and the consequent increasing need for regulators and policy makers to collaborate at the global level to oversee auditing firms and monitor audit quality. The Subcommittee on Concentration and Competition recommended that the PCAOB continue to collaborate and cooperate with its foreign counterparts.
10. The report states that “[t]estimonies and comment letters have suggested specific output-based audit quality indicators ... and input-based audit quality indicators....” The report describes these indicators as follows:

⁴ The UK FRC's Audit Quality Framework was published in February 2008 and can be accessed at: <http://www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web1.pdf>.

⁵ The Advisory Committee's final report can be accessed at: <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

- Output-based – indicators determined by what the auditing firm has produced in terms of its audit work, such as number of frauds discovered and nature and reason for financial restatements related to time periods when the underlying reason for restatement occurred during the auditing firm's tenure as auditor for the client.
 - Input-based – indicators of what the auditing firm puts into its audit work to achieve a certain result, such as the auditing firm's processes and procedures used for detecting fraud, the average experience level of auditing firm staff on individual engagements, the average ratio of auditing firm professional staff to auditing firm partners on individual engagements, and annual staff retention.
11. The report also suggests possible sources of information to consider regarding the recommendation relating to assessing the feasibility of developing key indicators of audit quality, such as:
- Annual reports currently filed by auditing firms in other jurisdictions, such as the UK.
 - The UK FRC's Audit Quality Framework.
 - Factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.
12. The vast majority of parties that provided feedback to the Advisory Committee agreed in substance with the recommendation on audit quality indicators. Firms commented that the UK FRC's audit quality framework and Article 40 Transparency Report of the EU's Eighth Directive⁶ can be used as starting points to build upon in this effort. One firm stressed that audit quality indicators may be more meaningful in the context of an individual audit versus an entire firm.⁷ The firms also cautioned that, because their size, structure, and client base can vary significantly, any indicators of audit quality and effectiveness should be designed so that they do not disadvantage smaller firms.
13. Academics noted in their comments a lack of empirical evidence that links better audit quality to many of the input-based measures suggested by the Committee. One input-based measure that researchers say has a well-established positive relationship to better audit quality is auditor industry specialization.⁸

D. PCAOB SAG

14. In October 2008, the PCAOB SAG met to discuss, among other matters, the recommendation of the Department of the U.S. Treasury's Advisory Committee on the Auditing Profession relating to assessing the feasibility of developing key indicators of audit quality and effectiveness.⁹

⁶ The EU's Eighth Directive can be accessed at:
http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_157/l_15720060609en00870107.pdf. Section E below summarizes the requirements for the Transparency Report.

⁷ See http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF.

⁸ See http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf.

⁹ The PCAOB SAG discussion paper can be accessed at:
http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Feasability_AQI.pdf.

15. Discussion topics addressed by the SAG included the following:
- Whether a definition of audit quality is a prerequisite for developing meaningful key indicators of audit quality and effectiveness. If so, how should audit quality be defined?
 - Whether it is feasible to develop meaningful key indicators of audit quality and effectiveness at:
 - An individual audit engagement level;
 - An auditing firm level; or
 - A combination thereof.
 - At the engagement level:
 - Whether there are measurable input-based and output-based indicators that have an established relationship to audit quality.
 - Whether auditor industry experience has a positive relationship to better audit quality.
 - Whether audit engagement complexity and size need to be considered when developing key indicators of audit quality and effectiveness, and, if so, how.
 - At the firm level:
 - Whether any individual pieces of information required by the EU Transparency Report would have a positive relationship to audit quality, including whether a leadership statement on the effectiveness of a firm's internal quality control system, as required by the Transparency Report, would have a positive relationship to audit quality.
 - Whether an auditing firm's size, ownership structure, and client portfolio need to be considered when developing key indicators of audit quality and effectiveness, and, if so, how.
16. The SAG also discussed the feasibility of, and the need for, key indicators of audit quality from the point of view of the following audit quality stakeholder groups:
- Investors
 - Importance and usefulness of currently available key indicators of audit quality and effectiveness, both at an individual audit engagement level and an auditing firm level, in making investment decisions.
 - Whether any additional key indicators of audit quality and effectiveness pertaining to an individual audit engagement would be useful to investors, and if so, what specific indicators.
 - Other steps that may be necessary to improve the public's knowledge of and confidence in auditing firms' audit quality.
 - Issuers

- Factors related to audit quality that issuers consider when making decisions on the selection or renewal of an auditing firm.
- Sufficiency of information on audit quality currently available to make an informed decision regarding retention of an auditing firm.
- Consideration of information regarding a board of directors' recommendation on the selection or renewal of an auditing firm, including items such as:
 - Audit hours and fees
 - Ratio of partner(s) to staff hours
 - Average years of professional experience per hour
 - Years of partner(s) industry experience
 - Years of auditing firm's tenure with the company
 - Discussion of reasons for recommending a particular firm as auditor
- Auditors
 - The most meaningful key indicators of audit quality and effectiveness at an individual audit engagement level, including how they are currently used.
 - The most meaningful key indicators of audit quality and effectiveness at an auditing firm level.
 - With regard to Article 40 of EU's Eighth Directive, the extent to which a firm leadership statement on effectiveness could serve as a key indicator of audit quality and effectiveness.

E. EU Eighth Directive

17. Article 40 of the EU's Eighth Directive provides that auditors of public entities publish, on their websites, an annual Transparency Report to include at least the following information:
- Legal structure and ownership;
 - Association with any network, and its structure and arrangements;
 - Governance structure;
 - Internal quality control system and leadership statement on its effectiveness;
 - Date of last quality assurance review;
 - List of public entities audited during the last fiscal year;
 - Independence practices and confirmation of independence compliance review;
 - Policy on continuing professional education;
 - Financial information, such as total audit fees as a percentage of total revenues; and fees charged for other assurance, tax, and non-audit services; and
 - Partners' compensation policies.

18. Separate from the more recent EU Transparency Report requirements, firms in the UK have for several years published annual reports on their websites in compliance with requirements applicable to all limited liability partnerships. In addition to financial disclosures, these reports have included such items as management discussion, disclosures on corporate governance, key performance indicators, and other information.

F. Basel Committee on Banking Supervision

19. In recent years, there has been a change in banking supervisors' reliance on audited information and in the nature of the major external audit firms. The need for bank supervisors to be confident of audit quality has been reinforced by a variety of factors and events. These include concerns about the risk of audit failures, the global expansion of the major audit firms, and increased complexity of both accounting standards and financial instruments. In addition, the challenges associated with fair value estimation processes, which have been amplified by the recent global financial crisis, have similarly underscored the importance of high quality audits. In response to these developments, the Basel Committee issued in December 2008 a paper describing the Basel Committee's understanding of these circumstances and steps it intends to take regarding key findings.¹⁰
20. In releasing the paper, the Basel Committee noted that the recent market turmoil and demand for increased transparency suggests that reliable, clear financial information supported by quality audits are key elements in enhancing market confidence. Accordingly, it determined that its continued involvement in promoting audit quality is warranted.
21. The paper summarizes four key areas of the Basel Committee's focus, including:
- The increase in bankers' and supervisors' reliance on external auditors' expertise and judgments
 - High-quality audits, which enhance market confidence, particularly in times of severe market stress
 - An increasing reliance on high quality bank audits to complement supervisory processes
 - The globalization of major external audit firms has contributed to the complexity of their structures and a lack of transparency regarding their governance
22. Among the actions in which the Basel Committee intends to engage to address these areas of focus are the following:
- Enhance promotion of sound auditing guidance and practices in areas of specific interest to banking supervisors, notably through an increased focus on:
 - Auditing fair value estimates derived through models;
 - Auditing disclosures (e.g., risks, fair value estimates and methodologies and uncertainty surrounding estimates);
 - Auditing loan-loss provisions, day-one gain recognition and own credit risk adjustments reflected in fair value estimates;

¹⁰ The Basel Committee's paper can be accessed at <http://www.bis.org/publ/bcbs146.pdf?noframes=1>.

- Auditing consolidation of and other involvement with off-balance sheet vehicles; and
- Auditors' responsibilities related to internal controls over fair value and other accounting estimates.
- Enhance audit quality by encouraging clarification of accounting principles in areas of specific interest to banking supervisors, such as valuations, consolidation, impairment and other areas that could be improved by relying on lessons learned from the current market turmoil.
- Encourage dialogue within and among audit firms to prepare for and address processes that should be conducted during future times of financial stress.
- Enhance engagement with independent audit oversight authorities.
- Encourage greater transparency of the corporate governance structures and the financial position of the global network firms.
- Encourage dialogue within and among the global network firms and other relevant bodies about the challenges that the firms face with respect to audit quality in audits of banks. In particular, the firms could identify impediments to their ability to consistently apply, on a global basis, accounting and auditing standards or internally developed guidance.
- Participate with the IAASB when it redrafts/updates IAPS 1004 and IAPS 1006.¹¹
- Continue to support audit quality by:
 - Participating in groups involved with audit and ethics standard setting and auditor oversight;
 - Monitoring and responding to emerging issues related to international auditing and accounting that may affect audit quality, such as developments in the area of auditor liability; and
 - Responding to requests for comment by the audit and ethics standard setters.

G. IOSCO

23. In September 2009, the IOSCO's Technical Committee launched three related consultation papers on the subjects of "Transparency of Firms that Audit Public Companies," "Auditor Communications," and "Exploration of Non-Professional Ownership Structures for Audit Firms."¹² The papers are in response to concerns raised by participants at an IOSCO roundtable on the *Quality of Public Company Audits from a Regulatory Perspective* in June 2007. These issues included:

¹¹ International Auditing Practice Statement (IAPS) 1004, *The Relationship Between Banking Supervisors and Banks' External Auditors*, and IAPS 1006, *Audits of the Financial Statements of Banks*.

¹² The comment period on IOSCO's consultation papers closes on January 15, 2010. The paper on transparency of firms can be accessed at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD302.pdf>. The paper on auditor communications can be accessed at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD303.pdf>. The paper on firm structures can be accessed at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD304.pdf>.

- The transparency of audit firms and the effect this could have on the quality of audits and the availability and delivery of audit services;
 - The adequacy of the standard audit report; and
 - The impact of audit firm ownership structure on concentration in the market for auditing large issuers.
24. The paper addressing the transparency of firms explores whether enhancing the transparency of audit firms' governance, audit quality indicators and audited financial statements could maintain and improve audit quality and the availability and delivery of audit services. The paper considers the benefits and possible disadvantages of enhanced transparency, while also examining alternative methods of achieving enhanced transparency and ways in which to mitigate any potential limitations arising from increased transparency.
25. The paper addressing auditor communications considers whether changes to the standard audit report or additional auditor communications are warranted to address concerns about the effectiveness of the standard audit report in communicating important information about the audit and audit process and, therefore, meet investor information needs. The paper:
- Highlights the evolution of the audit report;
 - Describes perceived shortcomings of the report observed by others;
 - Identifies possible solutions to these issues proffered by others; and
 - Notes possible advantages and disadvantages of such solutions.
26. The auditor communications paper also notes that some panelists at the June 2007 roundtable suggested that the binary nature of the opinion included in the standard audit report (i.e., the pass/fail model in which an opinion is expressed on whether or not the financial statements are fairly presented) may not be optimal for today's complex business environment. Others noted that the standard audit report does not specifically identify the actions that the auditor undertook to render an opinion or issues that the auditor uncovered during the course of the audit, which limits its value to investors.

H. ICAEW Audit Quality Forum

27. In November 2002, the ICAEW published a paper on Audit Quality that examines the fundamental practical issues that arise from the fact that auditing is a practical discipline that relies on individuals, and sets out the characteristics that facilitate audit quality. The paper emphasizes how audit quality is achieved in practice and provides illustrations of good practice that enhance audit quality. It also notes that audit quality depends on a number of factors, including:
- Good leadership
 - People with experienced judgment, technical competence, ethical values
 - Appropriate client relationships

- Proper working practices
 - Effective internal and external quality control and monitoring review processes
28. Through the Audit Quality Forum,¹³ the ICAEW further developed thinking on audit quality in a series of subsequent publications on audit quality-related themes and topics. A number of work streams addressed different aspects of audit quality as follows:
- First Work Stream: Shareholder Involvement
 - Purpose: to support shareholder involvement in the audit process
 - Outcomes were policy proposals to support shareholder involvement and increase transparency in the audit process by:
 - Disclosing the contractual terms of audit engagements for quoted companies on their websites.
 - Identifying the names of individual partners signing audit reports.
 - Empowering shareholders to put questions to auditors of listed companies in advance of the annual shareholders' meeting.
 - Communicating useful and timely information about the circumstances of auditor resignations.
 - Second Work Stream: Fundamentals
 - This series begun in December 2005 against the background of the adoption of ISAs by the UK Auditing Practices Board for 2005 calendar year audits. It considered matters outside the scope of global auditing standards which were fundamental to auditing practice. In addition, it broadened the focus to examine the relationships between shareholders, boards, auditors, regulators and others in the audit.
 - This work included:
 - A project articulating the purpose of the audit under national law
 - Closely related projects on principles-based auditing standards, making global standards local and auditor reporting
 - A study of the legal responsibilities of third parties in supporting high quality auditing
 - Third Work Stream: Evolution
 - The fundamental concern is to understand how best to maintain and enhance audit quality in the face of major changes in the environment in which auditing takes place.

¹³ The Audit Quality Forum is a body, set up by the ICAEW, which brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together to generate practical ideas for further enhancing confidence in independent audit by improving audit transparency and supporting shareholder involvement in the audit process.

- The series covers:
 - The changing environment in which auditors work
 - The reporting relationship between auditors and the audit committee
 - How the differing interests of stakeholders and their expectations of audit can be reconciled
- Current Work Stream: Global Challenges
 - The overarching themes being developed are:
 - Audit market needs, for example:
 - Is there more that auditors could do to share with investors or regulators insights gained from a range of clients about systemic risks?
 - How effective are national auditor independence requirements which operate primarily at the client level in giving investors confidence that auditors are independent from boards and management?
 - Audit performance, for example:
 - Notwithstanding the importance of global auditing standards, to what extent do differences in legal systems, business cultures, professional capacity and governance arrangements at a national level frustrate the delivery of consistent quality on the audits of international businesses?
 - Audited financial information, for example:
 - What should be the nature of the relationship between auditing and accounting standard setters? For example, how should considerations of auditability and audit costs and benefits influence the International Accounting Standards Board?
 - What should be done in the early years of implementing a new IFRS to minimize and mitigate laps in the development of audit practice?
 - Despite changes in the way financial statements are transmitted (such as through using XBRL) and in the range and complexity of financial information presented to investors (such as risk and sensitivity information), is there any reason to think that long-anticipated demands for changes in the scope of the audit or for new audit-type services will materialize?

I. IFAC TAC

29. In December 2007, the IFAC TAC released a good practice guidance paper titled *Tone at the Top and Audit Quality*¹⁴ in response to a recurring comment from inspection reports published by external audit oversight bodies and regulators that audit firms should do more and better evidence their activities and commitment to the “tone at the top.” The paper was

¹⁴ The good practice guide can be accessed at: http://www.ifac.org/Members/DownLoads/Tone_at_the_Top.pdf.

prepared based on the input of ten TAC members representing some of the largest international networks.

30. The TAC intends the paper to be a valuable tool for members of the Forum of Firms,¹⁵ as well as audit firms of all sizes, in developing further processes to establish an appropriate tone at the top and to demonstrate their ongoing commitment to delivering audit quality.
31. In issuing the paper, the TAC acknowledged the importance of the tone at the top in contributing to audit quality and that audit quality should be a priority for every audit firm. It noted that if audit quality is to remain a real priority, audit firms should create and sustain a culture of positive and constant reinforcement. The TAC emphasized that this can be supported by the tone set by firm management through the policies and procedures they put in place, their communications on their expectations with respect to compliance, the system of reward and sanctions they implement and, importantly, the example they set through their own behavior.
32. The paper describes the meaning of the term “tone at the top” and explains its importance to audit firms. It also sets out good practice guidance in the areas of:
 - Strategy
 - Communications
 - Job descriptions
 - Performance appraisal
 - Monitoring

J. IFAC Financial Reporting Supply Chain Report

33. In March 2008, IFAC published a report titled *Financial Reporting Supply Chain: Current Perspectives and Directions*¹⁶ based on an independent global survey among the participants in the financial reporting supply chain. The report sets out to address the following key questions that have arisen as a result of the significant efforts that have been undertaken around the world to change and improve financial reporting:
 - What is the result of these efforts?
 - Has the financial reporting process become better or worse?
 - Have financial reports become more or less relevant, reliable and understandable?
 - What should be done next?
34. The report summarizes the survey results in the following areas.
 - The financial reporting process

¹⁵ The Forum of Firms (FoF) is an association of international networks of accounting firms that perform audits of financial statements that are or may be used across national borders. More information about the FoF can be found at: http://www.ifac.org/Forum_of_Firms/. The TAC is the executive committee of the FoF.

¹⁶ The IFAC Report can be accessed at: <http://www.ifac.org/Store/Details.tmp?SID=12047547112246020>.

- Among the areas of concern noted (as would clearly affect audit quality) is the complexity of financial reporting standards.
- The audit of financial reports
 - Among the positives noted are:
 - Improved auditing standards and processes
 - Increased awareness, commitment and competence of auditors and audit committees
 - More risk-focused audits
 - Greater auditor independence
 - Improved quality review and auditor oversight
 - Among the areas of concern noted are:
 - Reduced scope for professional judgment
 - Overregulation
 - Liability fear leading to boilerplate audits and lack of innovation (i.e., development of a checklist mentality; defensive/compliance orientation to auditing)
 - Limited auditor's communication with external stakeholders
 - Increased audit cost relative to perceived benefits
 - Among areas of further improvements identified are:
 - Continue to focus on independence, objectivity and integrity
 - Converge to one set of global, principles-based auditing standards over time
 - Ensure consistent use of audit standards and safeguarding of quality within audit firms
 - Improve auditor's communication, both internally and externally

K. U.S. Government Accountability Office

35. The U.S. Government Accountability Office (GAO) published two studies in November 2003 and January 2008 that were not specifically focused on audit quality, but contained two definitions of audit quality. These definitions were developed for purposes of the reports and do not appear to have been used in another context.
36. The November 2003 study defined a quality audit as one in which the auditor conducts the audit:
- in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with generally accepted accounting principles (GAAP) and (2) are not materially misstated whether

due to errors or fraud. This definition assumes that reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with auditing standards and that, within the requirements of those auditing standards, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate changes or other adjustments were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reasons for the resignation to SEC.¹⁷

37. The January 2008 study considered audit quality as “including experience and technical capability of the audit firm partners and staff as well as the capability to efficiently respond to a client’s needs and identify and communicate material reporting issues in financial reports.”¹⁸

¹⁷ U.S. GAO, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (November 2003), p.13 (<http://www.gao.gov/new.items/d04216.pdf>).

¹⁸ U.S. GAO, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, GAO-08-163 (January 2008), p.91 (<http://www.gao.gov/new.items/d08163.pdf>).

Appendix 2

Overview of Approaches to Audit Quality Issues from Academic Research

1. The following overview of some research approaches to audit quality issues is excerpted from Appendix 3 of the UK FRC's November 2006 Discussion Paper titled *Promoting Audit Quality*.

Introduction

2. This overview concentrates on a small number of areas that are key to the audit quality debate – for example, whether quality considerations can be inferred from visible market choices and whether there is a link between regulation and quality. Although reference is made to some general findings, this overview does not set out to review or summarize all existing research, or to demonstrate what is good or bad quality research. Rather, the emphasis is placed on how research can inform thinking about the nature of audit quality; this could contribute to consideration of potential additional future research.
3. The most common definition of audit quality applied in academic research is:
the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach.¹⁹

This definition focuses on whether an appropriate opinion is given on the financial statements involved and is concerned with the risk that an auditor will give an unqualified audit opinion when this is not warranted. It incorporates the two primary dimensions of technical competence (discovery of any misstatement) and independence (willingness to report such misstatements once discovered) of the auditor. Under this approach, higher quality auditing involves a higher probability of detection and reporting of unadjusted misstatements.

4. The technical competence and independence of the auditor *in fact* can be referred to as the “monitoring strength” of the audit,²⁰ but the reference in the definition to “market-assessed...probability” draws attention to the importance of the market's perception of the technical competence and independence of the auditor – auditor reputation. While over time, the monitoring strength of an audit firm should be reflected in its reputation, the two attributes may not be consistent in the case of any individual audit. Thus, it is possible that a firm with a reputation for high quality auditing may not deliver an audit with a high level of monitoring strength on a specific engagement. Indeed, this is the problem that is often reflected in the major cases of alleged audit failure when high reputation firms are associated with an individual set of deficient financial statements.
5. Because of the difficulty of observing and measuring directly the monitoring strength aspect of audit quality in practice, research studies have often focused on auditor reputation as a surrogate indicator. This has normally been based on comparison between the top tier (big 4-8) and other firms, and assumes that larger firms have valid reputations for higher quality audits.

¹⁹ DeAngelo, L., (1981) “Auditor size and auditor quality,” *Journal of Accounting and Economics*, December, pp. 183-199.

²⁰ Watkins et al. (2004) op cit.

6. The overview below is organized around a number of linkages that have motivated research on audit quality. However, two caveats should be noted:
 - (a) Much of the research in this area has been conducted in North America and its applicability in the environment of the UK [and the rest of the world] cannot be assumed.
 - (b) The focus is on whether an appropriate opinion was given on the financial statements as the indicator of suitable quality auditing, which may be considered a measure of minimum quality only. Other dimensions that could be considered such as the role of the audit in enhancing the governance of an enterprise or its control systems are not considered below.

Investigating Audit Quality

The Link with Market Demand for Audit Quality

7. Several studies have investigated the extent to which the market for audit services acts as a driver for audit quality, and specifically in what circumstances the market demands higher quality auditing. The most common research approach has been to investigate whether particular types of client or circumstance²¹ are associated with the demand for auditors with a reputation for higher quality. If a higher quality audit will improve the credibility of the financial information being disclosed, then companies may be willing to pay for a brand name auditor to signal higher quality information.
8. While some studies have indeed identified a differentiated demand for higher quality auditors, overall results are mixed. A significant difficulty with this kind of research is that it demonstrates demand for auditors with quality reputations (normally measured by comparing the top tier firms with other firms) but does not measure the actual monitoring strength applied. Due to the unobservability problem, it remains an assumption that firms with higher quality reputations deliver higher quality audits.²²

The Link Between Actions by Audit Firms and Differences in Audit Quality

9. The corollary to looking at the demand for audit quality is to investigate the extent to which the actions of audit firms themselves act as drives for the supply of audit quality into the market.
10. The largest volume of research in this area is based on investigation into audit fees which are used as a surrogate for audit effort. For example, one way in which auditors can protect themselves against higher risks is to engage in a higher volume of audit work and to increase fees accordingly in order to maintain high quality. Conversely, there has also been concern that in the case of low fees, possibly as a result of “low-balling” in order to acquire a new audit client, the quality of audit will suffer.

²¹ For example, where there may be higher risks associated with reported financial numbers or where there is a high level of potential conflict in the agency relationship between management and investors.

²² Examples of studies looking at the demand for differential audit quality are: Francis, J.R. and E.R. Wilson (1984) “Auditor changes: A joint test of theories relating to agency costs and auditor differentiation,” *The Accounting Review*, Vol. 63, October, pp. 663-682; Clarkson, P.M. and D.A. Simunic (1994) “The association between audit quality, retained ownership and firm specific risk in U.S. vs. Canadian IPO markets,” *Journal of Accounting and Economics*, Vol. 17, pp. 207-228.

11. While overall there is some evidence that audit firms with higher quality reputations (top tier firms) may undertake more work and charge higher fees in certain circumstances, these findings have not proved to be very stable between different environments, different data sets and different time periods, and it remains uncertain whether any higher fees reflect higher underlying audit quality or the market power of the major suppliers of audit services.²³
12. The extent to which the methodology and evidence processes followed by the audit firm influence the quality of audit supplied is an area where very little systematic research exists. High quality auditing should be associated with high quality methods, processes and qc procedures, and high quality auditors are likely to invest in the development of methods that reduce the risk of conducting low quality audits. There has been only limited research into the link between what methods auditors actually use and audit quality. For example, one survey study has reported evidence that, faced with difficult technical choices, auditors will favor a compliance approach rather than apply higher standards of reporting.²⁴
13. An additional mechanism by which audit firms may be able to identify their quality status is through establishing industry specialization. An auditor with more specialist industry expertise is likely to be perceived to deliver higher quality audits, and the evidence does tend to support the relevance of expertise as a quality signal.

The Link with Factors that can Threaten Audit Quality

14. A related area of investigation into the behavior of individual auditors within firms has been the extent to which deliberate “quality threatening behaviors” (such as reducing audit work to meet budget pressure) are found in practice. While evidence that such behavior does take place has been reported from members of audit teams, this has been survey-based and so captures beliefs, often regarding the behavior of others, rather than evidence from actual audit engagements. Consequently, making any link to the consequences of such behavior for the level of audit quality ultimately achieved in practice and the quality of financial information reported is much more difficult to establish.²⁵
15. The incidence of behavior that could jeopardize audit quality and the related actions taken by audit firms to prevent such behavior and incentivize high quality auditing in part reflect the culture, values and leadership of the firm. These factors as potential drivers of quality, and their impact on practice and behavior of individual audit engagements have not been subject to systematic evaluation or research and remain important matters for consideration in the current environment.
16. An additional source of evidence about what factors undermine audit quality can be obtained from investigation of the circumstances that have occurred in real cases of alleged audit

²³ Palmrose, Z. (1986) “Audit fees and auditor size,” *Journal of Accounting Research*, Vol. 24:1, pp. 97-110 is one example of a study showing a link between reputation and audit fees.

²⁴ Martens, S.C. and J.E. McEnroe (1992) “Substance over form in auditing and the auditor’s position of public trust,” *Critical Perspectives on Accounting*, Vol. 3, pp. 389-401.

²⁵ For an example of a recent study in this area, see Pierce, B. and B. Sweeny (2006), “Perceived Adverse Consequences of Quality Threatening Behavior in Audit Firms,” *International Journal of Auditing*, Vol. 10:1, March.

failure.²⁶ Within the UK, the reports that result from Dept of Trade Investigations have been one source of information about problems in such cases. In contrast to the research approaches mentioned above, the principal difficulty with this type of evidence is the specifics of the context in which problems may have arisen are not necessarily applicable to other organizations.

17. A developing body of research has examined whether the market relationship between an audit firm and a client company can create threats to audit quality. Specifically, this work has investigated whether the joint provision of audit and non-audit services is associated with observable differences in auditor behavior which could indicate that quality is undermined, such as the auditor's willingness to issue a modified audit report and the extent of discretionary choices evident in the financial statement numbers that have been accepted by the auditor. While potentially this is an important line of research for policy decisions about the constraints that should be placed on auditor-company relationships, there is as yet little evidence based on the position in the UK.²⁷

The Link Between Auditor Liability and Audit Quality

18. With respect to auditor liability, two sets of arguments have been advanced. First, it can be reasoned that in the presence of higher liability associated with litigation, high quality auditors will be less willing to accept more risky clients because of the greater threat to reputation in the event of a problem. If this occurs, then those risky clients will be audited by auditors with less reputation at stake and this may mean that a lower quality of audit service is delivered to the market. Conversely, it can also be argued that the threat of litigation provides a powerful incentive for auditors to ensure that those audit engagements that they do undertake are executed to appropriate quality. For example, some evidence has been reported that following a relaxation in the liability regime in the United States to proportional liability, higher reputation firms accepted a greater level of accounting choices that had the effect of increasing clients' reported income.²⁸

The Link Between Regulation and Audit Quality

19. A further source of potential drivers for audit quality is the legal and regulatory environment within which the audit is conducted. This includes the regulatory regime that applies for deficient auditing, as well as the impact of standards that apply to auditors and

²⁶ For examples of discussion of some cases in recent years, see: Gwilliam, D.R. (2003), *Audit methodology, Risk Management and Non-Audit Services: What Can We Learn from the Recent Past and What Lies Ahead?*, Briefing 05:03, London: Centre for Business Performance, Institute of Chartered Accountants in England and Wales; Morrison, M.A. (2004) "Rush to judgment: the lynching of Arthur Andersen & Co.", *Critical Perspectives on Accounting*, Vol. 15 No. 3, pp. 335-375.

²⁷ For US evidence, see Larker, D.F. and S.A. Richardson, "Fees paid to Auditors, Accruals, Choices and Corporate Governance," *Journal of Accounting Research*, 42:3, June 2004, 625-658 and Kinney W.R., Z.V. Palmrose and S. Scholtz, "Auditor Independence, non-Audit Services and Restatements: Was the US Government Right?" *Journal of Accounting Research*, 42:3, June 2004, 561-588.

²⁸ Lee, H.Y. and V. Mande (2003) "The effect of the private securities litigation reform act of 1995 on accounting discretion of the client management of Big 6 and non-Big 6 auditors," *Auditing: A Journal of Practice and Theory*, Vol. 22:1, pp.93-108.

systems of inspection. While standards and codes make an important contribution, these tend to codify minimum standards and it is more difficult to articulate how standards can promote or motivate high quality above the standardized minimum. There can be debate, therefore, as to whether regulation promotes high quality, through raising standards, or limits quality by encouraging a compliance only mentality.

20. The link between standards, related schemes for inspection and monitoring of compliance and audit quality is an area that has not yet been subject to evidence-based examination to any significant extent. There are considerable issues regarding the extent to which standards codify existing good practice or lead the development of practice, the problem that standards primarily establish only minimum levels of quality and the fact that they are likely to have differential impact on different types of supplier. Thus, the impact of standards is likely to be greatest on smaller firms rather than the large firms with international reputations. The same may be true for systems of inspection, but there is also the related concern that the need to provide a documented record for inspection that is consistent with the requirements of standards can result in a compliance approach to the audit rather than an approach driven by objectives of high quality reporting.
21. A difficulty limiting the potential impact of regulation as a driver for audit quality more generally is the tendency for regulatory measures to be introduced to deal with identified past problems, rather than anticipated future risks.

The Link Between Audit Quality and Other Aspects of Corporate Governance

22. A major emerging area which requires more understanding concerns the interaction between auditing and other elements of the governance system intended to contribute to high quality financial reporting, most notably the role of the audit committee. As the responsibilities of audit committees with respect to matters such as the appointment of the auditor have grown, it is relevant to consider what attributes audit committee members equate with high quality auditing. There is the potential for a virtuous circle in which different parts of the governance structure reinforce one another. A more independent audit committee can be expected to recommend a higher quality audit, the results of which should lead to better information for use in the market.

The Link Between Audit Quality and the Quality of Financial Information

23. The product of the quality of the audit can be related to the quality of the financial information contained in the eventual financial statements. The monitoring strength of the audit is relevant to the quality of financial information produced, but the reputation of the auditor is also important in that this affects the credibility of the information. Thus, higher quality auditing should result both in financial information that is a more appropriate reflection of the economic activities of the company and more credible information.
24. The links between signals of differential audit quality (normally the size and standing of the audit firm) and a number of financial reporting variables have been investigated. These include the likelihood that a modified audit opinion will be attached to the financial statements (for example, for financially distressed companies), the subsequent identification of problems with the numbers disclosed, through actions by bodies such as

the Financial Reporting Review Panel, and the apparent presence in the financial statements of reporting choices that could be associated with earnings management.

25. Generally, it has been found that the manner in which the market reacts to financial statement information is influenced by the reputation of the auditor (again tested through the comparison of top-tier audit firms with other firms).²⁹ This suggests that the reputation dimensions of audit quality do influence users' confidence in the financial statements.

²⁹ Krishnan, G. (2003) "Audit Quality and the pricing of discretionary accruals," *Auditing: A Journal of Practice and Theory*, Vol. 22:1. Pp. 109-126.

Appendix 3

Rethinking Audit Quality

1. The following is an excerpt from Prof. Robert Knechel's inaugural lecture at Maastricht University in September 2009, which sets out eight propositions for auditors to explore when rethinking audit quality.

Proposition 1: We still do not know how to define audit quality (let alone measure it).

2. The classic definition of audit quality cited by most audit researchers is that of DeAngelo (1981): "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach." This definition highlights two important aspects of audit quality, i.e.:
 - (a) The competence of the auditor that determines how likely it is that a misstatement will be detected; and
 - (b) The independence/objectivity of the auditor that determines what the auditor is likely to do about a detected misstatement.
3. However, while this definition is highly useful to researchers, it does not help one know if an auditor has provided an adequate level of audit quality. It also does not fully address all the questions about audit quality, for example:
 - Is it an issue of the quality of inputs used in the audit process, the quality of the outputs, or both?
 - If it is function of the quality of the inputs or outputs, how should they be measured?
 - If both, how do the inputs relate to the outputs?
 - Should quality be addressed at the engagement level or for the firm in its entirety?
 - Is audit quality conditional on the characteristics of the client or a portfolio of clients?

Proposition 2: Zero risk cannot be the goal of audit quality.

4. The DeAngelo definition of audit quality suffers from a rather serious limitation in that it contradicts auditing theory – it presupposes that audit quality is unbounded, i.e. more assurance is always better than less. However, the audit risk model, which is the foundation of the audit process, assumes that an auditor has an assurance target in mind when conducting the audit, and while the level of assurance would be quite high, it is not absolute.
5. Absolute (or perfect) assurance is not possible for two reasons:
 - (a) Society is unlikely to be willing to pay for the cost of the work needed to even begin to approach absolute assurance.
 - (b) Absolute assurance is not an attainable because of the inherent limitations of the audit (e.g. completeness of liabilities, or verifying estimates which involves predicting the future).

Proposition 3: Audit quality as an outcome cannot be completely separated from the quality of financial reporting.

6. While accounting and auditing scandals of the past decade have often involved outright fraud, many accounting problems have had more to do with interpreting accounting standards in a highly aggressive manner, as was the case with swap transactions at companies such as Worldcom and Global Crossing in the telecommunications industry. While the accounting for such transactions was “technically correct,” it served primarily to obfuscate the financial health of the companies and the results of their operations.
7. Other accounting practices, such as those involving special purpose entities (e.g. Enron), the acquisition of in-process R&D, and barter transactions among internet companies recognized as advertising revenue (America OnLine), also resulted in misleading financial information despite being acceptable under accounting standards and signed off on by an auditor.

Proposition 4: Any definition of audit quality should reflect that it is a professional service.

8. To understand “audit quality” one must first understand “auditing”. Whether one considers auditing to be a noun (“an audit”) or a verb (“to audit”) has a significant effect on how one views audit quality.
9. The audit as a *noun* suggests that it is a black box that can be evaluated based on its output. What goes into the black box, or happens in the black box, is not relevant.
10. However, as noted in Proposition 3, audit quality is unobservable as an output, and the outcome of the audit may not correspond to the quality of the work performed. Auditing as a verb suggests something that a professional does on behalf of a client. Essentially, this is the nature of a “service”. An important feature of services is that the perception of their quality is usually based on how they are provided as much as their outcome. For example, virtually all airplane flights get the passengers to their destination (eventually), but there can be a great deal of variability in how the quality of a plane trip is perceived by the customers.
11. However, while many services are perishable and non-storable, auditing is a fundamentally different service in that it is a *professional* service. For example, the audit report is non-perishable, at least for a foreseeable period of time, and the use of the audit report by one person does not preclude its use by another. As another example, the value of a professional service is knowledge-based rather than asset-based: an audit’s value derives from what the professional knows, i.e., his or her expertise. It is therefore important to recognize that an audit is a knowledge-based service where the primary input is the time and expertise of individual professionals.

Proposition 5: Audit quality is inherently uncertain and idiosyncratic.

12. The audit risk model does not assume absolute assurance. No auditor, client or regulator can ever really know what level of assurance is achieved in an audit. If nothing goes wrong with the client, no one is ever likely to look too hard at the quality of the audit. However, if a scandal does erupt at the client, or the client experiences a financial crisis, many interested parties may take a hard look at the auditor’s work. But again, they can never determine the actual level of assurance.

13. With the benefit of hindsight, many may think the auditor did a bad job when a scandal erupts. However, the auditor has to make his or her judgments without the advantage of hindsight and a good audit process can, nevertheless, result in a bad outcome. Accordingly, given that the level of assurance is unobservable, it follows that a critical attribute of audit quality is its inherent uncertainty.
14. Also, judging audit quality is not the same as picking out the best toaster or pair of jeans from a display of similar items. While toasters may vary in color, functionality, price and warranty, many customers may purchase the exact same model because they are manufactured in batches. By contrast, no two audits are identical. The characteristics of the each client are different, and so are:
 - The risk profile of each client
 - The resources needed to conduct each audit
 - The personnel assigned to each auditFurther, the attitudes, mood, attention and level of care for a given auditor vary from day-to-day. All of these differences therefore conspire to make each audit idiosyncratic, meaning that every audit is essentially a one-off exercise.
15. The fact that the quality of an audit is inherently uncertain and idiosyncratic means that audit quality is essentially a client-specific characteristic, and generalizations about a firm's audits may not be appropriate beyond specific engagements.

Proposition 6: Audit quality reflects how closely the achieved assurance level comes to the target (appropriate) assurance level.

16. The audit process is designed to assess the likelihood of a material misstatement and reduce the likelihood of an undetected and uncorrected misstatement to an “appropriate” assurance level. Three possible definitions of assurance are relevant:
 - (a) Target assurance, i.e. the amount of comfort that the public demands. This implicitly reflects a balancing of the marginal costs and benefits of more assurance, and reflects that zero risk is not an option.
 - (b) Planned assurance, i.e. the extent of risk that an auditor will tolerate at the end of the engagement. It should reflect the auditor's best guess as to what the market desires.
 - (c) Achieved assurance, which reflects the extent of audit work actually performed in the engagement.
17. If audit quality depends on the auditor achieving the appropriate target level of assurance, two types of audit failure may occur:
 - (a) Calibration Failure, i.e. the variance of planned assurance from target assurance; and
 - (b) Execution Failure: i.e. the variance of achieved assurance from planned assurance.

The sum total of these two variances represents the actual loss of audit quality for a specific engagement. (Achieved assurance may actually exceed planned assurance due to extra

work. While such extra work would reduce the effect of the calibration error, it may not be enough to achieve the appropriate level of assurance.)

18. A calibration failure suggests that the auditor has not established the appropriate level of assurance as the target of the engagement. As a result of a calibration error, even if the auditor does a “perfect” audit, he will not achieve society’s objectives for the client.
19. However, it is also possible for an auditor to set the target assurance at too high a level, whether due to a misunderstanding of the demands of the stakeholders or an incentive to bill for extra work that may not really be necessary. While such behavior may actually increase audit quality, the excess effort may not be *pareto efficient* for the client or the market as a whole.

Proposition 7: The primary causes of an execution failure are misdiagnosis and inappropriate treatment of risk.

20. In general, execution failure would arise if (1) the auditor does not accurately “diagnose” the risk of the audit or (2) the audit program used to guide audit testing does not effectively “treat” the risk.
21. If an auditor overlooks a risk, misjudges the significance of a risk, or fails to plan adequate tests to compensate for a risk, the resulting audit work will be ineffective and/or inadequate. Even in the case where the auditor accurately assesses the riskiness of a client, errors can still occur. An auditor may use weak audit procedures, assign tests to personnel without adequate expertise or experience to carry them out, misinterpret audit evidence, or fail to properly act on indications of accounting problems signaled by the evidence.
22. However, it is also interesting to note that this is where most discussions of audit quality start, thus overlooking a number of critical aspects of audit quality previously mentioned.

Proposition 8: The quality of auditing is inherent in the nature and execution of the activities that diagnose and treat risk in the audit process.

23. The final proposition integrates the essence of all the other propositions. Given that the audit is a professional service with uncertain outcomes, executed by individuals in response to idiosyncratic client conditions, the *ex post* state cannot define the quality of the audit. Rather, the quality of the audit is inherent in the process used to conduct the audit. In essence, the quality of the audit process determines the quality of the audit.
24. There are important implications for audit practice. If process quality is essentially audit quality, then professional efforts to regulate and improve the audit process can be considered helpful for improving audit quality. Thus, educational requirements, staff training, auditing standards, and peer review or inspections that focus on the audit process can all be beneficial. However, it is also important to keep in mind that audits are idiosyncratic. This suggests that the same audit process is not necessarily effective or appropriate for all clients. In auditing, “one size does NOT fit all”. Consequently, if education, training, standards and inspection are primarily aimed at increasing the *standardization* of the audit, they may not lead to an improvement in audit quality.

25. Ultimately, judgment and flexibility may be more important for achieving high quality audits. However, utilizing judgment and flexibility also opens individual auditors to second-guessing and potential sanctions, especially when things go wrong. At the same time, excessive standardization may not do much to reduce the risk of audit failure because it ignores the idiosyncratic nature of the audit. This may not be visible in the vast majority of cases because very few audits will exhibit any observable signs of failure. However, this pattern creates the irony of audit quality: the quality of audit processes determines the quality of the audit but systematic efforts to make audit processes more standardized may have the effect of reducing the quality of audit outcomes.

Appendix 4

The UK FRC's Audit Quality Framework

26. The following lists the drivers and indicators that constitute the UK FRC's Audit Quality Framework.

Driver	Indicators
The culture within an audit firm	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> • Creates an environment where achieving high quality is valued, invested in and rewarded. • Emphasizes the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors. • Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise. • Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality. • Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgment. • Ensures robust systems for client acceptance and continuation. • Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing. • Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.
The skills and personal qualities of audit partners and staff	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards. • Partners and staff exhibit professional skepticism in their work and are robust in dealing with issues identified during the audit.

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Driver	Indicators
	<ul style="list-style-type: none"> • Staff performing detailed ‘on-site’ audit work have sufficient experience and are appropriately supervised by partners and managers. • Partners and managers provide junior staff with appropriate ‘mentoring’ and ‘on the job’ training. • Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.
The effectiveness of the audit process	<p>An audit process is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> ◦ Encourage partners and managers to be actively involved in audit planning. ◦ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently. ◦ Require appropriate audit documentation. ◦ Provide for compliance with auditing standards without inhibiting the exercise of judgment. ◦ Ensure there is effective review of audit work. ◦ Audit quality control procedures are effective, understood and applied. • High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with. • The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor. • The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.
The reliability and usefulness of audit reporting	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Audit reports are written in a manner that conveys clearly and unambiguously the auditor’s opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations.

Driver	Indicators
	<ul style="list-style-type: none"> • Auditors properly conclude as to the truth and fairness of the financial statements. • Communications with the audit committee include discussions about: <ul style="list-style-type: none"> ◦ The scope of the audit. ◦ The threats to auditor objectivity. ◦ The key risks identified and judgments made in reaching the audit opinion. ◦ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.
Factors outside the control of auditors	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none"> • An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process. • Audit committees that are active, professional and robust in dealing with issues identified during the audit. • Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements. • Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period. • Appropriate agreed arrangements for any limitation of liability. • An audit regulatory environment that focuses on the drivers of audit quality.