

**DRAFT**

**AUDIT QUALITY: AN INTERNATIONAL FRAMEWORK**

**Version 1 – August 2012**

**Note**

This paper sets out an Audit Quality Framework (“Framework”) developed by a Task Force of the IAASB.

A previous version dated August 2011 (the CAG Draft) was discussed with a number of stakeholder groups. This draft responds to the many helpful suggestions as to how the Framework could be improved. Changes include the following:

Introductory material has been added describing the nature of an audit.

The material has been reorganized so that the sections on the inputs, process and outputs are addressed before those on context and key stakeholder interactions.

Within the inputs, process and outputs sections, the key attributes are separated into engagement, audit firm and national levels.

While the IAASB has discussed elements of the Framework, it has not concluded its deliberations. The current plan is that the IAASB will discuss the Framework at its September and December 2012 meetings and will consult publicly on the Framework during 2013.

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*Key Terms Used in This Paper in the Public Sector Context*

In the public sector environment, the terms “client,” “engagement,” “engagement partner,” and “firm” should, where relevant, be read as referring to their public sector equivalents as defined in International Standard of Supreme Audit Institutions (ISSAI) 40, *Quality Control for Supreme Audit Institutions*, Section 7.

## Foreword from the IAASB Chairman

1. Recent financial crises have highlighted the critical importance of credible, high-quality financial reporting in all sectors of the world economy, including the capital markets, small companies, not-for-profit and government organizations. They have also reinforced the need, in the public interest, for high audit quality.
2. The term “audit quality” is frequently used in debates amongst stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting. However, audit quality is a complex subject and there is no definition or analysis of it that has achieved universal recognition.
3. In the IAASB’s view, a high quality audit has been achieved when the auditor’s opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that:
  - Exhibited appropriate values, ethics and attitudes;
  - Was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work;
  - Applied a rigorous audit process and quality control procedures;
  - Provided valuable and timely reports; and
  - Interacted appropriately with a variety of different stakeholders.
4. Many factors contribute to maximizing the likelihood of high quality audits being consistently performed. The IAASB believes there is value in describing these factors and thereby encouraging audit firms and other stakeholders to challenge themselves about whether there is more that they can do to increase audit quality in their particular environments.
5. For this reason, the IAASB has undertaken a project to develop an Audit Quality Framework (“Framework”) that describes the input and output factors at the engagement, audit firm and national levels. The Framework also demonstrates the importance of appropriate interactions between stakeholders and the importance of various contextual factors.
6. This Consultation Paper sets out the proposed Framework, which is summarized in Section 2, and invites comments from stakeholders on whether it is clear, comprehensive and useful.
7. While the primary responsibility for performing high quality audits rests with auditors, audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain.<sup>1</sup> While developing the proposed Framework, the IAASB has identified a number of areas for consideration by both auditors and other participants in the financial reporting supply chain that may benefit audit quality on a global basis, including:
  - Establishing a common understanding of competence as it relates to audit quality for use by audit firms when evaluating, promoting and remunerating partners and staff.
  - Improving information sharing between audit firms when one firm decides not to accept an audit appointment.

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<sup>1</sup> See paragraph 164 for a description of the financial reporting supply chain.

- Encouraging more self-examination by audit firms and the wider audit profession in order to learn from audit deficiencies and address systemic issues.
- Increasing the information value of audit reports.
- Achieving improved two-way communication between auditors and regulators, particularly in the financial services sector.
- Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit.
- Encouraging audit committees to provide more information to users of the financial statements of the work they have undertaken and the reasons for their conclusions.

The IAASB welcomes views on whether international collaboration in these areas would be fruitful and whether there are other areas that need to be explored internationally to improve audit quality.

## 1. Introduction

### 1.1 Nature of an Audit

1. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by auditors gathering sufficient appropriate audit evidence in order to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>2</sup> Usually, that opinion is on whether the financial statements “present fairly, in all material respects” or give “a true and fair view” of the entity’s financial position as at the period end and of its results and cash flows for the period.
2. While national laws and accounting standards provide criteria for “fair presentation,” many aspects of the financial reporting process, and therefore the audit of the financial statements, involve judgment.
3. Auditing standards provide an important foundation supporting audit quality. In particular, the International Standards on Auditing (ISAs) issued by the IAASB describe the auditor’s objectives and establish minimum requirements. However, the majority of the requirements in ISAs either provide a framework for the judgments made in an audit, or need judgment for them to be properly applied.
4. Audit is therefore a discipline that relies on competent individuals using their experience and applying integrity, objectivity, and skepticism to enable them to make reliable judgments that are supported by the facts and circumstances of the engagement. The qualities of perseverance and robustness are also important in ensuring that necessary changes are made to the financial statements in the face of persuasive and, possibly, intimidating client management, or, where such changes are not made, to ensure that the auditor’s report is appropriately qualified.

### 1.2 The Challenges of Defining Audit Quality

5. In addition to the judgmental nature of aspects of the underlying financial statements, there are a number of factors that make it challenging to describe and evaluate the quality of an audit. These include:
  - The existence, or lack, of material misstatements in the audited financial statements provides only a partial insight into audit quality.
  - Entities, and audits of them, vary and, to a degree, what is considered to be sufficient appropriate audit evidence to support an audit opinion is judgmental.
  - Perspectives of audit quality vary amongst stakeholders.
  - There is limited transparency about the work performed on an audit and its findings.

#### *The Existence, or Lack, of Material Misstatements in the Audited Financial Statements is an Imprecise Measure of Audit Quality*

6. Given the objective of an audit, the existence of material misstatements in the financial statements that were not detected by the audit is likely to be an indicator of a poor quality audit.

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<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 3

7. However, the absence of material misstatements in the financial statements cannot, of itself, be the only measure of audit quality because management may have prepared the financial statements such that there were no material misstatements to detect but the audit performed was flawed and would not have detected material misstatements if they had existed.
8. Even the existence of an undetected material misstatement in the audited financial statements may not necessarily indicate a poor quality audit as audits are designed to provide reasonable,<sup>3</sup> not absolute, assurance that the financial statements do not contain material misstatements. The difference between absolute and reasonable assurance is especially relevant when misstatements result from frauds that have been concealed through forgery, collusion and intentional misrepresentations.<sup>4</sup>
9. The difference between an audit process designed to provide absolute assurance and one designed to provide reasonable assurance means that there is a risk of undetected material misstatement in a small proportion of audits. If material misstatements are subsequently identified that were not detected by the audit, it can be difficult to determine whether they arise as result of the overall audit model or failings in the quality of the individual audit concerned.
10. The concepts of “sufficient appropriate audit evidence” and “reasonable assurance” are closely related. Neither can be defined with precision but need to be considered in the context of applicable standards and established practice.

*Audits Vary and What is Considered to be Sufficient Appropriate Audit Evidence is, to a Degree, Judgmental*

11. No two entities are exactly the same and therefore the audit work and judgments required will rightly vary. What is considered to be “sufficient appropriate evidence” is therefore, to a degree, a matter for judgment, reflecting the nature and complexity of the entity as well as the auditor’s assessment of the risks that the financial statements prepared by management could be materially misstated.
12. Audit firms are usually profit-making entities and the profitability of an audit firm is usually linked to the relationship between the audit fees charged<sup>5</sup> and the cost involved in gathering sufficient appropriate audit evidence. This can lead to perceptions on the part of third parties that, notwithstanding the application of auditing standards and ethical requirements, audit firms may have a short term incentive to limit the work performed while recognizing that in the longer term,

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<sup>3</sup> ISA 200, paragraph A45, states the following: “The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.”

<sup>4</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 6–8, contain a discussion of the relationship between fraud and reasonable assurance.

<sup>5</sup> While the audit fee charged is often a reflection of the skills and experience of the audit engagement team and the time that they spend on the audit, there may be other factors affecting the actual audit fee charged including competitive forces, the audit firm’s cost base, and the number of years that the firm expects to undertake the audit.

sustained audit quality is needed to protect the audit firm's reputation and to avoid damaging regulatory or legal actions. Also, in the public sector, while public sector audit bodies are not profit-making entities, budget constraints may provide them with an incentive to limit the amount of work performed.

#### *Perspectives of Audit Quality Vary amongst Stakeholders*

13. Different stakeholders are likely to have different perspectives about the nature of audit quality. For example, users of the financial statements may see audit quality as maximizing the amount of audit evidence obtained and the challenge provided to management. Considering audit quality solely from this perspective would suggest that the more resources (both in quantitative and qualitative terms) are allocated to an audit, the higher its quality would be.
14. Management may have an interest in ensuring that the cost of the audit is constrained, the audit is completed as quickly as possible and that the disruption to the entity's ongoing operations is minimized. Considering audit quality from this perspective may suggest that the resources allocated to an audit should be minimized.
15. Balancing these different views suggests that a quality audit involves an effective audit being performed efficiently and on a timely basis and for a reasonable fee. There is, however, subjectivity around the words "effective," "efficiently," "timely," and "reasonable." Those charged with governance, including audit committees, are often well placed to consider these matters. For this reason, in many countries audit committees have responsibilities for considering audit quality and approving, or recommending for approval, audit fees.

#### *Limited Transparency of Audit Work Performed and Audit Findings*

16. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly. However, many stakeholders, especially the shareholders of listed companies, do not usually have detailed insights into the work performed in the audit and the issues that were identified and addressed. They therefore cannot directly evaluate audit quality.
17. While the IAASB hopes that it will be possible to provide additional information in audit reports which may provide stakeholders with additional insights into audit quality, it recognizes that such additional information will inevitably be only a relatively small portion of the total information known by the auditor and which may be relevant to a full appreciation of audit quality.

#### **1.3 A Framework for Achieving Consistently High Audit Quality**

18. Auditors are responsible for the quality of individual audits. A high quality audit has been achieved when the auditor's opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that:
  - Exhibited appropriate values, ethics and attitudes;
  - Was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work;
  - Applied a rigorous audit process and quality control procedures;
  - Provided valuable and timely reports; and
  - Interacted appropriately with a variety of different stakeholders.

19. Many factors contribute to maximizing the likelihood of high quality audits being consistently performed, including the actions and attitudes of audit firms, public sector audit bodies, regulators and other participants in the financial reporting supply chain, and the characteristics of the environment in which the audits are performed. The IAASB believes there is value in describing these factors and thereby encouraging audit firms and other stakeholders to challenge themselves about whether there is more that they can do to increase audit quality in their particular environments.
20. For this reason, the IAASB has developed an Audit Quality Framework that describes the inputs and outputs to audit quality at the engagement, audit firm and national levels. The Framework also demonstrates the importance of appropriate interactions between stakeholders and the importance of various contextual factors.
21. The IAASB believes that such an Audit Quality framework will be in the public interest as it will:
  - Encourage audit firms and professional bodies to reflect on how to improve audit quality and better communicate information about audit quality;
  - Raise the level of awareness and understanding amongst stakeholders of the important elements of audit quality;
  - Enable stakeholders to recognize those factors that may deserve priority attention to enhance audit quality. For example, a framework could be used to inform those charged with governance about audit quality and help audit committees to ask themselves appropriate questions about it;
  - Assist standard setting. For example, it could facilitate the IAASB's consideration of whether there are areas in the ISAs and ISQC 1<sup>6</sup> that may require attention. It may also assist the International Ethics Standards Board for Accountants (IESBA) and International Accounting Education Standards Board (IAESB) in considering improvements to their authoritative pronouncements;
  - Facilitate dialogue and closer working relationships between the IAASB and key stakeholders as well as amongst these key stakeholders themselves; and
  - Stimulate academic research on the topic and assist students of auditing to more fully understand the fundamentals of the profession they are aspiring to join.
22. While the quality of an individual audit will be influenced by the inputs, outputs and interactions described in this Framework, the Audit Quality Framework, by itself, will not be sufficient for the purpose of evaluating the quality of an individual audit. This is because detailed consideration will need to be given to matters such as the nature and extent of audit evidence obtained in response to the risks of material misstatement in a particular entity, the appropriateness of the relevant audit judgments made and compliance with relevant standards.

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<sup>6</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

## 2. Audit Quality Framework

23. The Framework described in this paper sets out the key attributes that are conducive to high audit quality, reflecting the different perspectives of stakeholders.
24. The Framework applies to audits of all entities and all audit firms regardless of size. It also applies to both private sector and public sector audits although, due to their societal role and constitutional mandate, public sector audit bodies may give specific emphasis to certain factors. Different aspects of the Framework may also impact group audits and smaller audits and small and medium practices (SMPs), and Section 7 of the Framework provides additional commentary.
25. The Framework distinguishes the following elements:



### *Inputs*

26. Inputs are grouped into the following categories:
  - (a) The values, ethics and attitudes of individual auditors which, in turn, are influenced by the culture prevailing within the audit firm;
  - (b) The knowledge and experience of auditors and the time allocated for them to perform the audit; and
  - (c) The effectiveness of the audit process and quality control procedures.
27. Within these categories, quality attributes are further organized between those that apply directly at:
  - (a) The audit engagement level;
  - (b) The level of an audit firm, and therefore indirectly to all audits undertaken by that audit firm; and

(c) The national (or jurisdictional) level and therefore indirectly to all audit firms operating in that country and the audits they undertake.

28. The inputs to audit quality will be influenced by the context in which an audit is performed, the interactions with key stakeholders and the outputs. For example, law and regulations (context) may require specific reports (output) that influence the skills (input) utilized.

*Outputs*

29. Outputs from the audit are often determined by the context, including legislative requirements. While some stakeholders can influence the nature of the outputs, others have less influence. Indeed, for some stakeholders, such as investors in listed companies, the auditor’s report is the primary output and this is relatively standardized.

*Interactions amongst Key Stakeholders*

30. While each separate stakeholder in the financial reporting supply chain plays an important role in supporting high quality financial reporting, the way in which the stakeholders interact can have a particular impact on audit quality. These interactions, including both formal and informal communications, will be influenced by the context in which the audit is performed and allow a dynamic relationship to exist between inputs and outputs. For example, discussions between the auditor and those charged with governance at the planning stage can influence the use of specialist skills (input) and the form and content of the auditor’s report to those charged with governance (output).

*Context*

31. There are a number of contextual factors that can facilitate financial reporting quality, including corporate governance requirements and the applicable financial reporting framework. The contextual factors, including legislative and regulatory requirements, also shape the interactions amongst key stakeholders. These factors can also impact audit risk, the nature and extent of audit evidence required and the efficiency of the audit process.

**Summary of Attributes**

32. The IAASB’s Framework contains the following attributes.

Framework Element	Attributes
<p><b>INPUTS</b> – Values, Ethics, Attitudes</p>	<p><b>Engagement Level</b></p> <ol style="list-style-type: none"> <li>1. The engagement team recognizes that the audit is performed in the wider public interest.</li> <li>2. The engagement team exhibits professional skepticism.</li> <li>3. The engagement team exhibits objectivity and integrity.</li> <li>4. The engagement team exhibits professional competence and due care.</li> <li>5. The engagement team is independent.</li> </ol> <p><b>Firm Level</b></p> <ol style="list-style-type: none"> <li>1. Governance arrangements are in place that establish the appropriate</li> </ol>

Framework Element	Attributes
	<p>“tone at the top.”</p> <ol style="list-style-type: none"> <li>2. The firm promotes the personal characteristics essential to audit quality.</li> <li>3. Financial considerations do not drive actions and decisions that may have a negative effect on audit quality.</li> <li>4. The firm provides partners and staff access to high quality technical support.</li> <li>5. The firm promotes a culture of consultation on difficult issues.</li> <li>6. Robust systems exist for making client acceptance and continuance decisions.</li> </ol> <p><b>National Level</b></p> <ol style="list-style-type: none"> <li>1. Ethical requirements are promulgated which make clear both the underlying ethical principles and the specific requirements that apply.</li> <li>2. Professional bodies are active in ensuring that the ethical principles are understood and the requirements are consistently applied.</li> <li>3. Information relevant to client acceptance decisions is shared between audit firms.</li> </ol>
<p><b>INPUTS</b> – Knowledge, Experience and Time</p>	<p><b>Engagement Level</b></p> <ol style="list-style-type: none"> <li>1. Partners and staff have the necessary competencies.</li> <li>2. Partners and staff understand the entity’s business.</li> <li>3. Partners and staff make reliable professional judgments.</li> <li>4. The audit engagement partner is actively involved in risk assessment, planning and supervising the work performed.</li> <li>5. Staff performing detailed “on-site” work have sufficient experience, their work is appropriately directed, supervised and reviewed, and there is a reasonable degree of staff continuity.</li> <li>6. Partners and staff have sufficient time to undertake the audit in an effective manner.</li> <li>7. The audit engagement partner and other experienced members of the audit team are accessible to management and the audit committee.</li> </ol> <p><b>Firm Level</b></p> <ol style="list-style-type: none"> <li>1. Partners and staff have sufficient time and resources to deal with difficult issues as they arise.</li> <li>2. Engagement teams are properly structured and have sufficient time.</li> <li>3. Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.</li> <li>4. Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.</li> </ol>

Framework Element	Attributes
	<p><b>National Level</b></p> <ol style="list-style-type: none"> <li>1. Robust arrangements exist for licensing audit firms/individual auditors.</li> <li>2. Educational requirements for auditors are clearly defined and robust.</li> <li>3. Arrangements exist for briefing auditors on current issues and for training them in new accounting, auditing or regulatory requirements.</li> <li>4. The auditing profession is well positioned to attract and retain high quality individuals.</li> </ol>
<p><b>INPUTS – Audit Process and Quality Control Procedures</b></p>	<p><b>Engagement Level</b></p> <ol style="list-style-type: none"> <li>1. The engagement team complies with auditing standards and the firm's quality control procedures.</li> <li>2. The engagement team makes proper use of information technology.</li> <li>3. There is effective interaction with others involved in the audit including, where applicable, internal auditors.</li> <li>4. There is engagement with management so as to achieve audit efficiency.</li> <li>5. There is appropriate audit documentation.</li> </ol> <p><b>Firm Level</b></p> <ol style="list-style-type: none"> <li>1. The audit process is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.</li> <li>2. The audit methodology encourages individual team members to think creatively, apply professional skepticism and exercise appropriate professional judgment.</li> <li>3. The methodology requires effective supervision and review of audit work.</li> <li>4. The methodology requires appropriate documentation.</li> <li>5. Audit quality is monitored and appropriate consequential action is taken.</li> <li>6. Where required, effective engagement quality control reviews are undertaken.</li> </ol> <p><b>National Level</b></p> <ol style="list-style-type: none"> <li>1. Auditing standards are promulgated which make clear both the underlying objectives as well as the specific requirements that apply.</li> <li>2. Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.</li> <li>3. Effective systems exist for investigating allegations of poor audit quality and taking disciplinary action when appropriate.</li> </ol>
<p><b>OUTPUTS</b></p>	<p><b>From the Auditors</b></p> <ul style="list-style-type: none"> <li>• The auditor's report on the financial statements and such other matters required by law and regulations</li> </ul>

Framework Element	Attributes
	<ul style="list-style-type: none"> <li>• Reports from the auditor to those charged with governance</li> <li>• Reports from the auditor to management</li> <li>• Reports from the auditor to regulators</li> <li>• Transparency reports</li> <li>• Annual reports</li> </ul> <p><b>From the Entity</b></p> <ul style="list-style-type: none"> <li>• The audited financial statements</li> <li>• Reports from audit committees</li> </ul> <p><b>From Audit Regulators</b></p> <ul style="list-style-type: none"> <li>• Reports on the results of inspections of individual audits</li> </ul>
<b>INTERACTIONS</b>	<p><b>Effective Interactions Between:</b></p> <p><b>Auditors</b> and management, audit committees, users, regulators</p> <p><b>Management</b> and audit committees, regulators, users</p> <p><b>Audit committees</b> and regulators, users</p> <p><b>Regulators</b> and users</p>
<b>CONTEXTUAL FACTORS</b>	<ul style="list-style-type: none"> <li>• Business practices and commercial law</li> <li>• Laws and regulations relating to financial reporting</li> <li>• The applicable financial reporting framework</li> <li>• Corporate governance</li> <li>• Information systems</li> <li>• Financial reporting timetable</li> <li>• Broader cultural factors</li> </ul>



### 3. Input Factors

33. High quality audits involve auditors:

- Exhibiting appropriate values, ethics and attitudes;
- Being sufficiently knowledgeable and experienced and having adequate time allocated to them to undertake their work; and
- Applying a rigorous audit process and quality control procedures.

34. Key attributes that foster audit quality are described below. These attributes apply at the audit engagement level, at the audit firm level, and at a national (or jurisdictional)<sup>7</sup> level.

#### 3.1 Values, Ethics and Attitudes – Engagement Level

35. The audit engagement partner is responsible for an audit engagement and therefore directly responsible for audit quality. As well as taking responsibility for the performance of the audit, the audit engagement partner has an important role in ensuring that the engagement team exhibits the values, ethics and attitudes necessary to support a quality audit. Key attributes are:

- The engagement team recognizes that the audit is performed in the wider public interest.
- The engagement team exhibits professional skepticism.
- The engagement team exhibits objectivity and integrity.
- The engagement team exhibits professional competence and due care.
- The engagement team is independent.

#### *The Engagement Team Recognizes that the Audit is Performed in the Wider Public Interest*

36. The audit team needs to be committed to performing the audit in the interests of the entity's stakeholders and in the wider public interest. While it will usually be necessary for the auditor to work closely with management in the course of the audit, the audit team needs to provide an appropriate degree of challenge to management and make objective judgments.

#### *The Engagement Team Exhibits Professional Skepticism*

37. Professional skepticism is the application of a questioning mindset in the context of an appropriate understanding of the entity, its business and the environment in which it operates. This understanding, together with more general business knowledge and experience, allows the auditor to assess the risks of material misstatement in an entity's financial statements, assess the adequacy of audit evidence, and reach appropriate conclusions.

38. Professional skepticism is an important aspect of auditor judgment related to planning, performing and evaluating the results of an audit. Unless auditors are prepared to challenge management's assertions, they will not act as a deterrent to fraud nor be able to conclude, with confidence, that an entity's financial statements are fairly presented.

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<sup>7</sup> A jurisdiction can be larger or smaller than a country. In some areas of the world some aspects of audit regulation span a number of countries. In some countries aspects of audit regulation are undertaken by smaller units such as states or provinces.



39. Professional skepticism involves all members of the engagement team:
- Having a questioning mind and a willingness to challenge management assertions;
  - Assessing critically the information and explanations obtained in the course of their work;
  - Seeking to understand management motivations for possible misstatement of the financial statements;
  - Keeping an open mind until appropriate audit evidence has been obtained;
  - Having the confidence to challenge management and the persistence to follow things through to a conclusion; and
  - Being alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.

*The Engagement Team Exhibits Objectivity and Integrity*

40. The principle of objectivity imposes an obligation on auditors not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.<sup>8</sup>
41. The need for auditors, in particular, to be objective arises from the fact that many of the important issues involved in the preparation of financial statements involve judgment. For example, many items included in the financial statements cannot be measured with absolute certainty and estimates have to be made. Auditors need to be objective when they evaluate management judgments to reduce the risk that the financial statements are materially misstated through management, whether deliberately or inadvertently, making a biased judgment or following an otherwise inappropriate accounting practice.
42. Integrity is a prerequisite for all those who act in the public interest. It is essential that the engagement team acts, and is seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candor, courage and intellectual honesty.

*The Engagement Team Exhibits Professional Competence and Due Care*

43. Professional competence and due care involves all members of the engagement team:
- Maintaining professional knowledge and skill at an appropriate level;
  - Acting carefully, thoroughly and on a timely basis; and
  - Acting diligently in accordance with applicable technical and professional standards.

*The Engagement Team is Independent*

44. Independence is required to avoid individual members of the engagement team or the audit firm from being affected by influences that compromise professional judgment, thereby allowing them to act with integrity and exercise objectivity and professional skepticism (independence of mind). It is also required to avoid facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised (independence in appearance).

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<sup>8</sup> IESBA *Code of Ethics for Professional Accountants* (IESBA Code), paragraph 120.1



45. Issues impacting auditor independence include:
- Financial interests existing between the auditor and the audited entity. Holding a financial interest in an audit client may create a self-interest threat.
  - Business relationships between the auditor and the audited entity. A close business relationship between the audit firm, or a member of the engagement team or an immediate family member, and the entity may create self-interest or intimidation threats.
  - Provision of non-audit services to audit clients. Audit firms have traditionally provided to their audit clients a range of non-audit services that are consistent with their skills and expertise. Providing non-audit services may, however, create threats to independence. The threats created are most often self-review, self-interest and advocacy threats.
  - Partners and staff believe that their remuneration and, indeed, their ongoing careers with the audit firm are dependent on retaining an audit client and maintaining good client relationships.
46. Another issue relates to the possible familiarity threat created by using the same senior personnel on an audit engagement over a long period of time. From a management perspective, however, accumulated prior knowledge of the entity and its business is likely to be thought to be conducive to audit quality as it is likely to lead to efficiency and the most insightful recommendations for improvement in particular areas of an entity's business operations.
47. In this area, threats to auditor independence need to be balanced with the potential benefits to audit quality that arise from the senior personnel's detailed knowledge of the entity and its business resulting from involvement in the audit over a number of years. To address this threat, the IESBA Code requires audit engagement partners of public interest entities to change (or "rotate") after seven years; ethical or legal requirements in some countries mandate a shorter rotation period. Some believe that in addition to the rotation of audit engagement partners, the audit firm itself should be periodically changed.

### 3.2 Values, Ethics and Attitudes – Firm Level

48. The audit firm's culture has an important influence on the values, ethics and attitudes of audit partners and other members of the engagement team because the environment in which the engagement team works can materially affect the mindset of partners and staff, and consequently the way they discharge their responsibilities. While the audit is designed to protect the public interest, audit firms are usually commercial entities. Each firm's culture will be an important factor in determining the extent to which its partners and staff function in the public interest as opposed to merely achieving the firm's commercial goals.
49. Key attributes in relation to creating a culture where audit quality is valued are:
- Governance arrangements are in place that establish the appropriate "tone at the top."
  - The firm promotes the personal characteristics essential to audit quality.
  - Financial considerations do not drive actions and decisions that may have a negative effect on audit quality.
  - The firm provides partners and staff access to high quality technical support.
  - The firm promotes a culture of consultation on difficult issues.
  - Robust systems exist for making client acceptance and continuance decisions.



*Governance Arrangements Are in Place that Establish the Appropriate “Tone at the Top”*

50. The firm’s leadership has a vital role in avoiding situations that might compromise the firm’s objectivity or independence. Creating an appropriate environment within the audit firm includes encouraging adherence to the principles underlying ethical requirements that apply to auditors.
51. It is also important that an audit firm has effective internal governance arrangements to safeguard the public interest nature of the audit function and to avoid the firm’s commercial interests adversely affecting audit quality, for example, by promoting other practice areas (such as tax, corporate finance and consultancy) to the detriment of audit quality.

*The Firm Promotes the Personal Characteristics Essential to Audit Quality*

52. Appropriate personal characteristics, including integrity, objectivity, professional competence and due care, need to be nurtured and developed by the firm. This involves embedding them in recruitment and training programs. It is also important that partners and staff are periodically appraised on the basis of audit quality using appropriate competency frameworks and that conclusions are used to support promotion and remuneration decisions.

**Area to explore**

**Establishing a common understanding of competence as it relates to audit quality for use by audit firms when evaluating, promoting and remunerating partners and staff.**

Audit firms often use competency frameworks but the extent to which these address audit quality, and the manner in which this is done, vary. There may be benefit in standardizing elements of audit firm competency frameworks, perhaps using the competencies that have been developed by the IAESB (see also paragraph 99).

Further consideration of competencies will also give audit firms the opportunity to consider whether their current approach to staff recruitment and training is providing the appropriate resources for the performance of high quality audits.

53. Audit firms also need to ensure that audit partners and staff are not penalized for jeopardizing a client relationship by taking a robust position on audit issues.

*Financial Considerations Do Not Drive Actions and Decisions that May Have a Negative Effect on Audit Quality*

54. Financial considerations both at the firm level (such as the financial target that a firm sets for the profit margin to be achieved on audit work and the willingness to invest in training and support systems for audit) and at the engagement level (such as the relationship between the audit fee and the underlying cost of the work performed) should not be allowed to prevent the performance of a robust audit that meets the public interest.
55. There should also not be:
  - Emphasis on winning audit appointments and on the retention of audit clients at the expense of audit quality.
  - Emphasis on marketing non-audit services to entities that the firm audits at the expense of undertaking a high quality audit in the public interest.



- Cost cutting (including by reducing partners and staff) in the audit practice (for example, during times of economic downturn) that damage the provision of audit quality.

*The Firm Provides Partners and Staff Access to High Quality Technical Support*

56. Auditing requires knowledge of a considerable number of technical areas including company and tax law, and financial reporting, auditing and ethical standards. It is important that audit firms have technical support arrangements to help individual partners and staff keep up to date with developments in these areas and to provide assistance on complex areas.
57. In larger audit firms, audit quality can also be enhanced if an information infrastructure is developed that enables the firm to support audit judgments (for example, by assembling business and industry-related databases), to track and appropriately address independence issues, and to plan and effectively manage the rotation of partners on audit engagements.

*The Firm Promotes a Culture of Consultation on Difficult Issues*

58. Auditing often requires difficult decisions and judgments to be made. Staff will discuss these issues within the audit team and with the audit engagement partner. Audit engagement partners will often wish to discuss difficult decisions and judgments with other partners or with technical specialists. This process will be facilitated if there is a culture of consultation and where those involved have sufficient time available to deal properly with issues as they arise.
59. A culture of consultation is also important for sole practitioners, and they may use external technical resources available to them, whether through their professional bodies, their relationships with other firms, or suitably resourced third-party organizations.

*Robust Systems Exist for Making Client Acceptance and Continuance Decisions*

60. Prior to accepting an audit engagement, and annually thereafter, it is important that audit firms consider whether they are competent to perform the engagement and have the capabilities and resources to do so. This includes whether the firm can comply with relevant ethical requirements.
61. While auditors need to be skeptical, if an audit is to be undertaken cost effectively, it also involves a degree of trust. Management lacking in integrity, by definition, cannot be trusted. Good client acceptance and continuance systems therefore also evaluate whether there is information to suggest that client management lack integrity to the extent that it will not be possible to perform a high quality audit. Having a rigorous client acceptance and continuance system is therefore important in helping an audit firm avoid engagements where there is a high chance of fraud or illegal acts, and thereby maintain a reputation for providing high quality audits.

**3.3 Values, Ethics and Attitudes – National Level**

62. National audit regulatory activities have an important influence on the culture within firms and the values, ethics and attitudes of audit partners and other members of the engagement team. Key attributes are:
  - Ethical requirements are promulgated which make clear both the underlying ethical principles and the specific requirements that apply;
  - Professional bodies are active in ensuring that the ethical principles are understood and the requirements are consistently applied; and



- Information relevant to client acceptance decisions is shared between audit firms.

*Ethical Requirements are Promulgated which Make Clear Both the Underlying Ethical Principles and the Specific Requirements that Apply*

63. Ethical requirements may be imposed by law or regulations or mandated through the national professional body. IFAC requires its member bodies to use their best endeavors to implement the IESBA *Code of Ethics for Professional Accountants* (IESBA Code) when and to the extent possible under local circumstances.<sup>9</sup> In some countries, the IESBA Code is supplemented by additional national requirements, and audit firms and public sector audit bodies may choose to impose higher requirements on their partners and staff.
64. Ethical requirements cannot address all possible situations. Therefore, auditors need to understand both the requirements and the fundamental principles underlying them and understand how to apply them in practice. An understanding of how to apply the principles can be developed through internal communications within the audit firm, through coaching or on-the-job training, and through staff observing more experienced staff in action.
65. The IESBA Code establishes, and requires auditors to comply with, the following fundamental principles of professional ethics:<sup>10</sup>
- Integrity – to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.<sup>11</sup>
  - Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
  - Professional competence and due care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques, and act diligently and in accordance with applicable technical and professional standards.
  - Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
  - Professional behavior – to comply with relevant laws and regulations, and avoid any action that discredits the profession.

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<sup>9</sup> In December 2011, IFAC issued an exposure draft of a proposed revised Statement of Membership Obligations (SMO) 4, *IESBA Code of Ethics for Professional Accountants*. Under the proposals, IFAC member bodies will be required to identify and undertake actions to have the IESBA Code adopted and implemented in their jurisdictions in accordance with the SMO's proposed applicability framework. This framework specifies the requirements with which the member bodies should comply (i.e., a requirement to implement all the requirements of the SMO or to use best endeavors to do so) depending on whether the member bodies have direct responsibility for the area covered by the SMO, no responsibility for such area, or a shared responsibility with government, regulators, or other appointed authorities.

<sup>10</sup> IESBA Code, paragraph 100.5

<sup>11</sup> IESBA Code, Section 110



66. In addition, the IESBA Code contains additional requirements for auditor independence and describes the approach auditors should take, including:
- Identifying threats to independence;
  - Evaluating the significance of the threats identified; and
  - Applying safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
67. The IESBA Code states that when auditors determine that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.<sup>12</sup>

*Professional Bodies are Active in Ensuring that the Ethical Principles are Understood and the Requirements are Consistently Applied*

68. Consistent application of ethical requirements, and the principles that underlie them, is facilitated by training and support activities performed by professional bodies and others. This can include the issuance of guidance material such as answers to frequently asked questions as well as organizing interactive workshops.

*Information Relevant to Client Acceptance Decisions is Shared between Audit Firms*

69. Individual audit firms will make decisions on whether to accept a new, or continue with an existing, audit client. Firms may choose not to continue with an audit client if they have concerns about financial reporting practices or management integrity. In such circumstances, it is important that other audit firms who are invited to tender for the audit are aware of this information.

**Area to Explore**

**Improving information sharing between audit firms when one firm decides not to accept an audit appointment.**

Information sharing in this area is often informal and is sometimes inhibited by actual, or perceived, legal constraints. Consideration can usefully be given to how this can be improved and thereby reduce the risk of high-risk audits being undertaken by audit firms without the necessary background information and possibly without the requisite skills and experience.

**3.4 Knowledge, Experience and Time – Engagement Level**

70. The audit engagement partner is responsible for being satisfied that the engagement team collectively has the appropriate competence and capabilities and that the team has sufficient time to be able to obtain sufficient appropriate audit evidence before issuing the audit opinion
71. Key attributes are:
- Partners and staff have the necessary competencies.
  - Partners and staff understand the entity's business.

<sup>12</sup> IESBA Code, paragraph 290.7. Public sector audit bodies are, however, not usually able to resign from audit engagements.



- Partners and staff make reliable professional judgments.
- The audit engagement partner is actively involved in risk assessment, planning and supervising the work performed.
- Staff performing detailed “on-site” audit work have sufficient experience, their work is appropriately directed, supervised and reviewed, and there is a reasonable degree of staff continuity.
- Partners and staff have sufficient time to undertake the audit in an effective manner.
- The engagement partner and other experienced members of the audit team are accessible to management and the audit committee.

#### *Partners and Staff Have the Necessary Competencies*

72. The necessary competencies for auditors are described in International Education Standards (IESs) issued by the IAESB. In particular, IES 8 requires that the skills requirement within the education and development program for audit professionals should include developing the following professional skills in an audit environment:<sup>13</sup>
- Applying relevant audit standards and guidance;
  - Evaluating applications of relevant financial reporting standards;
  - Demonstrating capacity for inquiry, abstract logical thought, and critical analysis;
  - Demonstrating professional skepticism;
  - Applying professional judgment; and
  - Withstanding and resolving conflicts.

#### *Partners and Staff Understand the Entity's Business*

73. A sound understanding of the entity, its business and the industry in which it operates is key to the auditor being able to assess the risks of material misstatement in the financial statements to appropriately focus audit procedures and to evaluate the findings from them. It also underlies professional skepticism and the ability to make appropriate audit judgments.
74. Industry knowledge, including an understanding of relevant regulations and accounting issues, can be especially important for clients in, for example, the financial services industry. However, it is important that knowledge areas are not so narrow that they prevent the auditor seeing wider issues. Auditors can acquire general business knowledge from undertaking non-audit work and from exposure to different clients in different industries. This allows them to stand back from the specifics of a particular entity's business and reflect upon their wider knowledge of business issues, risks, and control systems.

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<sup>13</sup> IES 8, *Competence Requirements for Audit Professionals*. An exposure draft of a proposed revised IES 8, *Professional Development for Engagement Partners Responsible for Audits of Financial Statements*, was issued on August 9, 2012. The proposed revised version specifies the learning outcomes that demonstrate the professional competence required of a newly appointed engagement partner in areas relating to technical competence, professional skills, and professional values, ethics and attitudes. It also recognizes the professional development needed to foster and maintain professional competence for those currently serving as engagement partners, especially for those serving on audits involving more complex industries, operations, or reporting requirements.



*Partners and Staff Make Reliable Professional Judgments*

75. Auditing is a discipline that relies on competent individuals using their experience and the values of integrity, objectivity and skepticism to enable them to make reliable professional judgments that are supported by the facts and circumstances of the engagement.
76. Making reliable professional judgments involves partners and staff:
  - Remaining objective;
  - Applying knowledge of business, financial accounting and reporting and information technology;
  - Researching the topic and considering different perspectives;
  - Evaluating alternatives in the light of the relevant facts and circumstances;
  - Considering whether a suitable process was followed in reaching a conclusion and whether sufficient appropriate audit evidence exists to support it;
  - Consulting, as appropriate; and
  - Documenting the conclusion and the rationale for it.

*The Audit Engagement Partner is Actively Involved in Risk Assessment, Planning and Supervising the Work Performed*

77. As engagement partners are responsible for the audits they undertake, it is important that they are directly involved in planning the audit, evaluating the evidence obtained and in reaching final conclusions. Some believe that partners will be encouraged to take an active responsibility for the quality of work performed if they are named in the auditor's report.
78. While much of the detailed audit work may be delegated to less experienced staff, audit engagement partners need to be accessible to them in order to provide timely input as the audit progresses.

*Staff Performing Detailed "On-Site" Audit Work Have Sufficient Experience, Their Work is Appropriately Directed, Supervised and Reviewed, and there is a Reasonable Degree of Staff Continuity*

79. The structure of many audit firms is hierarchical – firms are often described as having a “pyramid structure” – and the make-up of audit teams for individual engagements generally reflects this structure. As a result, much of the detailed “on-site” audit work is likely to be performed by staff who are relatively inexperienced; indeed, many may still be completing an accounting qualification.
80. While not all members of the team can be expected to have the same level of knowledge and experience, it is the responsibility of the audit engagement partner to ensure that collectively the team has the appropriate competence and capabilities. This may entail involving specialists with particular skills such as information technology or on particular financial reporting issues, either from within the audit firm or from external sources. If specialists are involved, it is important, as with other members of the engagement team, that their work is appropriately directed, supervised and reviewed.
81. Involving the same staff members on an audit, one year after another, is likely to assist them in understanding the entity's business and systems. This is likely to result in effective responses to



business risks as well as audit efficiency. However, prolonged involvement can result in a lack of skepticism and threats to auditor independence.

*Partners and Staff Have Sufficient Time to Undertake the Audit in an Effective Manner*

82. Partners and staff often have responsibilities other than the audit of a single entity, and audits can be undertaken to challenging timetables. Planning is important, both at the level of an individual audit and at the level of the audit firm, to ensure that adequate resources are available to gather sufficient appropriate audit evidence and to interact appropriately with management and those charged with governance.
83. Audit firms are usually profit-making entities and the profitability of an audit firm is usually linked to the relationship between the audit fees charged and the cost involved in gathering sufficient appropriate audit evidence. Audit engagement partners are usually accountable within their audit firms for the financial return on the audits they perform and, if audit fees cannot be increased, this can result in reduced testing and threats to audit quality.<sup>14</sup>

*The Engagement Partner and Other Experienced Members of the Audit Team are Accessible to Management and the Audit Committee*

84. It is important that the audit engagement partner is accessible to senior members of management and those charged with governance. Regular contact allows the audit engagement partner to be well briefed on developments in the entity's business as well as raise issues related to the audit on a timely basis.

**3.5 Knowledge, Experience and Time – Firm Level**

85. The audit firm's policies and procedures will impact the required knowledge and experience of audit engagement partners and other members of the engagement team, and the time available for them to undertake the necessary audit work. Key attributes are:
  - Partners and staff have sufficient time and resources to deal with difficult issues as they arise.
  - Engagement teams are properly structured and have sufficient time.
  - Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or "on-the-job" training.
  - Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.

*Partners and Staff Have Sufficient Time and Resources to Deal with Difficult Issues as They Arise*

86. Partners and senior staff usually work on a number of audits often with similar reporting timetables. This can lead to concentrated periods of activity. Partners and senior staff also often undertake other activities for clients or within the firm. It is important that firms anticipate, as best they can, and manage possible time conflicts when allocating responsibilities. Firm management need to proactively monitor work levels to reduce the risk that an unacceptable burden is put on individual partners or staff.

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<sup>14</sup> Ethical requirements (for example, IESBA Code 240.2) often describe this threat and require it to be evaluated and, where appropriate, safeguards applied.



87. Resource allocation also needs to take account of audit risk. A danger exists that the most competent partners and staff will be allocated to the firm's largest, most prestigious, clients and as a result, will not be available to audit other clients where the risks that the financial statements are misstated may be greater.

*Engagement Teams are Properly Structured and Have Sufficient Time*

88. An audit firm needs to allocate its resources so that engagement teams have the expertise and time to undertake particular audits. This involves allocating partners and senior staff who have both an appropriate knowledge of the industry in which the client operates and its applicable financial reporting framework, and sufficient time to be able to perform high quality audits.
89. Allocating resources involves the firm gathering information on:
- Skills and experience;
  - Estimated time commitments; and
  - Periods of service – to facilitate compliance with ethical requirements, for example, in relation to the rotation of audit partners.

*Partners and More Senior Staff Provide Less Experienced Staff with Timely Appraisals and Appropriate Coaching or “On-the-Job” Training*

90. An audit firm's appraisal process is an important aspect of developing an individual's capabilities. Although it is difficult to measure, audit quality is likely to be improved if it is specifically addressed in the appraisals for both partners and staff. In the case of partners, this can be used to promote the exercise of good audit judgment, including consultation on difficult issues.
91. A distinction can usefully be made between providing staff with appraisals and giving coaching and on-the-job training. While appraisals can be used to help identify the absence of an important skill or competence, coaching or on-the-job training can be used to help an individual develop that skill or competency. Coaching and on-the-job training is likely to be especially important in relation to developing key personal characteristics such as integrity, objectivity, rigor, skepticism, and perseverance as well as assisting less experienced staff deal with unfamiliar audit areas.
92. However, the number of people capable of providing coaching is limited. Such people may have other demands on their time, including “special” or non-audit work, or involvement in the internal management of the firm. Being able to coach effectively may also require additional skills, knowledge and experience. It is important that firms provide incentives to their more experienced staff to allocate the necessary time to undertake this important staff development role effectively and, as part of the appraisal process, evaluate them on whether this is achieved.

*Sufficient Training Is Given to Audit Partners and Staff on Audit, Accounting and, Where Appropriate, Specialized Industry Issues*

93. The profession endeavors to equip auditors with the necessary competence through initial professional development (IPD), comprising training in technical and professional skills and values, ethics and attitudes and practical experience, and continuing professional development (CPD) requirements.
94. Firms generally provide training in the technical aspects of audit and in the requirements of their audit methodologies. Firms also provide essential practical experience by including trainees in audit



teams undertaking audit work.<sup>15</sup> Merging learning about the technical aspects of auditing with gaining practical experience is important because formal training is only part, and perhaps only a small part, of the process by which auditors develop skills and experience.

95. Accountancy bodies that are members of IFAC have requirements relating to CPD and the development programs used by the firms have the potential to be an important contributor to an auditor's competence. Such programs often address a wide range of areas relevant to the firm's business as a whole, such as project management and communication skills. It is important that firms dedicate sufficient time, resources and importance to training in audit and accounting matters so as to provide the technical skills needed to support audit quality

### 3.6 Knowledge, Experience and Time – National Level

96. National activities can impact the competence and capabilities of auditors and the time spent. Key attributes are:
- Robust arrangements exist for licensing audit firms/individual auditors.
  - Educational requirements for auditors are clearly defined and robust.
  - Arrangements exist for briefing auditors on current issues and for training them in new accounting, auditing or regulatory requirements.
  - The auditing profession is well positioned to attract and retain high quality individuals.

#### *Robust Arrangements Exist for Licensing Audit Firms/Individual Auditors*

97. Auditing is a public interest activity which needs to be performed by suitably qualified individuals working in an appropriate environment. To achieve this, there will commonly be national arrangements for licensing audit firms and/or individual auditors to perform audits. A register of approved firms/persons will often be maintained by a competent authority. Authorities will often have the power to revoke the license in defined circumstances.

#### *Educational Requirements for Auditors are Clearly Defined and Robust*

98. Criteria for obtaining a license will usually involve educational requirements both for IPD and CPD. Audit quality will be facilitated if educational requirements are both clearly defined and robust.
99. The professional skills described in IESs underlie the competences needed to support audit quality. These are developed by a combination of theoretical training and practical experience and coaching within audit firms. IESs are addressed to IFAC member bodies (which have responsibility for the theoretical training) but do not apply directly to audit firms (which provide the practical experience and coaching). It may assist audit quality if audit firms are required to apply relevant IESs and, in particular, use the competence framework in IES 8 when developing their own competency frameworks for use when evaluating, promoting and remunerating partners and staff.

#### *Arrangements Exist for Briefing Auditors on Current Issues and for Providing Training in Accounting, Auditing or Regulatory Requirements*

100. In addition to training related to an auditor's IPD, appropriate arrangements within a country for CPD are an important factor in contributing to audit quality. CPD needs to be provided in order that

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<sup>15</sup> IES 8, paragraphs 54 and 59, establishes requirements for practical experience for audit professionals.



more experienced auditors continue to develop their skills and knowledge related to auditing, and keep informed about changes in the accounting and regulatory requirements.

101. CPD is particularly important when there are major changes to auditing standards. This provides an opportunity to brief auditors on the new technical requirements, to explain the objectives of those changes, and to help create the enthusiasm and support necessary for the new requirements to be implemented in a cost effective manner.

*The Auditing Profession is Well Positioned to Attract and Retain High Quality Individuals*

102. The competences of audit partners and staff are a critical factor underlying audit quality. While auditors can, and are, provided training, some of the required qualities are, to a degree, inherent in the individuals. It is therefore important that individuals with the right qualities are attracted to a career in the auditing profession.
103. There are likely to be a number of factors that will influence the individuals attracted to a career in the auditing profession, including:
- The status of auditing as a profession in the national environment;
  - Perceptions of career opportunities and remuneration incentives;
  - The quality of training provided; and
  - The potential for being exposed to litigation.
104. The same factors are likely to influence the ability of audit firms to retain the best staff for an extended career in auditing. In some countries, there is a tendency for large numbers of newly qualified accountants to leave the audit firms and take jobs in business. While this may have a beneficial impact on financial reporting, it can limit the number of experienced staff available to audit firms and thereby jeopardize audit quality.
105. The status of the auditing profession in a national environment can also impact the respect in which auditors are held and therefore the effectiveness of the audit function. In environments where the audit profession is not well respected or given appropriate authority, auditors will be in a weaker position relative to management. In such circumstances, there may be a lower likelihood that auditors will probe management on significant matters or stand firm on significant audit issues. Conversely, where the profession is highly regarded or is conferred appropriate authority through the relevant mechanisms, it will be easier for auditors to demonstrate professional skepticism and undertake robust audits.

**3.7 Audit Process and Quality Control Procedures – Engagement Level**

106. Audits need to be performed in accordance with auditing standards and are subject to the audit firm's quality control procedures which comply with IAASB's ISQC1.<sup>16</sup> These provide the foundation for a disciplined approach to risk assessment, planning, performing audit procedures and ultimately forming and expressing an opinion. Sometimes, audit firms' methodologies and internal policies and procedures provide more specific guidance on matters such as who undertakes specific activities, internal consultation requirements; and documentation formats.

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<sup>16</sup> Quality control for firms that perform audits and reviews of financial statements and other assurance and related services engagements.



107. While the audit firm's methodology and auditing standards will shape the audit process, the way that process is applied in practice will be tailored to a particular audit. Key attributes are:
- The engagement team complies with auditing standards and the firm's quality control procedures.
  - The engagement team makes proper use of information technology.
  - There is effective interaction with others involved in the audit including, where applicable, internal auditors.
  - There is engagement with management so as to achieve audit efficiency.
  - There is appropriate audit documentation.

*The Engagement Team Complies with Auditing Standards and the Audit Firm's Quality Control Procedures*

108. Auditors are usually required by national law or regulations to comply with auditing standards. However, not all aspects of the audit process are defined by auditing standards, and audit firms will usually have methodologies that provide further specification. Even within the structure created by auditing standards and firm methodologies, there is flexibility for the audit team in terms of what specific audit work is performed, how it is undertaken in practice, and the nature and timing of interactions with management. The way that the work is performed in practice can be an important factor in both effectiveness and efficiency.

*The Engagement Team Makes Proper Use of Information Technology*

109. The automation of accounting systems allows auditors to spend less time obtaining audit evidence regarding the accuracy of transaction processing and enables them to devote more time to areas of greater potential risk. Information technology also provides an opportunity for auditors to gather audit evidence more effectively through the use of computer-assisted audit techniques, although sometimes these need the involvement of specialists and can be expensive to set up, especially in the first year.
110. Information technology has also had an effect on the way auditors communicate, both within audit teams and with management and those charged with governance. E-mails in particular are increasingly used. While e-mail generally increases accessibility, especially on an international basis, e-mails can have limitations. In particular, there may be a reduced opportunity to obtain useful audit evidence from e-mail exchanges than from the richer interaction that comes through having a fuller open discussion with management. Depending on the circumstances, e-mail might also make it easier for management to provide inaccurate or incomplete responses to the auditor's questions or be less forthright with information if management is motivated to do so.

*There is Effective Interaction with Others Involved in the Audit Including, Where Applicable, Internal Auditors*

111. Others involved in the audit could include auditor experts, or, in a group context, the auditors of components. Where others are involved in the audit, it is important that:
- The engagement team clearly communicates with them about the work to be performed;
  - Others involved clearly communicate the findings from the work performed; and



- The engagement team determines that the work performed is adequate for its purpose and reacts appropriately to the findings.

112. Many large entities will have an internal audit function. It is likely to be important for both audit efficiency and effectiveness for there to be effective interaction between the external and internal auditors. For example, the internal audit function is likely to have obtained insight into the entity's operations and business risks that will provide valuable input into the auditor's understanding of the entity and risk assessments or other aspects of the audit.

*There is Engagement with Management so as to Achieve Audit Efficiency*

113. Management may have an interest in ensuring that the audit is completed as quickly as possible and the disruption to the entity's ongoing operations is minimized. Engagement teams can assist this through:

- Rigorous planning, including, where appropriate, agreeing with management information needs and timetable;
- Timely engagement with management to resolve issues identified during the audit;
- Striving to meet agreed timelines and reporting deadlines; and
- Avoiding, as far as possible, duplicate inquiries of management on the same matter from different engagement team members.

*There is Appropriate Audit Documentation*

114. Auditing standards require audit documentation to be prepared sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of the procedures performed, the results of those procedures, the significant matters arising and the conclusions reached. This documentation supports quality control activities both within the audit team, before the audit is completed, and by others who decide to review the quality of work performed after the audit has been completed.

**3.8 Audit Process and Quality Control Procedures – Firm Level**

115. The audit firm's policies and procedures will impact the audit process. Key attributes are:

- The audit process is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.
- The audit methodology encourages individual team members to think creatively, apply professional skepticism and exercise appropriate professional judgment.
- The methodology requires effective supervision and review of audit work.
- The methodology requires appropriate audit documentation.
- Audit quality is monitored and appropriate consequential action is taken.
- Where required, effective engagement quality control reviews are undertaken.



*The Audit Process is Adapted to Developments in Professional Standards and to Findings from Internal Quality Control Reviews and External Inspections.*

116. The audit firm's audit process should not remain static but should evolve with changes in professional standards. Importantly, continual improvements to the firm's audit methodology and tools should be made to respond to findings from internal reviews and regulatory inspections.

*The Audit Methodology Encourages Individual Team Members to Think Creatively, Apply Professional Skepticism and Exercise Appropriate Professional Judgment*

117. Most audit firms use methodologies to assist staff in achieving an efficient and effective audit and for quality control processes. These methodologies are often in the form of software that sometimes supports decisions and generates electronic working papers that can be viewed at remote locations.

118. Such methodologies can be an effective mechanism for achieving consistent compliance with auditing standards and for checking whether all necessary steps in the audit process have been performed. Methodologies also assist with documentation and, if in an electronic form, with the rapid sharing of information, including with specialists at remote locations.

119. However, there is a risk that increasing too far the level of prescription in audit methodologies will have negative implications for other elements of audit quality. For example:

- If compliance with a very prescriptive methodology is over-emphasized, there is a risk that insufficient emphasis will be given to experienced staff tailoring the specified audit procedures to the circumstances and considering whether further procedures need to be performed.
- Over-emphasizing the process by which an audit is performed may detract from experienced audit partners and staff making important judgments.
- Reducing too far the freedom of action of partners and staff may undermine the motivation of these individuals and cause them not to pursue a career in auditing.

120. The trend to use computerized methodologies also has the potential to distance both partners and staff from the company being audited. In part, this trend increases the risk that the information and audit evidence that have historically been obtained by spending time with company personnel, "walking the floor" and observing and inspecting the company's operations may not be obtained.

*The Methodology Requires Effective Supervision and Review of Audit Work*

121. Much of the detailed "on-site" audit work may be performed by staff who are relatively inexperienced. In such circumstances, it is vital that their work is supervised and reviewed by experienced staff.

122. Although some modern methodologies provide the opportunity for electronic, off-site review of working papers, this may not be an effective means of assessing whether staff have undertaken the audit thoroughly and demonstrated an appropriate degree of skepticism. Furthermore, electronic, off-site review is unlikely to assist with the coaching or on-the-job-training that is so vital for developing the skills and competencies of less experienced staff.



*The Methodology Requires Appropriate Audit Documentation*

123. Audit documentation performs a number of roles, including:
- Assisting the engagement team to plan and perform the audit.
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work.
  - Enabling the engagement team to be accountable for its work.
  - Retaining a record of matters of continuing significance to future audits.
  - Enabling the conduct of intra-firm quality control reviews and inspections, and external inspections in accordance with applicable legal, regulatory or other requirements.
124. Documentation of the rationale for an audit judgment is likely to increase the rigor, and therefore the quality, of that judgment. The process of committing to writing the issues and how they have been resolved is likely to improve the rigor of the auditor's thought process and the validity of the conclusions reached.

*Audit Quality Is Monitored and Appropriate Consequential Action Is Taken*

125. Auditing involves compliance with standards and internal firm policies and procedures. It also involves difficult decisions and judgments made by staff at different levels of experience and sometimes under time pressure. Monitoring audit quality within an audit firm is an important aspect of ensuring that standards are being adhered to and that the partners and staff are performing appropriately.
126. As well as audit firms monitoring audit quality, audits may be subject to external review by audit regulators.
127. In addition to addressing any shortcomings that have been identified on individual audits, it is important that audit firms identify systemic issues revealed by both internal and external monitoring activities and take appropriate action.

*Where Required, Effective Engagement Quality Control Reviews are Undertaken*

128. Engagement quality control reviews (EQCRs) allow for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. They are required to be performed on audits of listed companies and those other audit engagements for which the audit firm considers them appropriate.
129. To be effective, EQCRs need to be performed by individuals with the necessary experience, authority and time. EQCRs require the cooperation of the engagement partner so that they can be performed on a timely basis and allow the engagement team to respond appropriately to findings.

**3.9 Audit Process and Quality Control Procedures – National Level**

130. National audit regulatory activities can impact the audit process. Key attributes are:
- Auditing standards are promulgated which make clear the underlying objectives as well as the specific requirements that apply.



- Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.
- Effective systems exist for investigating allegations of poor audit quality and taking disciplinary action when appropriate.

*Auditing Standards are Promulgated Which Make Clear the Underlying Objectives as Well as the Specific Requirements that Apply*

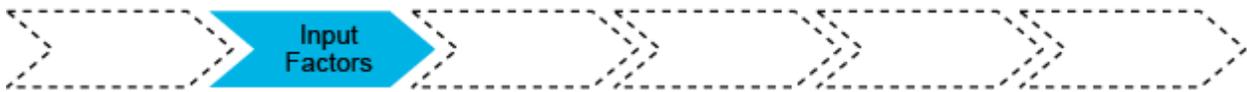
131. Auditing requirements may be imposed by law or regulations or mandated through the national professional body. IFAC requires its member bodies to use their best endeavors to [adopt] the ISAs. In some countries, the ISAs are supplemented by additional national requirements.

*Bodies Responsible for External Audit Inspections Consider Relevant Attributes of Audit Quality Both Within Audit Firms and on Individual Audit Engagements*

132. In many countries, arrangements exist for the independent monitoring of audit quality either by a separate audit firm (a peer review) or by independent audit inspectors. Increasingly, law and regulations provide that the inspections of audits of listed companies, and sometimes those of other public interest entities, are undertaken by an independent audit regulator with a mandate to protect the public interest.
133. External audit inspections provide an opportunity for evaluating auditors' compliance with auditing standards, and depending on their mandate, other aspects of audit quality. Actions taken by audit firms to address weaknesses identified by audit inspectors lead to improvements in audit effectiveness and, where the results of audit inspections are published, greater awareness amongst stakeholders about audit quality issues.
134. A number of independent audit regulators are relatively new organizations. In an international context, the establishment of the International Forum of Independent Audit Regulators (IFIAR) facilitates knowledge sharing and promotes greater coordination amongst audit regulators.<sup>17</sup>
135. IFIAR's Core Principles for Independent Audit Regulators are that the responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation. In addition, audit regulators should:
- Be operationally independent;
  - Be transparent and accountable;
  - Have comprehensive enforcement powers;<sup>18</sup>
  - Ensure that staff are independent from the profession;
  - Have sufficient staff of appropriate competence;
  - Be objective and free from conflicts of interest, and maintain appropriate confidentiality arrangements;

<sup>17</sup> Currently, IFIAR has over 40 members. Further information about its activities can be found on its website: [www.ifiar.org](http://www.ifiar.org).

<sup>18</sup> Including the capability to ensure that their inspection findings or recommendations are appropriately addressed: these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit license and/or registration.



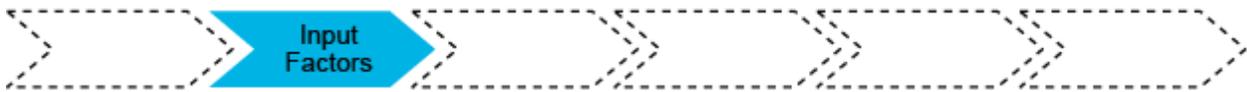
- Make appropriate arrangements for cooperation with other audit regulators and, where relevant, third parties;
- As a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements and other laws, rules and regulations;
- Ensure that a risk-based inspection program is in place;
- Ensure that inspections include procedures for both firm-wide and file reviews; and
- Have a mechanism for reporting inspection findings to the audit firm and ensuring remediation of findings with the audit firm.

*Effective Systems Exist for Investigating Allegations of Poor Audit Quality and Taking Disciplinary Action when Appropriate.*

136. The requirements of auditing and other relevant standards are only effective if they are properly enforced. This involves investigation of allegations of audit failure and, where appropriate, disciplinary action being taken. As well as acting as an incentive to audit firms to comply with applicable standards, effective disciplinary arrangements give other stakeholders confidence.
137. However, some believe that excessive use of disciplinary mechanisms or an overly litigious environment can impact audit efficiency through highly prescriptive methodologies and internal review processes and excessive documentation. An overly regulated environment may also act as a disincentive for talented individuals to join, or remain in, the auditing profession and for auditors to develop innovative approaches that may enhance the value and relevance of the audit.
138. Investigation and disciplinary action can be undertaken by professional bodies; however, as is the case with audit inspection, in relation to listed companies and other public interest entities, it is increasingly being undertaken by independent audit regulators. To be effective, disciplinary functions must have a clear mandate and have sufficient resources to undertake their work.
139. The effectiveness of disciplinary activities is also increased when there are effective sanctions available to the regulator and clear criteria have been established as to what represents an audit failure. However, audit failures are difficult to define, especially as so much of an audit involves judgment, and criteria in laws and regulations are sometimes vague and difficult to enforce.
140. Authorities will often have the power to revoke the license of audit firms or individual auditors in defined circumstances. Such actions may be appropriate in extreme cases but it may also assist the regulatory process if more proportional sanctions are also available for lesser failings. These may include fines and mandatory retraining.
141. Over a period of time, the findings from external audit inspections and investigations need to be captured and fed back to the standard-setting process. There will also be benefit in audit firms analyzing the results from internal inspections and investigations in order to learn from their mistakes and improve their methodologies and procedures to prevent repeating those mistakes.

**Area for Possible Action**

**Encouraging more self-examination by audit firms and the wider profession in order to learn from audit deficiencies and address systemic issues.**



To the extent that information of this nature can be shared between audit firms, trends can be identified and the audit profession as a whole can benefit. Critical self-analysis of this nature is, however, currently inhibited by the litigation environment faced by firms and concerns about client confidentiality.

#### 4. Output Factors

142. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly by considering the quality of the outputs. However, the outputs available to users of the audit are usually rather limited and, in the case of shareholders of listed companies, may only comprise the auditor’s report on the financial statements.
143. Other stakeholders, especially management, those charged with governance and some regulators, do have more direct insights into the inputs to audit quality and are therefore better placed to evaluate it. Outputs from these other stakeholders may provide useful information to external users on audit quality.
144. Outputs can provide insights into audit quality; the outputs themselves are also likely to be evaluated in terms of their value and timeliness.
145. Relevant outputs may include:

Level	Outputs
Engagement Level	<p>From the Auditor:</p> <ul style="list-style-type: none"> <li>• The auditor’s report on the financial statements and such other matters required by law and regulations</li> <li>• Reports from the auditor to those charged with governance (e.g., audit committee reports)</li> <li>• Reports from the auditor to management (e.g., recommendations on internal controls)</li> <li>• Reports from the auditor to regulators</li> </ul> <p>From the Entity:</p> <ul style="list-style-type: none"> <li>• The audited financial statements</li> <li>• Reports from audit committees</li> </ul> <p>From Audit Regulators:</p> <ul style="list-style-type: none"> <li>• Reports on the results of inspections of individual audits</li> </ul>
Firm Level	<p>From the Audit Firm:</p> <ul style="list-style-type: none"> <li>• Transparency reports</li> <li>• Annual reports</li> </ul> <p>From Audit Regulators:</p> <ul style="list-style-type: none"> <li>• Reports on the results of individual firm inspections</li> </ul>
National Level	<p>From Audit Regulators:</p> <ul style="list-style-type: none"> <li>• Aggregate reports on the results of inspections</li> </ul>



#### 4.1 Outputs – Engagement Level

146. Key attributes in relation to an evaluation of the quality of engagement level outputs from the auditor are:

- The reliability and usefulness of audit reporting to users of audited financial statements.
- The value and timing of auditor reports to those charged with governance.
- The value and timing of auditor reports to management.
- The value and timing of auditor reports to financial or prudential regulators.

##### *The Reliability and Usefulness of Audit Reporting to Users of Audited Financial Statements*

147. The ultimate objective of an audit is the provision of an auditor's opinion that provides users confidence as to the reliability of the audited financial statements. For the majority of users, the absence of a qualified auditor's opinion is an important signal. However, the value of that signal is influenced by the reputation of the audit firm that has conducted the audit and an assumption about the effectiveness of the audit process employed.

148. Audit reports have evolved over the years to a degree that they are now largely standardized. Research indicates that some users want the auditor's report to contain more information about the entity and about the audit itself than is currently being provided. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as help them evaluate the quality of the audit. Additionally, some users also believe that the communicative value of the auditor's report could be improved if changes were made to the current structure and wording of the auditor's report.

##### **Area to explore**

##### **Increasing the information value of audit reports.**

The IAASB is undertaking a separate initiative to explore how to enhance the quality, relevance and value of auditor reporting and in June 2012 issued an Invitation to Comment with proposals for improvements to auditor reporting. There are many potential options for changes that might address these concerns, including some shorter-term options that fall under the IAASB's mandate and some longer-term options that would require co-operation with organizations the mandates of which extend to legislative and other regulatory frameworks. While the ideal future content and format are not clear, the IAASB supports the need to enhance the quality, relevance and communicative value of auditor reporting on an international basis.

149. In addition to expanding the information contained in the auditor's report, its value can also be increased if it contains additional assurance required by law or regulations. In some cases, such assurance can be provided without extending the scope of the audit (for example, confirmation that management have provided to the auditor all the information and explanations required). In other cases, the scope of the audit needs to be extended (for example, providing assurance on the effectiveness of internal financial controls).



### *The Value and Timing of Auditor Reports to Those Charged with Governance*

150. Auditing standards usually require the auditor to communicate with those charged with governance on specific matters on a timely basis. For example, ISAs<sup>19</sup> require communication about:

- The auditor's responsibilities.
- The planned scope and timing of the audit.
- Information about threats to auditor objectivity and the related safeguards that have been applied.
- The significant findings from the audit.

151. Such matters are often covered in written reports to audit committees. However, the formal requirements of auditing standards are expected to underpin wider and more extensive discussions between the auditor and those charged with governance. Those charged with governance are likely to evaluate the value and timing of both the written reports and the less formal communications when considering overall audit quality.

### *The Value and Timing of Auditor Reports to Management*

152. During the course of the audit, the auditor will also have extensive communication with management. Many of these communications are informal but sometimes the auditor may decide, or management may request, the auditor to formalize observations in a written report. In such circumstances, management is likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.

### *The Value and Timing of Auditor Reports to Regulators*

153. National laws or regulations may require the auditor to communicate with financial or prudential regulators, either on a routine basis or in specific circumstances. National requirements vary but can include:

- Providing assurance on aspects of the financial reporting process, for example, on internal control.
- Reporting matters that the regulators believe are likely to be of material significance to them.
- Reporting illegal acts, including suspicions of money laundering.

154. In such circumstances, the regulators are likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.

### *The Audited Financial Statements*

155. The audit often results in management making changes to the draft financial statements. In addition to quantitative adjustments, this can include qualitative changes such as clarification of note disclosures. While such changes are not transparent to users, faced with high quality financial statements, users may impute that a quality audit has been performed. The converse is certainly likely to be the case, i.e., faced with financial statements that contain arithmetical errors,

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<sup>19</sup> ISA 260, *Communication with Those Charged with Governance*



inconsistencies and disclosures that are difficult to understand, in the absence of a qualified auditor's report users may conclude that a poor quality audit has been performed.

#### *Reports from Audit Committees*

156. In a number of countries, audit committees have specific responsibilities for a degree of oversight of the auditor or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.
157. There is potential for fuller disclosure of the activities of audit committees to benefit both actual audit quality and user perception of it. Consequently, some countries<sup>20</sup> are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

#### *Reports from Audit Regulators*

158. In some countries, audit regulators make available the results of inspections on individual audits to relevant audit committees although such information is not usually made publically available.

## **4.2 Outputs – Firm and National Levels**

#### *Transparency Reports*

159. Audit firms may provide generic information on audit quality issues. A number of countries have introduced requirements for audit firms to provide Transparency Reports that provide information about their governance and quality control systems.<sup>21</sup> Making such information publically available may assist users of audited financial statements understand the characteristics of individual audit firms and this information may assist entities in selecting a new audit firm.
160. Transparency reports also provide an opportunity for audit firms to distinguish themselves by highlighting particular aspects of their arrangements and therefore to compete on aspects of audit quality. Publication of information on, for example, the firm's processes and practices for quality control, for ensuring independence, and on its governance provides a clear incentive to all within the audit firm to live up to both the spirit and the letter of what the firm promises.

#### *Annual Reports*

161. Some audit firms and public sector audit bodies issue annual reports. Annual reports provide an opportunity for these bodies to describe key performance indicators in relation to audit quality and initiatives undertaken to increase it. Such information may help them differentiate themselves on audit quality.

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<sup>20</sup> For example, the UK's Financial Reporting Council (FRC) is exploring an enhanced model of corporate governance reporting that could provide a platform for further reporting by those charged with governance to the entity's shareholders (or other external stakeholders), building on the existing two-way communication and dialogue about the audit between the auditor and the audit committee.

<sup>21</sup> For EU Member States, for example, the Statutory Audit Directive requires firms that audit public interest entities to disclose annually specified information covering the legal structure of audit firms, any network they are part of, corporate governance and quality control systems, financial information and information about the basis of partner remuneration.

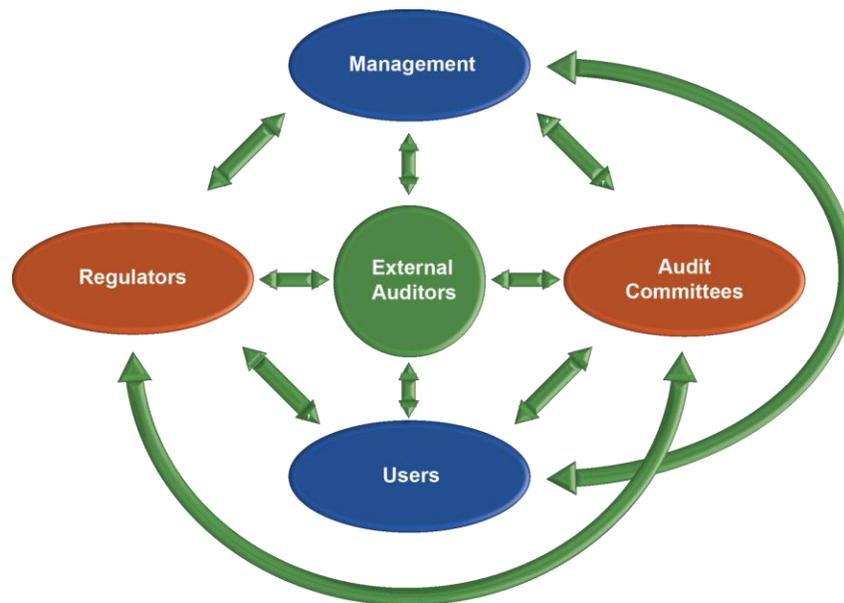


*Reports from Audit Regulators*

162. In many countries, audit regulators report annually on the outcome of audit inspection activities. The level of detail provided in such reports varies. In some countries, the reports aggregate the results of inspections of all audit firms; in others countries, reports are published for separate audit firms.
163. The debate on whether it is beneficial for audit regulators to report publicly on individual audit firms is finely balanced. Some believe that providing transparency on the inspection findings relating to individual audit firms will assist audit committees fulfill their responsibilities, and will have a positive impact on audit quality (by giving firms the incentive to show year-on-year improvements in the quality of their work). Others believe that public reporting on audit-firm-specific findings may cause audit firms to adopt a more defensive approach to responding to the findings from inspections.

## 5. Key Interactions within the Financial Reporting Supply Chain Influencing Audit Quality

164. In its 2008 report *Financial Reporting Supply Chain: Current Perspectives and Directions*,<sup>22</sup> IFAC describes the financial reporting supply chain as “the people and processes involved in the preparation, approval, audit, analysis and use of financial reports.”
165. IFAC observed that all the links in the chain need to be of high quality and closely connected to supply high-quality financial reporting. While each separate link in the supply chain plays an important role in supporting high quality financial reporting, the nature of the connections, or interactions, between the links can have a particular impact on audit quality.
166. It is through these interactions, including both formal and informal communications, that participants in the supply chain can influence the behavior and views of others and thereby contribute to improvements in audit quality. The nature and extent of the interactions will be influenced both by the objectives of the individuals involved and the context in which the interactions take place.
167. Some of the more important interactions with regard to audit quality are described below.



### 5.1 Interactions between Auditors and Management

168. Management is responsible for the preparation of the financial statements and for such internal control necessary to ensure that the information for preparing the financial statements is reliable and available on a timely basis. Management is also responsible for ensuring that the financial statements comply with the applicable financial reporting framework and, where relevant, represent the underlying transactions and events in a manner that achieves fair presentation.

<sup>22</sup> The report can be accessed at: <http://web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf>.



169. Auditors need full and timely access to relevant information and individuals both within and outside the entity. This assists the auditor in gathering audit evidence. An open and constructive relationship assists the auditor in identifying, assessing and responding to the risks of material misstatement, particularly with regard to complex or unusual transactions, or matters involving significant judgment or uncertainty. In the absence of cooperation and open dialogue, it is unlikely that a high quality audit can be performed efficiently.
170. To assist audit efficiency, at an early stage in the audit the auditor is likely to discuss information needs with management and to agree an appropriate timetable. The auditor is also likely to discuss audit findings with management as they arise so that management can provide explanations on a timely basis or undertake additional analysis where necessary.
171. An open and constructive relationship between auditors and management also helps create an environment in which management can benefit from auditors' observations on matters such as:
- Possible improvements to the entity's financial reporting practices.
  - Possible improvements in internal control over financial reporting.
  - New financial reporting requirements.
  - Perspectives on industry issues.
  - Observations on regulatory matters.
172. An open and constructive relationship between the auditor and management needs to be distinguished from one of over-familiarity. It is vital for audit quality that auditors remain skeptical and objective and are prepared to challenge the reliability of the information they are given.

## 5.2 Interactions between Auditors and Those Charged with Governance

173. Those charged with governance are responsible for overseeing the strategic direction of the entity, and obligations related to, the entity's accountability. This includes overseeing the entity's financial reporting process. In listed companies and other large entities, much of the work related to overseeing the entity's financial reporting process is often undertaken by an audit committee.
174. Effective two-way communication with auditors can assist those charged with governance fulfill these responsibilities. In particular, those charged with governance are likely to benefit from the auditor's views on such matters as the risks faced by the entity, the main areas of management judgment in the financial statements, and insights into the quality of the entity's financial reporting process including weaknesses in its internal financial controls. This information can assist those charged with governance ensure the fair presentation of the financial statements, especially if the auditor has concerns which have not been acted upon by management.
175. It is customary for the auditor to have annual meetings with the audit committee both before the audit commences (to discuss planning issues) and just before it is completed (to discuss the significant findings). Sometimes, effective communication is facilitated if at least one meeting, or part of a meeting, takes place without management in attendance.
176. Those charged with governance are also in a position to influence the quality of the audit through:
- Providing views on financial reporting risks and areas of the business that warrant particular audit attention.



- Considering whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this.
- Creating an environment in which management is not resistant to being challenged by the auditors and are not overly defensive when discussing difficult or contentious matters.

### 5.3 Interactions between Management and Those Charged with Governance

177. A strong commitment to honesty and integrity within an entity has a positive bearing on the quality and reliability of its financial reporting process, and therefore on audit quality. Such a culture, which is established and nurtured by those charged with governance working in conjunction with senior members of management, promotes the development and maintenance of appropriate accounting policies and processes as well as the open sharing of information that is necessary for high-quality financial reporting.

178. To achieve this, those charged with governance depend on a transparent and constructive relationship with management in assisting them to discharge their responsibility for oversight of the financial reporting process. This requires a willingness by management to come forward to discuss with those charged with governance matters such as:

- Identified, and potentially significant, issues on financial reporting and regulation;
- Assumptions behind significant accounting judgments involved in the financial reporting process; and
- Areas where the financial reporting process may be strengthened.

179. In the absence of evidence of a transparent and constructive relationship between management and those charged with governance, the auditor needs to be especially alert for significant deficiencies in internal control, errors in the financial reporting process and fraud risks. It will also be important for the auditor to seek to understand the reasons behind such relationships as the nature of any audit responses will depend on the circumstances. For example, an audit response where those charged with governance doubt management's integrity will differ from one where management harbors reservations about the competence of those charged with governance.

### 5.4 Interactions between Auditors and Regulators

180. There are three main types of regulators that impact the audit: regulators of the financial markets and financial market participants ("financial regulators"); prudential regulators of certain types of entity such as banks ("prudential regulators"); and regulators with direct oversight over some audit firms ("audit regulators"). In some countries, there are a number of financial and prudential regulators and it will be beneficial for them to coordinate their activities related to audit quality.

#### *Financial and Prudential Regulators*

181. In many respects, financial and prudential regulators and auditors have complementary concerns, although the focus of their concerns may be different. Appropriate sharing of information between these parties can therefore both enhance the regulatory process and contribute to audit quality.

182. An audit is important to financial and prudential regulators. These regulators usually require the financial statements of relevant entities to be audited, and sometimes extend the scope of the audit to include matters such as the effectiveness of the company's system of internal financial control. In



addition, these regulators sometimes request auditors to provide them assurance privately on specific matters.

183. In addition to formal reporting responsibilities, financial and prudential regulators may wish to be informed about matters that come to the auditor's attention during the course of undertaking the audit. In the case of banking regulators, this may involve matters such as:

- Information that indicates a failure to fulfill one of the requirements of a banking license.
- Information that may indicate a material breach of laws and regulations.
- Material adverse changes in the risks of the banks' business and going concern issues.

184. Financial and prudential regulators sometimes have information that, if known by the auditor, would impact the scope of the audit and potentially the auditor's conclusions and audit opinion.

185. To address practicality and confidentiality issues relating to communications between auditors and regulators, it is desirable that criteria for what is to be communicated and the process for such communications should be established either in law or by means of formal agreements or protocols.

**Area to explore**

**Achieving improved two-way communication between auditors and regulators, particularly in the financial services sector.**

*Audit Regulators*<sup>23</sup>

186. The formation of independent audit regulators in many countries tasked with the inspection of audit firms and individual audits provides an opportunity both for increasing audit quality and for making audit quality more transparent to users.

187. Open communication between audit firms and the audit regulators will assist regulators undertake their activities effectively. Furthermore, clear communication of the findings of audit inspections will assist audit firms understand the root causes of deficiencies identified and respond to them in a positive manner.

**5.5 Interactions between Management and Regulators**

188. The extent to which financial regulators interact with management in relation to financial reporting varies between countries and industry sectors. Some financial regulators establish and enforce the financial reporting frameworks and may raise questions with management about aspects of the financial statements. Furthermore, in some sectors such as banking, prudential regulators may undertake direct supervisory activities which involve interaction with management. These activities can have a positive effect on financial reporting and the auditor needs to be informed about the interactions that have occurred.

<sup>23</sup> In the public sector, public sector audit institutions are usually not subordinated to external regulatory oversight. They answer to parliament, who from time to time may question the quality of audit activities.



## 5.6 Interactions between Regulators and Those Charged with Governance

189. As with management, the extent to which financial regulators interact with those charged with governance varies between countries and industries.
190. While to date there is relatively little interaction between audit regulators and those charged with governance, the potential for this exists. For example, it is possible that at some stage in the future:
- Audit regulators might communicate, or require the auditors to communicate, the findings from inspections of individual audits to the audit committees of the relevant entities; or
  - Audit inspectors might seek the views of audit committees on the quality of individual audits as part of their inspection activities.

## 5.7 Interactions between Auditors and Financial Statement Users

191. In addition, in some countries, the regulatory framework provides users with an opportunity to interact, to some degree, with the auditors. For example, in a number of jurisdictions, proposals for the appointment, re-appointment or replacement of an entity's auditor are required to be approved by the entity's shareholders in general meeting. Shareholders may also have the right in general meeting to question the auditor on any significant matters pertaining to the audit. These interactions can provide an added motivation for auditors to perform high-quality audits.
192. Users may also wish to probe the rationale for a change in auditor. This will be facilitated when information related to the reasons for the previous auditor withdrawing from the engagement, or not seeking reappointment, are made publicly available on a timely basis.

## 5.8 Interactions between Management and Financial Statement Users

193. Aside from issuing the financial statements themselves, management may interact with users, particularly investors, in a number of other ways, including through issuing press releases announcing significant transactions or events, and holding analyst briefings and other meetings with investors. The greater the interactions between management and users, the greater the opportunity to enhance the users' understanding of the financial statements. In addition, two-way interactions such as meetings between management and investors may provide an added motivation for management to achieve high quality financial reporting.
194. More generally, users, such as institutional investors, can act as a buttress to audit quality by taking an active interest in exploring with management matters on which the auditor has taken a public position – such as by modifying the audit opinion or issuing a statement to shareholders explaining relevant matters.

## 5.9 Interactions between Those Charged with Governance and Financial Statement Users

195. In a number of countries, audit committees have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.



#### 5.10 **Interactions between Audit Regulators and Financial Statement Users**

196. External inspection of audit quality takes place in a growing number of countries as part of independent audit oversight arrangements. Audit regulators usually report publicly on their activities in overall terms and this can give users an impression of audit quality generally. Some oversight bodies report publicly on their findings relating to individual audit firms and this will provide users with more specific information.

## 6. Contextual Factors

197. In less developed countries, business practices may be relatively informal and commercial law relatively unsophisticated. In such countries, external financial reporting may be limited and user expectations related to it low. As a country develops and, in particular, as businesses grow in size and need to obtain finance from capital markets, the environment becomes more complex. Financial reporting becomes more important and user expectations of the speed and reliability of financial statements grow. In response, law, financial reporting requirements and corporate governance processes evolve.
198. There may also be broader cultural issues that affect financial reporting within a country. Collectively, these environmental factors – or contextual factors – are likely to impact the nature and quality of financial reporting. These factors can also impact audit risk, the nature and extent of audit evidence required and the efficiency of the audit process.
199. Contextual factors, include:



### 6.1 Business Practices and Commercial Law

200. The formality of the way business is undertaken will be influenced by national customs and commercial law. In some national environments, for example, it may be customary for entities to enter into transactions with other parties on an informal basis, relying on relationships of trust. Such environments may exist where trading parties primarily involve related parties, such as entities owned by family members of management or entities that are government-controlled.
201. In such circumstances, the terms and conditions of transactions may therefore be vague or unrecorded and agreements may be subject to oral amendment. This creates opportunities for fraud and corruption. The lack of adequate documentation in these circumstances will present significant challenges for auditors in understanding the economic substance of the transactions and determining whether they have been fully and appropriately accounted for.

202. Commercial law will affect the formality with which business undertake transactions. In particular, contract law determines when rights are established and obligations created as transactions are completed. Where the legal environment is weak, it can be challenging for management to prove ownership claims and justify the adequacy of provisions for liabilities.
203. Attitudes to tax compliance also vary. In some environments, it is customary to not fully declare profits to the tax authorities. Several sets of accounting records may be retained and confusion between the “economic” and the “tax” position can exist. In such circumstances, it may be necessary to calculate a contingent tax liability which is usually subject to considerable measurement uncertainty. The wish to minimize tax liabilities can also result in entities deferring issuing invoices even when performance obligations have been met.

## 6.2 Law and Regulations Relating to Financial Reporting

204. As well as providing a general framework for the way that business is conducted, law and regulations can assist the quality of financial reporting especially if they are rigorously enforced. In particular, law and regulations can usefully:
- Define management’s responsibilities in relation to financial reporting.
  - Provide for punitive action to be taken against management for committing fraudulent financial reporting.
  - Impose obligations on management to cooperate fully with auditors, including providing all necessary information and access.
  - Provide for punitive actions against management for providing misleading information to auditors.
205. Given human nature, however, even the strongest laws and regulations will not completely eliminate poor attitudes to compliance or unethical business practices. Accordingly, there are limitations to how far the legal and regulatory framework can influence management behavior.

## 6.3 The Applicable Financial Reporting Framework

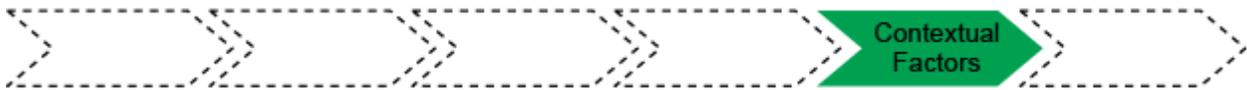
206. The financial reporting framework is a critical factor in the quality of financial reporting. The nature and complexity of the financial reporting framework can also influence perceptions of audit quality.
207. Some believe that an accounting framework that is unduly principles-based allows management too much latitude to account for transactions in a manner that suits management’s objectives and makes it difficult for auditors to challenge this. On the other hand, others believe that over-emphasis on rules encourages a strict compliance approach to financial reporting, which may mean that it is difficult for auditors to focus on the substance of transactions and challenge the fair presentation of the financial statements.
208. Furthermore, a complex applicable financial reporting framework can make it difficult for management to understand the accounting requirements and for those charged with governance to provide effective oversight of the financial reporting process.
209. These problems are exacerbated by frequent changes in financial reporting and disclosure requirements which may, at least in the short term, increase the potential for greater inconsistency in how management apply the standards and how auditors determine that they have obtained sufficient appropriate audit evidence.

210. In recent years, developments in financial reporting have focused increasingly on meeting users' needs for financial information that is more "relevant," even if such information may be more subjective and less "reliable." This has led in particular to a trend towards greater use of fair value measurements and other estimates, which may have significant measurement uncertainty. Disclosures regarding the underlying assumptions made and measurement uncertainty (e.g., sensitivity analyses) are an integral part of faithful representation of such financial statement amounts. But some of those disclosures are qualitative in nature, such as risk exposures. As a result, some question the "auditability" of all such financial information as it is less objectively verifiable as financial statements items such as cash.<sup>24</sup> Audit challenges include the following:
- A disproportionate amount of the time of senior members of the audit team may be taken up with dealing with accounting complexities, with the risk of those members not being sufficiently involved in the direction, supervision and review of other aspects of the audit work.
  - Measurements and disclosures may rely to a considerable extent on the exercise of judgment by management in applying the relevant financial reporting requirements, particularly when they involve assumptions, probabilities, forward-looking expectations, or the use of complex models. The financial reporting framework may be unclear on what management is expected to do to support the assumptions and judgments they make. This can result in limited availability of objective audit evidence to substantiate management's judgments.
  - The applicable financial reporting framework may provide for alternative accounting treatments depending on the entity's intended actions (for example, whether an investment is held for trading or intended to be held to maturity). Management's intent may be difficult for the auditor to verify in practice, particularly if management have never faced identical circumstances in the past.
  - Some fair value measurements may need to be based on unobservable inputs if there is not an active market for the financial instrument. Verifying the fair value in such circumstances can be challenging because the determinants of it can involve highly judgmental assumptions and calculations involving complex models, often requiring specialized expertise.
211. The degree to which accounting estimates involving significant measurement uncertainty are required is likely to vary depending on the industry in which the entity operates and the general economic environment:
- Some businesses have a relatively short business cycle and goods or services are produced and sold relatively quickly. In these businesses, there is a fairly close correlation between profits and cash. In others, the business cycle is much longer and there is a need for increased estimation.
  - Some businesses, such as banks, actively trade in financial instruments while others use them sparingly.

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24 In 2009, the IAASB formalized a process by which it monitors developments in financial reporting standards. The goals of this process are to:

- (a) Provide the International Accounting Standards Board (IASB) with timely input on aspects of its proposed standards that may have potential verifiability or auditability issues; and
- (b) Assist the IAASB in determining whether matters in the financial reporting standards may affect the pronouncements of the IAASB or create a need for new pronouncements.



- Periods of adverse economic conditions are likely to require estimates of realizable values and impairment reserves. In these circumstances, there are also likely to be heightened concerns regarding whether trading partners, and indeed the entity itself, are going concerns.

#### 6.4 Corporate Governance

212. Notwithstanding the specificity of the applicable financial reporting framework, the quality of financial reporting is underpinned by management being motivated to disclose accurate and reliable financial information and having the knowledge and skills to do so.
213. Oversight of management by those charged with governance establishes expectations for behavior, and provides motivation to management to fulfill their responsibilities. Strong corporate governance practices can have a positive impact on the reliability of the financial information that an entity prepares.
214. Audit committees exist in many larger entities and can contribute to the strength of corporate governance, especially when members are independent from management and have an appropriate degree of financial literacy.
215. Audit committees usually have specific responsibilities regarding the appointment or reappointment of the auditor. In fulfilling this responsibility, it is important that audit committees consider audit quality and evaluate whether the audit fee is adequate to allow a high quality audit to be performed. This is especially important when audit fees are negotiated directly with management as management may have a different perspective on what audit quality is from the audit committee.
216. While some countries expect audit committees to have direct role in considering audit quality, others do not. Even for those countries where there is an expectation, the way in which this responsibility is described varies, giving the potential for uncertainty as to the scope of this remit.

##### Area to explore

##### **Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit.**

Even in those countries that have a direct role in considering audit quality, the way in which this responsibility is described varies. Different expressions include:

- “Reviewing the effectiveness of the audit process;”
- “Overseeing the auditor’s work;”
- “Monitoring the statutory audit;”
- “Reviewing the performance of the statutory auditors;” and
- “Evaluating the appropriateness of the audit.”

217. As part of their governance and internal control structures, many larger entities establish an internal audit function. While the objectives and scope of an internal audit function vary widely, they typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance processes, risk management and internal control. Audit committees often have oversight of the internal audit function and are likely to be interested that there is appropriate interaction between the external auditor’s and the internal audit function’s work.



218. The activities of the audit committee can make a valuable contribution to the quality of financial reporting and the quality of the external audit. Greater transparency about the work done by the audit committee and the reasons for their conclusions will assist users of the financial statements.

#### **Area to explore**

**Encouraging audit committees to provide more information to users of the financial statements of the work they have undertaken and the reasons for their conclusions.**

#### **6.5 Information Systems**

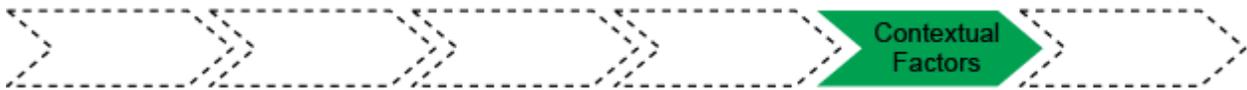
219. Sound information systems are also necessary to support high quality financial reporting. Some jurisdictions have specific legal requirements relating to accounting systems and internal controls over them. Many, however, do not.
220. Increasingly, information systems are computerized. While computer systems will usually process information accurately, they can be subject to systemic weaknesses and continuity problems. Effective corporate governance arrangements will often require internal auditors to provide assurance to those charged with governance about the reliability of the entity's information systems.
221. While the basic accounting systems of many entities are well controlled and reliable, financial reporting requirements increasingly require additional information, especially for the notes to the financial statements. Information on matters such as the fair values of assets and non-financial key performance indicators will often need to be obtained as a discrete activity or from non-accounting systems. Such activities are less likely to be well controlled and there can be challenges for management in developing reliable information on a timely basis.

#### **6.6 Financial Reporting Timetable**

222. The timeframe within which the audit needs to be completed can influence financial reporting processes and the way in which an audit is performed. From a practical standpoint, the advent of accelerated reporting regimes in many jurisdictions limits the extent to which the auditor can perform detailed work after the end of the reporting period. As a result, it has become increasingly necessary for the auditor to place reliance on systems of internal control and audit procedures performed before the period end.
223. Listed companies may be required, or choose, to release earnings estimates or preliminary results at an early stage. In some jurisdictions, auditors are required to agree such releases or perform specific work on them. This has the advantage that the auditor will be comfortable with the financial results before the information is released but adds further time pressure. In jurisdictions where the auditor is not involved with such releases, there is a danger that, having announced the results, management will be resistant to suggested changes to them that arise from the audit as it progresses.

#### **6.7 Broader Cultural Factors**

224. A number of academics have explored the impact of culture on accounting and auditing activities, although the findings are somewhat inconclusive.



225. Two broad cultural differences that may impact the attitudes of management and their interactions with auditors are:

- Deference to authority; and
- Transparency.

*Deference to Authority*

226. Some cultures value, or perhaps just tolerate, younger, less experienced, people challenging the views of older, more senior people, in organizations. In other cultures, relative status can be very important and it is more difficult for less experienced staff to challenge the views of senior people. Undue deference to authority can impact both the willingness of less experienced accountants in the entity to raise concerns with their supervisors as well as the effectiveness of an audit team involving less experienced staff.

227. Auditing is a process that requires a skeptical mindset. While the concept of professional skepticism is embedded in auditing standards, in certain environments it is possible that auditors may not interpret it as intended by auditing standards, especially if those environments do not have a culture of questioning authority. Reluctance by auditors to challenge management can adversely impact on audit quality.

*Transparency*

228. A further aspect of culture that may have an influence on the effectiveness of the auditor's interactions with management is the extent to which secrecy or confidentiality is expected in business dealings. A lack of openness or transparency by management may undermine auditors' ability to obtain the necessary understanding of the entity in order to properly identify and assess the risks of material misstatement in the financial statements. It may make it more difficult for auditors to gather sufficient appropriate audit evidence and to evaluate the completeness and adequacy of disclosures.

## 7. Considerations Relating to Group Audits, Public Sector Audits and Smaller Audits and SMPs

229. The Audit Quality Framework described in this paper sets out the key attributes that lead to audit quality, taking into account the different perspectives of stakeholders. The Framework applies to audits of all entities and all audit firms regardless of size. Having said that, the attributes can vary in importance and affect audit quality in subtly different ways. Set out below is additional commentary in relation to group audits, public sector audits and smaller audits and SMPs.

### 7.1 Considerations Specific to Group Audits

#### *Inputs*

230. Audit process and quality control procedures – Engagement Level. Group management usually expects the group auditor to co-ordinate the work undertaken on components efficiently. Some believe that this can be facilitated if the audits of components are undertaken by the same audit firm or firms within the same audit network. The firm's geographic reach, and therefore its ability to provide efficient audit coverage for subsidiaries and other components of the group, can therefore be important.
231. Audit process and quality control procedures – Engagement Level. Most large entities will have divisions, subsidiaries, joint ventures or investees accounted for by the equity method (components), and one or more components are frequently audited by audit teams other than the group audit team. It is important for the group auditor to determine the nature, timing and extent of work to be undertaken by component auditors and, for significant components, be involved in it.
232. Audit process and quality control procedures – Firm Level. Some audit firms operate internationally through a network of firms. Network firms often share common methodologies and quality control and monitoring policies and procedures.

#### *Contextual Factors*

233. Business practices and broader cultural factors. Differences in business practices and cultural factors can present practical challenges in a multi-national entity context in relation to the preparation of group financial statements. Group management can, however, take specific steps to overcome, or at least mitigate the effects of, such challenges through the implementation and maintenance of effective group-wide controls over financial reporting. Such controls may include, for example:
- Consistent policies and procedures in all countries where the group operates;
  - Group-wide programs, such as codes of conduct and fraud prevention programs;
  - Internal auditors assessing the accuracy and completeness of financial information received from components;
  - Central monitoring of components' operations and their financial results;
  - Regular liaison visits from group management; and
  - Staff secondments.

## 7.2 Considerations Specific to Public Sector Audits

234. The interactions and input, output and contextual factors of this Framework are largely relevant to public sector audit bodies including Supreme Audit Institutions (SAIs). However, due to their societal role and constitutional mandates, such bodies may give specific emphasis to certain factors.

### *Inputs*

235. Values, Ethics and Attitudes – Engagement Level. Independence can be easier to achieve in public sector audits as it is unlikely that auditors will have direct financial interests in the entities they audit. In addition, due to set mandates, public sector auditors are often prohibited from providing non-audit services to the audited entity.
236. Knowledge, Experience and Time – Engagement Level. Public sector mandates are sometimes wide and require auditors to provide assurance on matters such as compliance with law or performance indicators. Partner and staff technical competencies need to reflect the mandate. .
237. Knowledge, Experience and Time – Firm Level. In some countries, public sector audit institutions have to keep within fixed limits for how much they may spend on staff resources. There may also be regulations that impact recruitment of staff and the salaries that can be paid. This can mean it is challenging for the audit institutions to recruit and retain sufficient numbers of high quality staff to consistently achieve audit quality.

### *Outputs*

238. Engagement Level. Public sector auditors often carry out their work in an environment which gives citizens access to official documents. This freedom of information can result in the public sector auditor disclosing more detailed information in their reports, for example, on an entity's business risks and internal control.
239. Engagement Level. In addition to auditor reports, public sector auditors often issue additional publicly accessible reports disclosing detailed findings. Usually, a range of recommendations are listed in these reports. Actions taken by the entity in response to recommendations are often recorded and seen as an expression of the "value" from the audits.
240. Firm Level. Public sector audit bodies may draw general conclusions across the range of audits that they undertake, identifying common weaknesses in governance, accounting and reporting. These reports may include recommendations for improvements in general laws and regulations concerning government entities.
241. National Level. Public sector bodies are usually not-for-profit organizations and, provided they operate in line with set budget limits, there is usually relatively little focus from stakeholders on the financial outcome of the entity. There may be more focus on matters such as:
- The entity's general performance, achievement of the objectives set for it by the legislature or the government, and the efficiency in the use of funds;
  - Compliance with laws and regulations; and
  - Environmental issues.

In many countries, such information is included in, or issued in connection with, the annual financial reports. In such circumstances, the auditor will either have a mandate to report on this information or be associated with it.

#### *Interactions*

242. **Auditors and Users.** Public sector auditors often have direct contact with primary users of the financial statements. It is not unusual for auditors to make presentations about their findings to the legislature or ministries (concerning government agencies or government-owned companies) as well as providing them with:

- Unbiased and politically neutral insights into the operations and financial reporting practices of the entity.
- Constructive and timely recommendations in areas of performance (including value for money) and compliance with relevant mandates.

Such presentations may enhance the auditors' knowledge of expectations of primary users of financial statements and provide the primary users with an opportunity to evaluate audit quality.

#### *Contextual Factors*

243. **Applicable Financial Reporting Framework and Corporate Governance.** In some countries, especially developing countries, financial reporting frameworks and corporate governance arrangements are lacking or incomplete.

### **7.3 Considerations Specific to Smaller Audits and SMPs**

#### *Inputs*

244. **Values, Ethics and Attitudes – Engagement Level.** Smaller entities often lack in-house financial reporting expertise and will often hope to utilize the auditor's financial reporting expertise in the preparation and presentation of annual financial statements. Where this involvement is permitted, it can assist the auditor with understanding the entity and its accounting systems but could result in threats to auditor objectivity. In some jurisdictions the auditor is prevented from providing accounting assistance.

245. **Values, Ethics and Attitudes – Firm Level.** Sole practitioners have direct control over their firm's culture, and in SMPs a small number of partners can have a very direct influence over input factors such as governance arrangements, consultation, and monitoring activities. This could be either a strength or a weakness of the small firm environment.

246. **Values, Ethics and Attitudes – Firm Level.** The small number of staff in an SMP allows it to develop relatively straightforward quality control policies and procedures, although SMPs can face challenges in relation to consultation, providing technical support and using independent staff in quality monitoring processes. Developing close working relationships with other SMPs can assist in these areas.

247. **Knowledge, Experience and Time – Engagement Level.** Audits of smaller entities by sole practitioners and SMPs are often conducted on site by experienced personnel who have been involved with the entity for a number of years. While such personnel usually have a good knowledge of the entity's business, there may be threats to their objectivity and skepticism.

248. Knowledge, Experience and Time – Engagement Level. The auditor is often viewed as a valued business and tax advisor to the entity and there are usually frequent direct communications with senior management, resulting in the auditor being well informed about business developments. This gives the auditor good knowledge of both the client’s financial reporting process and its industry but can also be seen as a threat to independence.
249. Knowledge, Experience and Time – Firm Level. Audits of smaller entities are not mandated in some countries. This can mean that in such countries it is challenging for SMPs that have only a small number of audit clients to retain partners and staff with relevant audit knowledge and experience.
250. Audit Process – Firm Level. As the audits are relatively simple, audit methodologies need not be overly complex.

#### *Outputs*

251. Engagement Level. A close involvement in the entity’s business, often over many years, gives the auditor an enhanced opportunity to provide meaningful business advice to their clients. The relationship between the engagement partner and senior management is often very strong and communications direct and frequent.

#### *Contextual Factors*

252. Business Practices and Information Systems. The business undertaken by smaller entities is often uncomplicated, with few sources of income and activities. Accounting systems are usually simple and utilize relatively uncomplicated technology, although doing business through the internet can cause complexities.
253. Corporate Governance. In many smaller entities, there is little distinction between management and those charged with governance. An owner-manager will usually fulfill both roles. Formal corporate governance requirements do not usually apply to smaller entities. Audit committees are rare and, when they exist, members are often not independent or financially literate.
254. Applicable Financial Reporting Framework. The business undertaken by smaller entities often means that the accounting is uncomplicated. Often, the applicable financial reporting framework applied by smaller entities is less complex than that mandated for larger entities.
255. Financial Reporting Timetable. Reporting deadlines can be less onerous for audits of smaller entities than for listed entities, thus allowing the auditor to benefit from evidence obtained from events and transactions after the balance sheet date. Furthermore, it is very rare for smaller entities to release earnings estimates prior to completion of the audit.

### Survey of Stakeholder Perspectives of Audit Quality

1. Some academics have observed that audit involves both a technical component and a service component. The relative importance of these two components is likely to vary between different stakeholder groups.
2. The technical component of audit quality is often considered as having been achieved when there is a high probability that an auditor will both (a) discover a misstatement in the client's financial statements, and (b) report that misstatement.<sup>25</sup> The technical component is most likely to be of greatest importance to users of financial statements, those charged with governance and regulators.
3. The service component of audit quality is more likely to be of importance to management who will likely focus on the efficiency of the audit and its cost. Management is likely to have an interest in ensuring that the cost of the audit is constrained, the audit is completed as quickly as possible and that the disruption to the entity's ongoing operations is minimized.
4. In order to understand better the different perspectives on audit quality, the IAASB undertook a survey of stakeholders in nine countries (Australia, Canada, Germany, Japan, Netherlands, New Zealand, South Africa, UK, US) as well as some members of the IAASB's Consultative Advisory Group.
5. Stakeholders were provided with a list of possible factors that they might take into account in forming a view on the likely quality of an audit and asked to indicate whether the factors were (a) important, (b) less important or (c) not important. Stakeholders were also requested to add other factors not on the list and provide comments.
6. 169 responses were received from the following stakeholder groups:

Stakeholder Group	#
Audit committee members	32
Institutional investors	43
Senior management of larger entities	32
Senior management of smaller entities	33
Primary public sector users	29
<b>Total</b>	<b>169</b>

7. The results demonstrate that perceptions of audit quality vary amongst stakeholders. This, in itself, is not surprising as the level of their direct involvement in, and access to information relevant to, an audit varies greatly.

<sup>25</sup> Based on L. E. DeAngelo, *Auditor Size and Auditor Quality*, Journal of Accounting and Economics, 1981

8. Based on the survey, the key factors that key stakeholder groups are likely to take into account in forming a view on the likely quality of an audit are described below. These factors have been used to help develop the Audit Quality Framework and the links are as follows:

Factor	M	AC	Inv	Link to AQ Framework
Robustness of the audit		✓		The entire Framework is designed to ensure that a robust audit is performed. But there is a difficult balance to be achieved between robustness and the cost of an audit, as discussed in paragraphs 13-14 and 54.
Engagement efficiency	✓			Engagement efficiency is addressed by: <b>Inputs</b> , Audit process and quality control procedures – Engagement Level; Attribute 4
Efficient use of management's time and resources		✓		Engagement efficiency is addressed by: <b>Inputs</b> , Audit process and quality control procedures – Engagement Level; Attribute 4
Engagement team competence and continuity	✓			Engagement team competence is addressed by: <b>Inputs</b> , Knowledge, experience and time – Engagement Level; Attributes 1,2 and 3 Engagement team continuity is covered by: <b>Inputs</b> , Knowledge, experience and time – Engagement Level; Attribute 5
Competence of senior team		✓		Competence of senior team is addressed by: <b>Inputs</b> , Knowledge, experience and time – Engagement Level; Attributes 1, 2 and 3.
Communications: quality usefulness, timeliness	✓	✓		The quality of communications is addressed under both <b>Outputs</b> and <b>Interactions</b>
Firm reputation	✓	✓	✓	The firm's reputation is not specifically addressed as it is not an element of audit quality but something that may emerge from sustained delivery of high quality audits. There will, however, be other factors impacting a firm's "brand image," including its size, its marketing activities and the degree to which it may be adversely affected by litigation or regulatory action.
Professional relationship	✓	✓		<b>Inputs</b> , Values, ethics and attitudes address aspects of professional behavior. This is an important element of a professional relationship.
Partner accessibility	✓	✓		Partner accessibility is addressed by: <b>Inputs</b> , Knowledge, experience and time – Engagement Level; Attribute 7

Factor	M	AC	Inv	Link to AQ Framework
Knowledge and experience of entity and industry	✓	✓		Knowledge and experience of entity and industry is addressed by: <b>Inputs</b> , Knowledge, experience and time – Engagement Level; Attribute 2
Independence from management		✓		Independence from management is addressed by: <b>Inputs</b> , Values, ethics and attitudes; Attribute 5
Perceptions of independence			✓	Independence from management is addressed by: <b>Inputs</b> , Values, ethics and attitudes; Attribute 5
Strength of regulatory framework, including quality of audit committee			✓	Strength of regulatory framework, including quality of audit committee is addressed in the section on <b>Contextual Factors</b>
Regulatory inspection			✓	Regulatory inspection is addressed by: <b>Inputs</b> , Audit process and quality control procedures – National Level; Attribute 2
Transparency reports			✓	Transparency reports are addressed under <b>Outputs</b>
Quality of client's financial reports			✓	The quality of the client's financial reports is addressed under <b>Outputs</b>

**Key**

M: Management

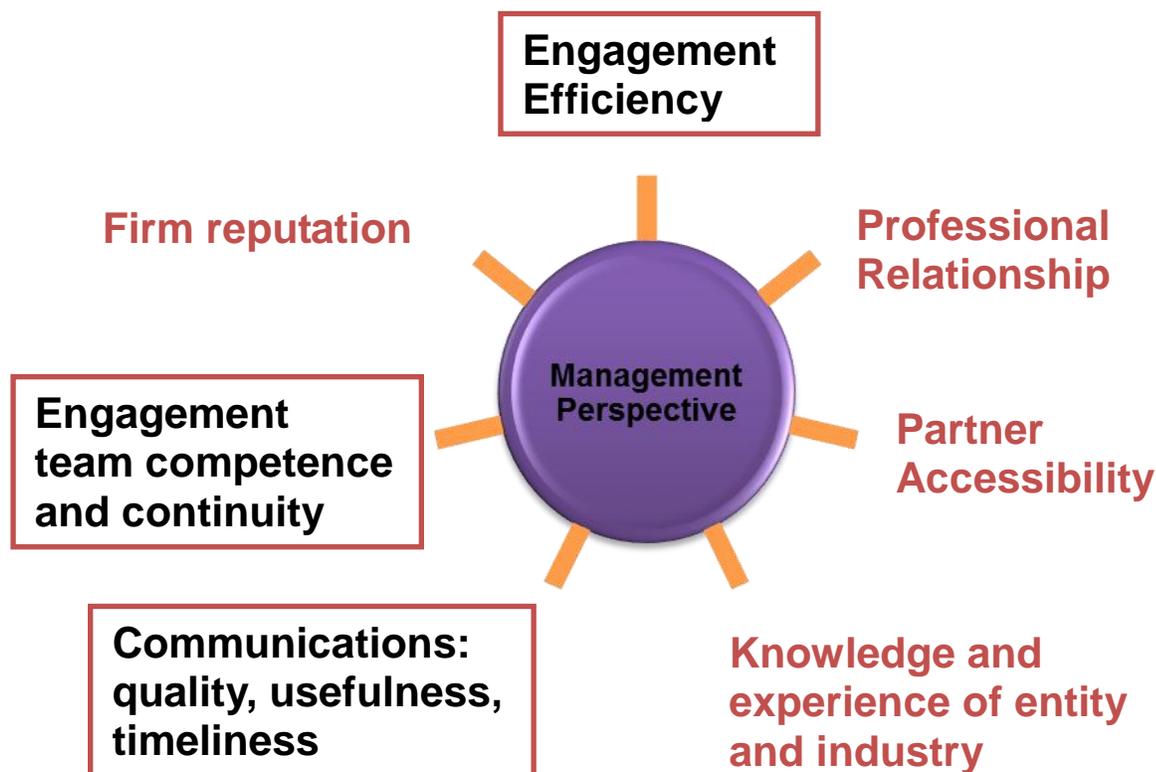
AC: Audit Committees

Inv: Institutional investors and public sector stakeholders

✓ Considered important

✓ Considered very important

## 1.1 Management



9. Management of both large entities and owner-managed entities place particular importance on:
- Engagement efficiency.
  - The quality, timeliness and usefulness of communications from senior team members.
  - The competence and continuity of the engagement team.

### *Engagement Efficiency, Including, Where Appropriate, Coverage of Subsidiaries*

10. Management has an interest in ensuring that the audit is completed as quickly as possible and the disruption to the entity's ongoing operations is minimized. Factors that contribute to audit efficiency include:
- Early notification of potential audit and financial reporting issues, including those arising from changes in standards and regulation.
  - Proactive and timely engagement with management on resolving issues identified during the audit.
  - Effective issue resolution, drawing on expert input in specialized areas where appropriate.
  - Meeting agreed timelines and reporting deadlines.
  - Timely submission and clear articulation of information requests.

- Avoidance of duplicate inquiries of management on the same matter from different engagement team members.
  - Effective interaction between the external auditor and the internal audit function (when one exists).
11. These same factors apply on group audits and group management expects the group auditor to coordinate the work undertaken on components efficiently. This can be facilitated if the audits of components are undertaken by the same audit firm or firms within the same audit network. The firm's geographic reach, and therefore its ability to provide efficient audit coverage for subsidiaries and other components of the group are therefore important.

*Quality, Timeliness and Usefulness of Communications*

12. The quality, timeliness and usefulness of communications from the engagement team, whether through informal discussions with management or a formal 'management letters', all add to the value of the service that management perceives it receives. Apart from communications on financial reporting issues, management may particularly value:
- Insights into, and recommendations for improvement in, particular areas of the entity's business.
  - Observations on regulatory matters.
  - Global perspectives on significant industry issues or trends.

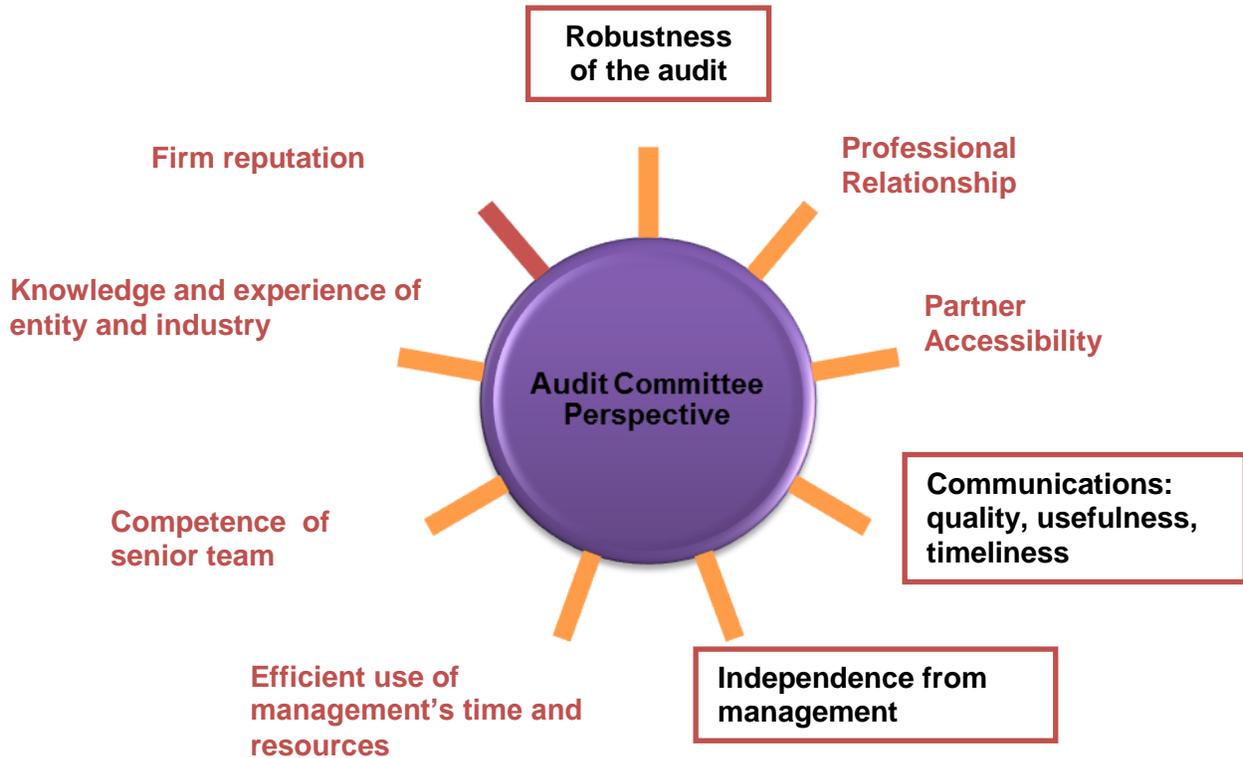
*Competence and Continuity of the Engagement Team*

13. The professional competence, including technical skills and experience, of engagement team members contributes to management's forming a view on the quality of the audit work.
14. Management may develop an appreciation of the engagement team's professional competence in a number of ways, such as:
- How the engagement team has dealt with significant unusual or complex issues during the engagement.
  - Whether the engagement team has asked probing questions on significant issues.
  - Whether the engagement team has effectively applied technical expertise in resolving highly complex financial reporting issues.
  - The timely involvement of partners and experienced staff.
15. In addition, continuity in the engagement team from year to year influences management's perception of audit quality. Accumulated prior knowledge of the entity and its business amongst the engagement team will likely be valued by management. Not only does this contribute to the conduct of an effective and efficient audit but it is also likely to lead to the most insightful recommendations for improvement in particular areas of an entity's business operations.. Conversely, having to provide the same information to new team members each year is seen as creating inefficiency.

16. Other factors that the survey indicated can be of importance to management are:

Factor	Description
Good working relationship with engagement partner	<p>Personal relationships impact how management perceives audit quality. In particular, good “chemistry” and a “cultural fit” between management and the engagement partner are likely positive factors influencing management’s view of audit quality.</p> <p>However, while seeking a good relationship between the auditor and management is understandable, if audit quality is to be achieved for other stakeholders, it is vital that this relationship does not result in over-familiarity or a loss of skepticism on the part of the auditor. The survey demonstrates that both audit committees and institutional investors place particular importance on auditor independence.</p>
Accessibility of engagement partner and others within the engagement team	<p>Accessibility to management of the engagement partner and others within the engagement team helps to build rapport and mutual understanding. It also helps to demonstrate to management that the entity’s audit and its business are valued by the audit firm. Frank and open dialogue between the engagement partner and management on a regular basis is seen as an aspect of accessibility. A number of respondents to the survey commented on the importance of the engagement partner being empowered to take decisions without over-referral to technical specialists within the firm.</p>
Knowledge of, and experience with, the entity and its industry	<p>The extent to which the auditor can demonstrate knowledge of, and experience with, the entity and its industry can be a powerful influence over management’s perception of audit quality. This factor is particularly important in specialized industries, such as the financial services or the oil and gas sectors, where prior industry knowledge and experience are almost invariably prerequisites for an auditor to be appointed.</p>
Audit firm reputation	<p>Management, especially of larger entities, value public reputation of the firm and its brand recognition. A number of larger audit firms have a very high public profile and this is thought to be associated in the public’s mind with high audit quality. Reputations are seen as being damaged by poor external inspection reports, disciplinary proceedings or regulatory sanctions. Client failures can also damage a firm’s reputation.</p>

1.2 **Audit Committees**



17. While many of the factors that influence audit committees' perceptions of audit quality are the same as those of management<sup>26</sup> others differ. In particular audit committees appear to place greater emphasis on the robustness of the audit and the auditor's independence from management and less on efficiency.
18. Based on the survey the factors that are of most importance to audit committees when evaluating audit quality are:
- The robustness of the audit;
  - Quality, timeliness and usefulness of communications; and

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<sup>26</sup> Important factors include:

- Professional relationship with the engagement partner
- The quality, timeliness and usefulness of communications
- Accessibility of the engagement partner and others within the engagement team
- Knowledge of, and experience with, the entity and its industry
- Competence of senior engagement team members
- Efficient use of management's time and resources
- Firm reputation

- Independence from management.

*The Robustness of the Audit*

19. The engagement team's audit approach is a major factor in the audit committee's overall evaluation of the effectiveness of the audit, and therefore audit quality. Factors that audit committees are likely to consider include whether:
- The audit is appropriately focused on the higher risk areas;
  - The engagement team is properly structured and sufficient time has been spent by partners and experienced staff;
  - The group auditor has been sufficiently involved in the audit of components.
20. Equally, in forming a view on audit quality, the audit committee considers whether the engagement partner has challenged management in a robust way on contentious issues, and displayed conviction in taking a principled position on those issues, including modifying the audit opinion where deemed necessary. These actions demonstrate to the audit committee professional skepticism, auditor independence from management and the conduct of a robust audit.

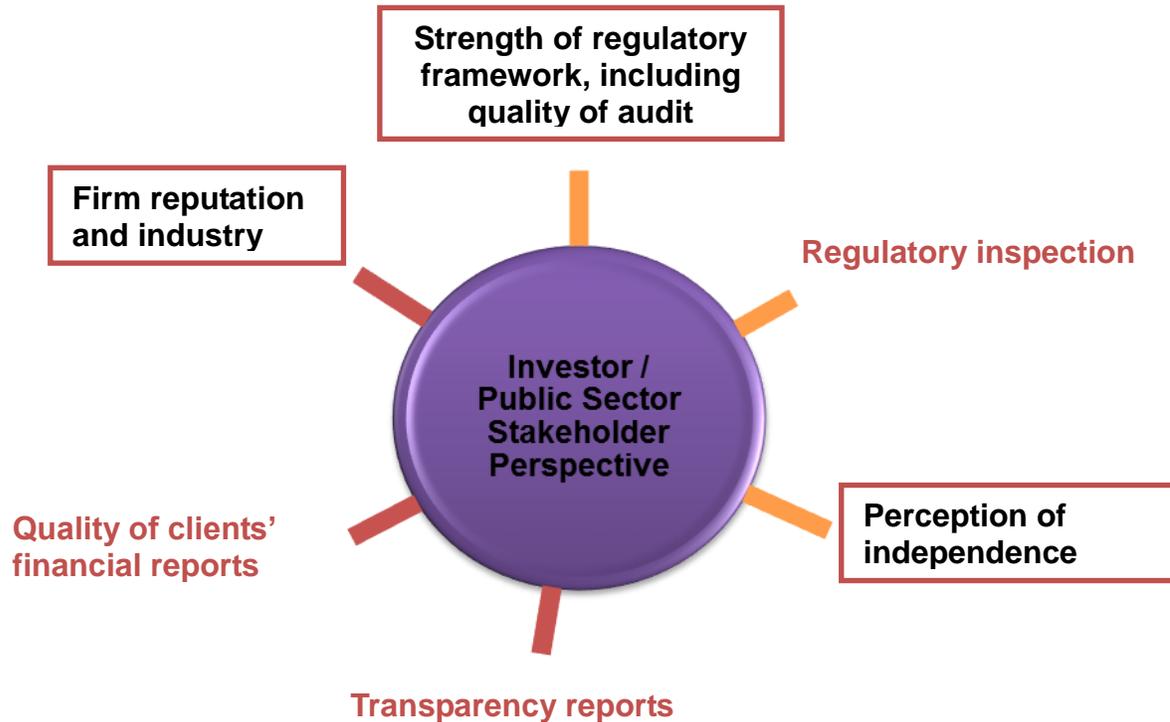
*Quality, Timeliness and Usefulness of Communications*

21. In relation to the quality, timeliness and usefulness of communications, audit committees value auditor communications that provide:
- Unbiased insights regarding the performance of management in fulfilling its responsibilities for the preparation of the financial statements.
  - Insight into the entity's financial reporting practices.
  - Recommendations for improvement to the entity's financial reporting process.
  - Information that enable them to effectively fulfill their governance responsibilities.

*Independence from Management*

22. Audit committees value the objectivity of the auditors and their willingness, where necessary, to take differing views from management and perhaps the audit committee itself.

### 1.3 Institutional Investors and Public Sector Stakeholders



23. Based on the survey, it seems that the most important factors that are likely to influence the perceptions of audit quality of institutional investors and public sector stakeholders are:
- Firm Reputation and Perceived Industry Expertise;
  - Perception of Independence; and
  - The Strength of the Regulatory Framework Surrounding Audit.

#### *Firm Reputation and Industry Expertise*

24. From an institutional investors' perspective, a firm's reputation and perceived industry expertise may be gauged through the firm's branding, its client list, and whether it has clients in the same industry.
25. The firm's client list can have an important impact on investors' perceptions of audit quality. A roster of high profile clients may be seen by investors as an implicit endorsement of quality on the presumption that such clients would not engage the firm if it did not offer a high-quality audit.

26. Investors may also view a firm that has many audits in the same industry as indicative of audit quality. This is on the presumption that entities competing in the same industry would not engage the same firm if it did not have the industry expertise and experience to meet their audit needs.

*Perception of Independence*

27. Institutional investors may form their perceptions of auditor independence in a number of ways, such as:
- The existence of a designated role for audit committees to consider auditor independence, including the provision of non-audit services.
  - The magnitude of fees for non-audit services
  - Robust regulatory requirements governing auditor independence, e.g. periodic rotation of audit engagement partners.
  - Reports from audit regulators of the results of their monitoring of regulatory requirements.
  - Firms resigning from the audit engagement if there are independence issues or withdrawing from other client relationships where appropriate.

*Strength of the Regulatory Framework Surrounding Audit*

28. The strength of the regulatory framework that surrounds the audit can be a significant influence on investor perceptions of audit quality. Investors look for robust mechanisms for ensuring adequate oversight of the audit firms, including provisions for adequate sanctions for poor quality or negligent audit work.
29. A strong system of corporate governance is also valued, Effective audit committees are thought likely to lead to effective audits. A number of investors observed that a strong audit committee gave them reassurance about the likely quality of the audit undertaken. This was particularly the case when the audit committee had described the work undertaken by them on audit effectiveness in the entity’s annual report.

*Other Factors*

Factor	Description
Quality of Clients’ Financial Reports, Periodic Disclosures Including	<p>The overall quality of the entity’s financial report can lead to perceptions of audit quality., including</p> <ul style="list-style-type: none"> <li>• The understandability and transparency of disclosures in significant areas, for example, going concern, measurement uncertainty, and transactions involving difficult substance-over-form issues.</li> <li>• The quality of the entity’s accounting policies and practices.</li> </ul>
Regulatory inspection reports	Findings from published regulatory inspection reports influence investors’ perceptions of audit quality as do the results of disciplinary findings.

Factor	Description
Transparency reports	A number of investors responded to the survey by observing that transparency reports (see paragraphs 159-160) can influence their perceptions of the quality of the audit firm.

*Public Sector Stakeholders*

30. Many of the factors affecting perceptions of audit quality for institutional investors and audit committees are likely to influence in similar ways perceptions of audit quality for primary public sector users. However, the latter’s expectations may differ in the sense that these often go beyond the financial aspects of the audit.
31. In addition to the factors applicable to audit committees as described above, the following aspects of reporting and communication by Public Sector Audit Institutions can contribute to primary public sector users’ views on audit quality:
  - Insight into the operations and financial reporting practices unique to public sector entities;
  - Constructive and timely recommendations in areas of performance (including value for money) and compliance with relevant mandates;
  - Fair, unbiased and politically neutral reporting;
  - Well-balanced and educational reports in the appropriate contexts.

## Key Questions for Audit Firms Relating to Attributes of Audit Quality

Set out below are those attributes of the Audit Quality Framework which are likely to be relevant to audit firms, together with possible questions that may help identify areas where they can make improvements to audit quality.

Attributes	Questions
<b><i>Value, Attitudes and Culture</i></b>	
Governance arrangements are in place that establish the appropriate “tone at the top.”	<ul style="list-style-type: none"> <li>• Is your firm proactive in strengthening governance arrangements; for example, by appointment of independent, non-executive members to the governing boards?</li> <li>• Have the firm’s values been clearly communicated to all partners and staff?</li> <li>• Are the results of internal monitoring of audit quality reported to the Firm’s leadership?</li> <li>• Are all complaints and allegations against the firm documented and evaluated? Does the firm’s leadership monitor them?</li> </ul>
The firm promotes the personal characteristics essential to audit quality.	<ul style="list-style-type: none"> <li>• Do you promote a culture that recognizes and rewards high quality work?</li> <li>• Do you evaluate partners and staff using competency frameworks that include audit quality?</li> <li>• Do you reward the development and maintenance of competence and commitment to ethical principles?</li> <li>• Do you recruit high quality individuals of integrity who have the capacity to develop the necessary competencies?</li> <li>• Do you emphasize the need for continuing training for all levels of firm personnel, and provide the necessary training resources and assistance to enable personnel to develop and maintain the required competence and capabilities?</li> <li>• Are procedures in place to manage differences of opinion within the engagement team or between</li> </ul>

Attributes	Questions
	partners?
Financial considerations do not drive actions and decisions that have a negative effect on audit quality.	<ul style="list-style-type: none"> <li>• Does the leadership of the audit function have sufficient input into overall firm management decisions?</li> <li>• Do you avoid over-emphasizing winning audit appointments and the retention of audit clients at the expense of the quality of audit judgments?</li> <li>• Do you avoid over-emphasizing marketing non-audit services?</li> <li>• Do you avoid excessive cost cutting (including by reducing partners and staff) in the audit practice during times of economic downturn that damage the provision of audit quality?</li> <li>• Do you measure the resources spent on quality control activities and monitor these over time?</li> </ul>
The firm provides partners and staff with access to high-quality technical support.	<ul style="list-style-type: none"> <li>• Are sufficient resources allocated to developing the firm's quality control policies and procedures?</li> <li>• Are sufficient technical resources made available to support engagement teams?</li> <li>• Does a "Helpline" exist? If so, are calls recorded and is there periodic analysis to identify systemic issues which need to be addressed?</li> <li>• Have you developed an appropriate information infrastructure to: <ul style="list-style-type: none"> <li>○ Support audit judgments?</li> <li>○ Track independence issues?</li> <li>○ Plan and effectively manage the rotation of partners and managers on audit engagements?</li> </ul> </li> </ul>
The firm promotes a culture of consultation on difficult issues.	<ul style="list-style-type: none"> <li>• Is there sufficient consultation on difficult or contentious issues?</li> <li>• Is consultation seen as being a strength in the firm's culture?</li> <li>• Are sufficient resources made available to enable appropriate consultation?</li> <li>• Are the results of consultations documented?</li> <li>• Are there agreed procedures for resolving</li> </ul>

Attributes	Questions
	differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer?
Robust systems exist for making client acceptance and continuance decisions.	<ul style="list-style-type: none"> <li>• Are there strong client acceptance and continuance systems?</li> <li>• Are they complied with?</li> <li>• Do the client acceptance and continuance systems deal with the integrity of owners, those charged with governance and management?</li> </ul>
<b><i>Knowledge, Experience and Time</i></b>	
Partners and staff have sufficient time and resources to deal with difficult issues as they arise.	<ul style="list-style-type: none"> <li>• Is there a system for monitoring partner and senior management time commitments and availability to avoid placing unreasonable requirements on them?</li> <li>• Is there excessive pressure on engagement teams to achieve a certain margin or to reduce time by set amounts?</li> <li>• Are fee estimates agreed with clients realistic?</li> </ul>
Engagement teams are properly structured and have sufficient time	<ul style="list-style-type: none"> <li>• Is the culture of the firm such as to ensure that engagement teams are adequately resourced?</li> <li>• Does the firm have policies for when specialists need to be involved?</li> <li>• Are partners and staff rotated in accordance with professional standards and applicable legal and regulatory requirements?</li> <li>• Is succession planning undertaken to reduce risks to audit quality when partners change?</li> </ul>
Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.	<ul style="list-style-type: none"> <li>• Are appraisals provided on a timely basis?</li> <li>• Do appraisals deal with audit quality?</li> <li>• Are partners and senior staff encouraged to provide appropriate coaching or “on-the-job” training to more junior staff?</li> <li>• Are partners and staff monitored on whether they provide coaching or “on-the-job” training?</li> </ul>
Sufficient training is given to audit partners	<ul style="list-style-type: none"> <li>• Does the firm emphasize the need for continuing</li> </ul>

Attributes	Questions
and staff on audit, accounting and, where appropriate, specialized industry issues.	<p>professional development (CPD) for all levels of firm personnel?</p> <ul style="list-style-type: none"> <li>• Are CPD records maintained and monitored?</li> <li>• Does it provide the necessary training resources and assistance to enable personnel to develop and maintain the required competence and capabilities?</li> <li>• Is on-site direction and supervision of less experienced engagement team members by more experienced team members adequate?</li> </ul>
<b>Audit Process</b>	
The audit process is adapted to developments in professional standards and is responsive to findings from internal quality control reviews and external inspections.	<ul style="list-style-type: none"> <li>• Does firm leadership give due recognition to the importance of responding constructively to regulatory inspection findings, including taking steps where necessary to improve the audit process?</li> <li>• Are adequate resources provided to support the audit methodology and ensure it is updated as needed?</li> <li>• Is the methodology updated on a timely basis in response to developments in professional standards and from the results of internal and external monitoring?</li> </ul>
The audit methodology does not discourage individual team members from thinking creatively, applying skepticism and exercising judgment.	<ul style="list-style-type: none"> <li>• Does the firm emphasize the use of professional judgment and skepticism and provide training and support to partners and staff?</li> <li>• Is the application of professional judgment embedded in appraisal, promotion and remuneration processes?</li> </ul>
The audit methodology makes effective use of technology.	<ul style="list-style-type: none"> <li>• Is the methodology computerized?</li> <li>• If so does the system provide sufficient flexibility for team members to think creatively, applying skepticism and exercising judgment?</li> </ul>
The methodology requires effective supervision and review of audit work.	<ul style="list-style-type: none"> <li>• Are partners and managers discouraged from reviewing audit work “off-site” using computerized systems?</li> </ul>
The methodology requires appropriate audit	<ul style="list-style-type: none"> <li>• Is guidance given on the nature and extent of</li> </ul>

Attributes	Questions
documentation.	<p>documentation required?</p> <ul style="list-style-type: none"> <li>• Does the firm have appropriate policies for the safe custody of working papers? If electronic systems are used, do arrangements ensure that information is kept confidential and is properly protected and can be accessed?</li> </ul>
Audit quality is monitored and appropriate consequential action is taken.	<ul style="list-style-type: none"> <li>• Are there strong systems for internal monitoring of audit quality?</li> <li>• Is monitoring undertaken by partners and staff who are independent from those performing the work?</li> <li>• Are the results of monitoring communicated within the firm?</li> <li>• Are actions taken to address weaknesses in the firm's procedures and methodology?</li> <li>• Are actions taken to address partner or staff failings?</li> </ul>
Where required, effective engagement quality control reviews (EQCRs) are undertaken	<ul style="list-style-type: none"> <li>• Are sufficiently experienced partners allocated to undertake EQCRs?</li> <li>• Are EQCRs monitored to ensure they are undertaken on a timely basis and that any disagreements have been satisfactorily resolved?</li> <li>• Is a review undertaken to ensure that EQCRs are undertaken when required by the firm's policies?</li> </ul>

## Key Questions for Audit Committees Relating to Attributes of Audit Quality

Set out below are those attributes of the Audit Quality Framework which are likely to be relevant to audit committees, together with possible questions that may help identify areas where they can make improvements to audit quality.

Attributes	Questions
<b><i>Interactions Between the Audit Committee and:</i></b>	
Management	<ul style="list-style-type: none"> <li>• Are audit committee members sufficiently independent of management and financially literate?</li> <li>• Does management openly raise issues related to financial reporting and regulation with the audit committee on a timely basis?</li> <li>• Does management openly discuss the assumptions behind significant accounting judgments involved in the financial reporting process?</li> <li>• Does management openly discuss with the audit committee areas where the financial reporting process may be strengthened?</li> <li>• Does management provide the audit committee with reliable information on a timely basis?</li> <li>• Does management provide the audit committee with a draft of the complete annual report and react appropriately to comments on overall presentation issues?</li> <li>• Has the audit committee created an environment in which management is not resistant to being challenged by the auditors and are not overly defensive when discussing difficult or contentious matters</li> </ul>
The auditor	<ul style="list-style-type: none"> <li>• Is there effective two-way communication with the auditors?</li> <li>• Did the auditors discuss the planned approach to the audit on a timely basis?</li> <li>• Did the auditors discuss the significant findings from the audit on a timely basis?</li> </ul>

Attributes	Questions
	<ul style="list-style-type: none"> <li>• Did the audit committee provide the auditors with their views on financial reporting risks and areas of the business that warrant particular audit attention?</li> <li>• Did the audit committee discuss with the auditor whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this?</li> <li>• Does the audit committee, on occasion, meet with the auditors without management in attendance?</li> </ul>
Users of the financial statements	<ul style="list-style-type: none"> <li>• Does the annual report contain information about the activities of the audit committee?</li> </ul>
<b><i>Values, Attitude and Culture of the auditors</i></b>	
<p>The engagement team appears to recognize that the audit is performed in the interests of the entity's shareholders and the wider public interest. The engagement team exhibits:</p> <ul style="list-style-type: none"> <li>• Professional skepticism;</li> <li>• Objectivity and integrity; and</li> <li>• Professional competence and due care.</li> </ul>	<ul style="list-style-type: none"> <li>• Are the engagement partner and the rest of the team prepared to challenge management judgments?</li> </ul>
The engagement team is independent.	<ul style="list-style-type: none"> <li>• Does the engagement partner discuss independence issues with the audit committee?</li> <li>• Is the audit committee involved in approving non-audit services?</li> <li>• Has the engagement partner been "rotated" in accordance with ethical requirements?</li> </ul>
<b><i>Knowledge, Experience and Time of the auditors</i></b>	
Partners and staff understand the entity's business.	<ul style="list-style-type: none"> <li>• Do partners and senior staff demonstrate a good understanding of the entity's business?</li> <li>• Where necessary, is the engagement team supported by an industry specialist group within the firm?</li> <li>• Has a reasonable degree of continuity been achieved in the staffing of the engagement team from one year to the next?</li> </ul>
Partners and staff have the necessary skills and	<ul style="list-style-type: none"> <li>• When important audit judgments have been</li> </ul>

Attributes	Questions
experience to make sound judgments.	<p>discussed with the audit committee do they appear to be:</p> <ul style="list-style-type: none"> <li>○ Objective;</li> <li>○ Well researched; and</li> <li>○ Reasonable?</li> </ul>
The audit engagement partner is actively involved in the work performed and staff performing detailed “on-site” audit work are appropriately supervised and reviewed.	<ul style="list-style-type: none"> <li>• Is the engagement partner often seen on site working with the team?</li> </ul>
The audit engagement partner and other experienced members of the audit team are accessible to management and the audit committee.	<ul style="list-style-type: none"> <li>• Have the engagement partner and other senior members of the engagement team been readily accessible to management and the audit committee throughout the engagement?</li> </ul>
Partners and staff have sufficient time to undertake the audit in an effective manner.	<ul style="list-style-type: none"> <li>• Has the engagement team experienced undue time constraints during the course of the audit?</li> </ul>
<b><i>Audit Process of the auditors</i></b>	
There is effective engagement with internal auditors where applicable.	<ul style="list-style-type: none"> <li>• Does the degree of interaction between the external auditor and the internal audit function seem appropriate?</li> </ul>
The group audit is effectively managed.	<ul style="list-style-type: none"> <li>• Does the group auditor efficiently co-ordinate the work undertaken at components?</li> <li>• Does the group auditor effectively engage with component auditors?</li> <li>• Is a consistent methodology used for the audit of components?</li> </ul>
The engagement team works with management so as to achieve audit efficiency.	<ul style="list-style-type: none"> <li>• Is management notified of potential audit and financial reporting issues, including those arising from changes in standards and regulation on a timely basis?</li> <li>• Does there appear to be timely engagement with management on resolving issues identified during the audit?</li> <li>• Have the auditors met agreed timelines and reporting deadlines?</li> </ul>
<b>Outputs of the auditors</b>	<ul style="list-style-type: none"> <li>• Are reports to the audit committee clear, valuable and timely?</li> </ul>