

International Auditing and Assurance Standards Board (IAASB)  
Consultation Paper  
January 2013

# A Framework for Audit Quality [Draft]

Comment Deadline: *[Date, 2013]*

The International Auditing and Assurance Standards Board (IAASB) seeks comments from all stakeholders on the consultation paper, *A Framework for Audit Quality* (the “Framework”). In particular, it is seeking views on whether the Framework is clear, comprehensive and useful.

The IAASB believes the development of the Framework to be in the public interest as it aims to contribute to improving audit quality. It describes a number of factors (inputs, outputs, interactions, and contextual factors) that contribute to maximizing the likelihood of quality audits being consistently performed and encourages 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.

While the primary responsibility for performing 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. In developing the Framework the IAASB has identified, at times with the input of stakeholders, 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.

These are described as “Areas to Explore” and have been outlined in Appendix 1 of the Framework. 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.

The IAASB seeks comments in response to the following questions:

1. Does the Framework cover all of the areas of audit quality that you would expect? If not, what else should be included?
2. Does the Framework reflect the appropriate balance of responsibilities for audit quality between the auditor (engagement team and firm), the entity (management and those charged with governance), and other stakeholders? If not, which areas of the Framework should be revised and how?
3. Will you use the Framework and, if so, how? Are there changes that need to be made to the form or content of the Framework to maximize the value to you?
4. What are your views on the suggested Areas to Explore? Which, if any, should be given priority and by whom? Should further Areas to Explore be identified and included in the framework?

Respondents are asked to submit their comments electronically through the IAASB website, using the [link to Framework to be provided], no later than [Date, 2013]. Please submit comments in both a PDF and Word file. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. Although IAASB prefers that comments are submitted via its website, comments can also be sent to James Gunn, IAASB Technical Director at [jamesgunn@iaasb.org](mailto:jamesgunn@iaasb.org).

#### *Stakeholder Survey*

To partly inform the development of the framework, 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.

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. They were also requested to add other factors not on the list and provide comments.

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>

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. Detailed discussion of the survey results is available at: [www.iaasb.org/xxx](http://www.iaasb.org/xxx).

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 Framework for Audit Quality and the links are as follows:

Key			
M:	Management	✓	Considered important
AC:	Audit Committees	✓	Considered very important
Inv:	Institutional investors and public sector stakeholders		

Factor	M	AC	Inv	Attribute <sup>1</sup>	Comments
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 13-15 and 52.
Engagement efficiency	✓			1.7.4	
Efficient use of management's time and resources		✓		1.7.4	
Engagement team competence and continuity	✓			1.4.1, 1.4.2, 1.4.3 and 1.4.5	
Competence of senior team		✓		1.4.1, 1.4.2 and 1.4.3	
Communications: quality usefulness, timeliness	✓	✓		2 and 3	

<sup>1</sup> Refer table at paragraph 29, *Summary of Attributes*.

Factor	M	AC	Inv	Attribute <sup>1</sup>	Comments
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 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	✓	✓		1.1, 1.2 and 1.3	
Partner accessibility	✓	✓		1.4.7	
Knowledge and experience of entity and industry	✓	✓		1.4.2	
Independence from management		✓		1.1.3	
Perceptions of independence			✓	1.1.3	
Strength of regulatory framework, including quality of audit committee			✓	4.1, 4.2 and 4.4	
Regulatory inspection			✓	1.9.2	
Transparency reports			✓	2.2.1	
Quality of client's financial reports			✓	2.1.5	

# **A FRAMEWORK FOR AUDIT QUALITY**

**Version 1.3 – November 2012**

### **IAASB's Vision for the Framework**

The objectives of the Framework for Audit Quality include:

- Raising awareness of the key elements of audit quality;
- Encouraging key stakeholders to explore ways to improve audit quality; and
- Facilitating greater dialogue between key stakeholders on the topic.

The IAASB expects that the framework will generate discussion, and positive actions for a continual improvement to audit quality.

Auditors are required to comply with relevant auditing standards and standards of quality control within audit firms, as well as ethics and other regulatory requirements. The framework is not a substitute for such standards, nor does it establish additional standards or provide procedural requirements for the performance of audit engagements.

## Foreword from the IAASB Chairman

Recent financial conditions 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 continual improvement to audit quality.

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. Audit quality is a complex subject and there is no definition or analysis of it that has achieved universal recognition.

In the IAASB’s view, a 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 resources allocated to perform the audit work;
- Applied a rigorous audit process and quality control procedures, applying high-quality standards and complying with relevant laws and regulations;
- Provided valuable and timely reports; and
- Interacted appropriately with a variety of different stakeholders.

Many factors contribute to maximizing the likelihood of 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.

For this reason, the IAASB has undertaken a project to develop a Framework for Audit Quality (“Framework”) that describes the input and output factors that contribute to audit quality at the engagement, audit firm and national levels. The Framework also demonstrates the importance of appropriate interactions among stakeholders and the importance of various contextual factors.

The IAASB believes that such a Framework for Audit Quality will be in the public interest as it will:

- Encourage national audit firms, global networks, and professional accountancy organizations 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 encourage them to consider their roles in enhancing it;
- Assist standard setting. For example, it could facilitate the IAASB’s consideration of whether there are areas in the standards, including International Standard on Quality Control (ISQC) 1<sup>2</sup> that may

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<sup>2</sup> ISQC 1 requires audit firms to establish and maintain a system of quality control to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and that reports issued by the firm or engagement partners are appropriate in the circumstances.

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.

This Consultation Paper sets out the proposed Framework—which is summarized in the second section, titled *A Framework for Audit Quality: Executive Summary*—and invites comments from stakeholders on whether it is clear, comprehensive and useful.

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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.

## The Challenges of Defining Audit Quality

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>3</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 appropriate 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, or, where such changes are not made, to ensure that the auditor’s report is appropriately qualified.
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, including that:
  - The existence, or lack, of material misstatements in the audited financial statements provides only a partial insight into audit quality.
  - Audits vary and what is considered to be sufficient appropriate audit evidence to support an audit opinion is, to a degree, 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 may be an indicator of audit failure. However, the absence of material misstatements in the financial statements cannot, of itself, be the only measure of audit quality because if there were no material misstatements to detect, but the audit performed was flawed, it would not have detected material misstatements even if they had existed.

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<sup>3</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. 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>4</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>5</sup>
8. An audit process that is designed to provide reasonable, rather than absolute, assurance means that there is a possibility of undetected material misstatements. 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.
9. 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 to Support an Audit Opinion, is, to a Degree, Judgmental*

10. 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 audit 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.
11. 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>6</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 ethics requirements, audit firms may have a short term incentive to limit the work performed while recognizing that in the longer term, 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.

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<sup>4</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>5</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>6</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.

*Perspectives of Audit Quality Vary amongst Stakeholders*

12. The perspectives 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.
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 quality of an audit would be higher, the more resources (both in quantitative and qualitative terms) that are allocated to an audit.
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. By considering audit quality from this perspective, management 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.

## A Framework for Audit Quality: Executive Summary

18. Auditors are responsible for the quality of individual audits, and should aim to ensure that quality audits are consistently performed. A 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 resources 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 enhancing audit quality within a jurisdiction, and maximizing the likelihood of 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.
20. The Framework described in this paper sets out the key attributes that are conducive to audit quality, reflecting the different perspectives of stakeholders. 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.
21. The Framework applies to audits of all entities and all audit firms regardless of size, including audit firms which are part of a network or association. However, the attributes can vary in importance and affect audit quality in subtly different ways. In particular:
  - the Framework 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; and
  - aspects of the Framework may have specific impacts on the audits of smaller entities.

Section 5 of the Framework, *Considerations Relating to Specific Audits*, provides additional commentary.

22. The Framework distinguishes the following elements:



#### *Inputs*

23. Inputs are grouped into the following categories:

- (a) The values, ethics and attitudes of 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.

24. 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.

25. 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*

26. 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 currently this is relatively standardized.

*Interactions amongst Key Stakeholders*

27. 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*

28. There are a number of contextual factors that can facilitate financial reporting quality, including corporate governance 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**

29. The IAASB’s Framework contains the following attributes. The numbering of each of these inputs, outputs, and contextual factors in the following table corresponds to the section and sub-section number on the following pages.

Framework Element	Attributes
<p><b>1. INPUTS</b></p> <p><b>INPUTS – Values, Ethics, Attitudes</b></p>	<p><b>1.1 Engagement Level</b></p> <p>1.1.1. The engagement team recognizes that the audit is performed in the wider public interest.</p> <p>1.1.2. The engagement team exhibits objectivity and integrity.</p> <p>1.1.3. The engagement team is independent.</p> <p>1.1.4. The engagement team exhibits professional competence and due care.</p> <p>1.1.5. The engagement team exhibits professional skepticism.</p> <p><b>1.2 Firm Level</b></p> <p>1.2.1. Governance arrangements are in place that establish independence and the appropriate “tone at the top.”</p> <p>1.2.2. The firm promotes the personal characteristics essential to audit quality.</p> <p>1.2.3. Financial considerations do not drive actions and decisions that may have a negative effect on audit quality.</p>

Framework Element	Attributes
	<p>1.2.4. The firm emphasizes the importance of providing partners and staff access to high quality technical support.</p> <p>1.2.5. The firm promotes a culture of consultation on difficult issues.</p> <p>1.2.6. Robust systems exist for making client acceptance and continuance decisions.</p> <p><b>1.3 National Level</b></p> <p>1.3.1. Ethics requirements are promulgated which make clear both the underlying ethics principles and the specific requirements that apply.</p> <p>1.3.2. Regulators and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied.</p> <p>1.3.3. Information relevant to client acceptance decisions is shared between audit firms.</p>
<p><b>INPUTS – Knowledge, Experience and Time</b></p>	<p><b>1.4 Engagement Level</b></p> <p>1.4.1. Partners and staff have the necessary competencies.</p> <p>1.4.2. Partners and staff understand the entity’s business.</p> <p>1.4.3. Partners and staff make reliable judgments.</p> <p>1.4.4. The audit engagement partner is actively involved in risk assessment, planning, supervising, and reviewing the work performed.</p> <p>1.4.5. 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.</p> <p>1.4.6. Partners and staff have sufficient time to undertake the audit in an effective manner.</p> <p>1.4.7. The audit engagement partner and other experienced members of the audit team are accessible to management and those charged with governance.</p> <p><b>1.5 Firm Level</b></p> <p>1.5.1. Partners and staff have sufficient time and resources to deal with difficult issues as they arise.</p> <p>1.5.2. Engagement teams are properly structured and have sufficient time.</p> <p>1.5.3. Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.</p> <p>1.5.4. Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.</p> <p><b>1.6 National Level</b></p> <p>1.6.1. Robust arrangements exist for licensing audit firms/individual auditors.</p> <p>1.6.2. Systems exist to provide appropriate training to auditors.</p> <p>1.6.3. Arrangements exist for briefing auditors on current issues and for</p>

Framework Element	Attributes
	<p>providing training to them in accounting, auditing or regulatory requirements.</p> <p>1.6.4. The auditing profession is well positioned to attract and retain high quality individuals.</p>
<p><b>INPUTS – Audit Process and Quality Control Procedures</b></p>	<p><b>1.7 Engagement Level</b></p> <p>1.7.1. The engagement team complies with auditing standards and the firm’s quality control procedures.</p> <p>1.7.2. The engagement team makes proper use of information technology.</p> <p>1.7.3. There is effective interaction with others involved in the audit including, where applicable, internal auditors.</p> <p>1.7.4. There are appropriate arrangements with management so as to achieve audit efficiency.</p> <p>1.7.5. There is appropriate audit documentation.</p> <p><b>1.8 Firm Level</b></p> <p>1.8.1. The audit methodology is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.</p> <p>1.8.2. The audit methodology encourages individual team members to think creatively, apply professional skepticism and exercise appropriate professional judgment.</p> <p>1.8.3. The methodology requires effective supervision and review of audit work.</p> <p>1.8.4. The methodology requires appropriate documentation.</p> <p>1.8.5. Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action is taken.</p> <p>1.8.6. Where required, effective engagement quality control reviews are undertaken.</p> <p><b>1.9 National Level</b></p> <p>1.9.1. Auditing standards are promulgated which make clear the underlying objectives as well as the specific requirements that apply.</p> <p>1.9.2. Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.</p> <p>1.9.3. Effective systems exist for investigating allegations of audit failure and taking disciplinary action when appropriate.</p>
<p><b>2. OUTPUTS</b></p>	<p><b>2.1 Engagement Level</b></p> <p><b>From the Auditors</b></p> <p>2.1.1. The reliability and usefulness of audit reporting to users of audited financial statements</p>

Framework Element	Attributes
	<p>2.1.2. The value and timing of auditor reports to those charged with governance</p> <p>2.1.3. The value and timing of auditor reports to management</p> <p>2.1.4. The value and timing of auditor reports to regulators</p> <p><b>From the Entity</b></p> <p>2.1.5. The audited financial statements</p> <p>2.1.6. Reports from those charged with governance, including audit committees</p> <p><b>From Audit Regulators</b></p> <p>2.1.7. Reports from audit regulators</p> <p><b>2.2 Firm and National Levels</b></p> <p><b>From the Audit Firm</b></p> <p>2.2.1. Transparency reports</p> <p>2.2.2. Annual reports</p> <p><b>From Audit Regulators</b></p> <p>2.2.3. Reports from audit regulators</p>
<p><b>3. INTERACTIONS</b></p>	<p><b>Effective Interactions Between:</b></p> <p><b>Auditors</b> and management, those charged with governance, users, regulators</p> <p><b>Management</b> and those charged with governance, regulators, users</p> <p><b>Those charged with governance</b> and regulators, users</p> <p><b>Regulators</b> and users</p>
<p><b>4. CONTEXTUAL FACTORS</b></p>	<p>4.1. <b>Business practices and commercial law</b></p> <p>4.2. <b>Laws and regulations relating to financial reporting</b></p> <p>4.3. <b>The applicable financial reporting framework</b></p> <p>4.4. <b>Corporate governance</b></p> <p>4.5. <b>Information systems</b></p> <p>4.6. <b>Financial reporting timetable</b></p> <p>4.7. <b>Broader cultural factors</b></p>



## 1. Input Factors

30. Quality audits involve auditors in:

- 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.

31. 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. Each attribute and level is described in separate sections.

	Engagement Level	Firm Level	National Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Audit Process and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

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

32. 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 objectivity and integrity.
- The engagement team is independent.

	Engagement Level	Firm Level	National Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Audit Process and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

<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.



- The engagement team exhibits professional competence and due care.
- The engagement team exhibits professional skepticism.

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

33. 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. For this reason the audit team needs to provide an appropriate degree of challenge to management and make appropriate judgments.

1.1.2 *The Engagement Team Exhibits Objectivity and Integrity*

34. 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>

35. 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. Few items included in the financial statements can be measured with absolute certainty, and many involve estimation and therefore judgment. Auditors need to be objective when they evaluate management judgments to reduce the risk that the financial statements are materially misstated by management, whether deliberately or inadvertently, making a biased judgment or following an otherwise inappropriate accounting practice.

36. 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.

1.1.3 *The Engagement Team is Independent*

37. Independence is required to safeguard individual members of the engagement team or the audit firm from 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).

38. Threats to 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 may believe that their remuneration and, indeed, their ongoing careers with the audit firm are dependent on retaining an audit client, creating a familiarity threat.

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



- Situations where a former member of the audit team, or partner of the firm, has joined the audited entity in a position to exert significant influence over the preparation of the accounting records and financial statements.
39. 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. 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.
40. 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 key audit partners of public interest entities to change (or "rotate") after seven years; ethics 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. Others believe that retaining the same firm is likely to assist the auditors in understanding the entity's business and systems and result in effective responses to business risks as well as audit efficiency.

#### *1.1.4 The Engagement Team Exhibits Professional Competence and Due Care*

41. 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.

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

42. Professional skepticism is an attitude that includes 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.
43. 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.
44. 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;



- 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.

## 1.2 Values, Ethics and Attitudes – Firm Level

45. 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.

	Engagement Level	Firm Level	Global Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Tenure	Section 1.4	Section 1.5	Section 1.6
Quality Assurance and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

46. Key attributes in relation to creating a culture where audit quality is valued are:

- Governance arrangements are in place that establish independence and 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.

### 1.2.1. Governance Arrangements Are in Place that Establish Independence and the Appropriate “Tone at the Top”

47. 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 ethics requirements that apply to auditors.
48. 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 inappropriately promoting other practice areas (such as tax, corporate finance and consultancy) to the detriment of audit quality.

**Areas to Explore** – 1. *Establishing global guidance against which audit firms can assess their governance arrangements.* (Refer Appendix 1)



### *1.2.2. The Firm Promotes the Personal Characteristics Essential to Audit Quality*

49. Appropriate personal characteristics, including integrity, objectivity, professional competence and due care, need to be nurtured and developed by the firm. This involves embedding these characteristics in recruitment selection criteria and in 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.

**Areas to Explore** – 2. *Establishing a common understanding of competence, and how it is demonstrated and assessed, as it relates to audit quality for use by audit firms when recruiting, evaluating, promoting and remunerating partners and staff. (Refer Appendix 1)*

50. 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.

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

51. 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.

52. There should also not be:

- Emphasis on winning audit appointments and on the retention of audit clients, particularly at unrealistically low fees, at the expense of audit quality.
- Emphasis on marketing non-audit services to entities that the firm audits at the expense of undertaking a 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) to the detriment of audit quality.

### *1.2.4. The Firm Emphasizes the Importance of Providing Partners and Staff Access to High Quality Technical Support*

53. Auditing requires knowledge of a considerable number of technical areas including company and tax law, and financial reporting, auditing and ethics 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.

54. 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.

### *1.2.5. The Firm Promotes a Culture of Consultation on Difficult Issues*

55. A culture of consultation is important for all audit firms. 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.

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

- 56. 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 ethics requirements.
- 57. 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 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 quality audits.

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

58. 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:

	Engagement Level	Firm Level	Individual Level
<b>Values, Ethics and Attitudes</b>	Section 1.1	Section 1.2	Section 1.3
<b>Knowledge, Requirements and Tools</b>	Section 1.4	Section 1.5	Section 1.6
<b>Audit Processes and Quality Control Procedures</b>	Section 1.7	Section 1.8	Section 1.9

- Ethics requirements are promulgated which make clear both the underlying ethics principles and the specific requirements that apply;
- Regulators and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied; and
- Information relevant to client acceptance decisions is shared between audit firms.

1.3.1. *Ethics Requirements are Promulgated which Make Clear Both the Underlying Ethics Principles and the Specific Requirements that Apply*

- 59. Ethics requirements may be imposed by law or regulations or mandated through professional accountancy organizations. The International Federation of Accountants (IFAC) requires its member bodies to use their best endeavors to adopt the IESBA *Code of Ethics for Professional Accountants* (IESBA Code), and to assist in its implementation, when and to the extent possible under local circumstances. 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.
- 60. Ethics 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.



61. The IESBA Code establishes, and requires auditors to comply with, the following fundamental principles of professional ethics:<sup>9</sup>
- Integrity – to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.<sup>10</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.
62. 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.
63. 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>11</sup> In some situations, the IESBA Code recognizes that the threat created would be so significant that no safeguards could reduce the threat to an acceptable level; and accordingly an auditor is prohibited from undertaking the audit.
- 1.3.2. *Regulators and Professional Accountancy Organizations are Active in Ensuring that the Ethics Principles are Understood and the Requirements are Consistently Applied*
64. Consistent application of ethics requirements, and the principles that underlie them, is facilitated by guidance, training and support activities performed by regulators, professional accountancy organizations and others. This can include the issuance of guidance material such as answers to frequently asked questions as well as organizing interactive workshops.

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<sup>9</sup> IESBA Code, paragraph 100.5

<sup>10</sup> IESBA Code, Section 110

<sup>11</sup> IESBA Code, paragraph 290.7. Public sector audit bodies are, however, not usually able to resign from audit engagements.



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

65. 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.

**Areas to Explore** – 3. *Improving information sharing between audit firms when one firm decides to resign from, or is not reappointed to, an audit engagement.* (Refer Appendix 1)

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

66. 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

	Engagement Level	Peer Level	Internal Level
Time, Ethics, and Motivation	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Skills, Processes, and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

67. Key attributes are:

- Partners and staff have the necessary competencies.
- Partners and staff understand the entity’s business.
- 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 those charged with governance.

1.4.1. *Partners and Staff Have the Necessary Competencies*

68. 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, and that external specialists, or experts, are engaged as required. This may entail particular skills such as information technology or on particular financial reporting issues, either from within the audit firm or from external sources. If specialists and/or experts are involved, it is important, as with other members of the engagement team, that their work is appropriately directed, supervised and reviewed.
69. The need to involve information technology specialists increases with the complexity of information systems and the degree to which the entity is IT dependent.
70. The necessary competencies for auditors are described in International Education Standards (IESs) issued by the IAESB. The recent exposure draft of IES 8 categorizes these between 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.<sup>12</sup> Professional skills include interpersonal and communications skills, which are especially important on large audits involving large audit teams.

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

71. 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.
72. 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 broader 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 broader knowledge of business issues, risks, and control systems.

#### 1.4.3. *Partners and Staff Make Reliable Judgments*

73. 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.
74. Making reliable judgments may involve partners and staff:
  - Identifying the issue;
  - 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.

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<sup>12</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.



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

75. 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 disclosure of the engagement partner's name in the auditor's report should be required for all entities, as it would provide the engagement partner with a greater sense of personal accountability, as this individual is ultimately responsible for the conduct of the audit. In many jurisdictions this is already required, usually by a requirement for a personal signature. Others believe that such a requirement would have no impact on an engagement partner's sense of accountability, and there are potential impediments of such a requirement. In particular, with respect to a perceived reduction in the responsibility of the firm and the possibility of increased legal liability for the engagement partner in some jurisdictions.
76. 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.

*1.4.5. 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*

77. 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.
78. 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. Some believe that this is likely to result in effective responses to business risks as well as audit efficiency. However, prolonged involvement may result in a lack of skepticism and threats to auditor independence.

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

79. 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.
80. Audit firms are usually profit-making entities and the profitability of an audit firm is influenced by 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 are restricted by management, this may put pressure on the engagement team to reduce testing; which in turn potentially threatens audit quality.<sup>13</sup>

<sup>13</sup> Ethics requirements (for example, IESBA Code 240.2) often describe this threat and require it to be evaluated and, where appropriate, safeguards applied.



1.4.7. *The Engagement Partner and Other Experienced Members of the Audit Team are Accessible to Management and Those Charged With Governance*

81. 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.

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

82. 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:

	Engagement Level	Firm Level	Global Level
Name, Title, and Position	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Skills, Processes, and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

- 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.

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

83. 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.

84. Resource allocation also needs to take account of 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.

1.5.2. *Engagement Teams are Properly Structured and Have Sufficient Time*

85. 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 quality audits.

86. Allocating resources involves the firm gathering information on:

- Skills and experience;
- Estimated time commitments; and



- Periods of service – to facilitate compliance with ethics requirements, for example, in relation to the rotation of audit partners.

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

87. 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.
88. 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.
89. However, there is not an unlimited number of people with the experience to provide coaching. 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.

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

90. 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.
91. 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>14</sup> Merging learning about the technical aspects of auditing with gaining practical experience is important because formal training is only part of the process by which auditors develop skills and experience.
92. 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

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<sup>14</sup> IES 8, paragraphs 54 and 59, establishes requirements for practical experience for audit professionals.



**1.6 Knowledge, Experience and Time – National Level**

93. 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.
- Systems exist to provide appropriate training
- 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.

	Engagement Level	Firm Level	Referral Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Audit Processes and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

*1.6.1. Robust Arrangements Exist for Licensing Audit Firms/Individual Auditors*

94. 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.

*1.6.2. Systems Exist to Provide Appropriate Training to Auditors*

95. Criteria for obtaining a license will usually involve educational requirements both for IPD and CPD. Audit quality will be facilitated if educational requirements are clearly defined and appropriately delivered.

96. 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 written for IFAC member bodies (which may 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.

*1.6.3. Arrangements Exist for Briefing Auditors on Current Issues and for Providing Training to Them in Accounting, Auditing or Regulatory Requirements*

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

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



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

99. 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.
100. 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; and
  - The quality of training provided.
101. The same factors are likely to influence individuals' decisions to remain in the auditing profession, and pursue 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.
102. The status of the auditing profession in a national environment can also impact the respect for auditors 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.

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

103. Audits need to be performed in accordance with auditing standards and are subject to the audit firm's quality control procedures which comply with the IAASB's ISQC1. 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.

	Engagement Level	Plan Level	Method Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Audit Process and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

104. While auditing standards and the audit firm's methodology 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, relevant laws and regulations, 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 interaction with management so as to achieve audit efficiency.
- There is appropriate audit documentation.

*1.7.1. The Engagement Team Complies with Auditing Standards, Relevant Laws and Regulations, and the Audit Firm's Quality Control Procedures*

105. 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.

106. 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. ISA 600<sup>15</sup> requires 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.

*1.7.2. The Engagement Team Makes Proper Use of Information Technology*

107. The automation of information systems provides opportunities for auditors to gather audit evidence; for example, through the use of computer-assisted audit techniques including file interrogations and the use of test data. These techniques have the advantage that greater coverage of transactions and controls can be achieved. However, sometimes the use of such techniques requires the involvement of specialists, which can be time consuming, especially in the first year that they are used.

108. Information technology platforms within audit firms have an effect on the way auditors conduct an audit and record the work performed. Increasingly methodologies are computerized. While this can result in efficiencies and improved quality control processes, risks to audit quality associated with their use include:

- Over-emphasizing compliance with the audit firm's system rather than encouraging thinking about the unique characteristics of the entity being audited.
- New staff spending too much of their time learning how to use the firm's systems rather than understanding the principles of auditing, and
- Partners and experienced staff reviewing audit work from remote locations and thereby reducing the opportunities for mentoring and on-the-job training.

109. Information technology also has an effect on the way auditors communicate, both within audit teams and with management and those charged with governance. For example, e-mails and other professional service automation tools are increasingly being 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

<sup>15</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, identifies the objectives and requirements of the auditor when acting as an auditor of group financial statements.



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.

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

110. Others involved in the audit could include specialists and experts (for example, IT specialists), 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.

111. 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.

*1.7.4. There are Appropriate Arrangements with Management so as to Achieve Audit Efficiency*

112. 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. While auditors need to gather sufficient appropriate audit evidence in all circumstances, audit efficiency can be achieved 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.

113. 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 or association. Others believe that having a number of different audit firms involved in a group audit provides an opportunity for a range of views on the risks of the entity, and appropriate audit responses, to be considered. 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.

*1.7.5. There is Appropriate Audit Documentation*

114. ISAs require 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 review the quality of work performed after the audit has been completed.

## 1.8 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 methodology 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.
- Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action is taken.
- Where required, effective engagement quality control reviews are undertaken.

	Engagement Level	Firm Level	Referral Level
<b>Values, Ethics, and Attitudes</b>	Section 1.1	Section 1.2	Section 1.3
<b>Knowledge, Experience, and Skills</b>	Section 1.4	Section 1.5	Section 1.6
<b>Audit Processes and Quality Control Procedures</b>	Section 1.7	Section 1.8	Section 1.9

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

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

1.8.2. *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. Highly prescriptive methodologies may arise from threats of litigation or overly compliance-based approaches to auditor regulation and inspections. Examples of the risk to audit quality include:

- 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 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.
- 1.8.3. The Methodology Requires Effective Supervision and Review of Audit Work*
121. Much of the detailed audit work may be performed by staff who are relatively less experienced. In such circumstances, it is vital that their work, whether performed ‘on-site’ or offshore, 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.
- 1.8.4. 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.
- 1.8.5. Rigorous Quality Control Procedures are Established and Audit Quality Is Monitored and Appropriate Consequential Action Is Taken*
125. Quality control procedures need to be established to provide the audit firm with assurance that:
- The firm complies with professional standards and applicable legal and regulatory requirements, and
  - Reports issued by the firm or engagement partners are appropriate in the circumstances<sup>16</sup>.

<sup>16</sup> The IAASB has issued ISQC1 ‘Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements’ that sets out those activities in which firms are required to develop policies and procedures and thereby meet this objective.



- 126. Quality control procedures will include monitoring and taking remedial action when needed. 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.
- 127. Some audit firms operate internationally through a network of firms. Network firms often share common methodologies and quality control and monitoring policies and procedures. Some networks also share guidance in relation to values, ethics, and attitudes, and have programs to enhance the knowledge and experience of partners and staff.
- 128. As well as audit firms monitoring audit quality, audits may be subject to external review by audit regulators. The results of these external reviews, and inspections, provide important feedback that should lead to actions that contribute to enhancing audit quality.
- 129. 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.

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

- 130. 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.
- 131. 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.

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

132. 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.

	Engagement Level	Firm Level	National Level
<b>Values, Ethics, and Attitudes</b>	Section 1.1	Section 1.2	Section 1.3
<b>Knowledge, Experience, and Time</b>	Section 1.4	Section 1.5	Section 1.6
<b>Audit Process and Quality Control Procedures</b>	Section 1.7	Section 1.8	Section 1.9

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

133. Auditing requirements may be imposed by law or regulations or mandated through the national professional accountancy organization. It is important that such requirements are high quality and



make clear the underlying objectives of the audit. ISAs, as issued by the IAASB, contain objectives, requirements, and application and other explanatory material.

134. IFAC requires its member bodies to use their best endeavors to adopt the ISAs, and to assist in their implementation. In some countries, the ISAs are modified to take account of, or are supplemented by additional, national requirements.

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

135. In many countries, arrangements exist for the independent monitoring of audit quality either by a separate audit firm (a peer review), a professional accountancy organization (which sometimes has been delegated responsibility by a regulator), 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.

136. 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 can lead to improvements in audit effectiveness and, where the results of audit inspections are published, will lead to greater awareness amongst stakeholders about audit quality issues. Over a period of time, the findings from external audit inspections need to be captured and fed back to standard setters.

137. A number of independent audit regulators are relatively new organizations. In an international context, the activities of the International Forum of Independent Audit Regulators (IFIAR) facilitate knowledge sharing and promote greater coordination amongst audit regulators.<sup>17</sup>

**Areas to Explore – 4. Considering whether audit inspection activities can do more to improve audit quality and to make audit quality more transparent to users. (Refer Appendix 1)**

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

138. The requirements of auditing and other relevant standards are most effective if they are properly enforced. This involves investigation of allegations of audit failure and, where appropriate, disciplinary action being taken.

139. As well as acting as an incentive to audit firms to comply with applicable standards, effective disciplinary arrangements give other stakeholders confidence in the quality of audit. To be effective, those responsible for investigation and disciplinary functions must have a clear mandate and sufficient resources to undertake their work.

140. Investigation and disciplinary action can be undertaken by professional accountancy organizations. 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.

<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). Have a mechanism for reporting inspection findings to the audit firm and ensuring remediation of findings with the audit firm.



141. Audit failures can be 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. The effectiveness of disciplinary activities is increased when clear criteria have been established as to what represents an audit failure.
142. Authorities also need a range of sanctions available to them, including the power to revoke the license of audit firms or individual auditors in defined circumstances. While such actions may be appropriate in extreme cases, the regulatory process is enhanced when more proportional sanctions are also available for lesser failings. These may include fines and mandatory retraining.

**Areas to Explore – 5.** *Exploring whether there would be value in national authorities responsible for determining sanctions on auditors exchanging information with a view to evaluating the relative effectiveness of their different arrangements. (Refer Appendix 1)*

143. Transparency through the timely disclosure of investigations and disciplinary actions has the potential to provide important feedback to auditors and audit firms, in relation to matters that may enhance audit quality.
144. There will also be benefit in audit firms analyzing the results from internal inspections and investigations in order to learn from mistakes and improve their methodologies and procedures to prevent repeating those mistakes.

**Areas to Explore – 6.** *Consideration of ‘root causes’ and best practices by regulators, audit firms, and the wider audit profession in order to learn from past audit deficiencies and to address systemic issues. (refer Appendix 1)*



## 2. Output Factors

145. 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 limited and, in the case of shareholders of listed companies, may only comprise the auditor’s report on the financial statements.
146. Different stakeholders receive different outputs from an audit. These outputs are likely to be evaluated in terms of their value and timeliness, and be seen as aspects of audit quality. They may also:
- Provide broader insights into audit quality. For example, reports from audit regulators are likely to describe weaknesses that have been identified from inspection activities; and
  - Directly impact audit quality. For example, having a specific responsibility to report on a matter, such as the effectiveness of internal controls, may result in more robust work in that area.
147. Some stakeholders, especially management, those charged with governance and some regulators, have more direct insights into some of the inputs to audit quality and are therefore better placed to evaluate it, at least in part. Outputs from these other stakeholders, for example audit committee reports, may provide useful information on audit quality to external users.
148. Relevant outputs may include:

Level	Outputs
<b>2.1 Engagement Level</b>	<p><b>From the Auditor:</b></p> <p>2.1.1. The auditor’s report on the financial statements and such other matters required by law and regulations</p> <p>2.1.2. Reports from the auditor to those charged with governance (e.g., audit committee reports)</p> <p>2.1.3. Reports from the auditor to management (e.g., recommendations on internal controls)</p> <p>2.1.4. Reports from the auditor to regulators</p> <p><b>From the Entity:</b></p> <p>2.1.5. The audited financial statements</p> <p>2.1.6. Reports from those charged with governance, including audit committees</p> <p><b>From Audit Regulators:</b></p> <p>2.1.7. Reports on the results of inspections of individual audits</p>
<b>2.2 Firm and National Levels</b>	<p><b>From the Audit Firm:</b></p> <p>2.2.1. Transparency reports</p> <p>2.2.2. Annual reports</p> <p><b>From Audit Regulators:</b></p> <p>2.2.3. Reports on the results of firm inspections.</p>



## 2.1 Outputs – Engagement Level

149. 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.

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

150. The ultimate objective of an audit is the provision of an auditor’s opinion that provides users with 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.

151. 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.

**Areas to Explore – 7. *The information value of audit reports and improving perceptions of the value of the audit.*** (Refer Appendix 1)

152. 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 controls over financial reporting).

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

153. Auditing standards usually require the auditor to communicate with those charged with governance on specific matters on a timely basis. For example, ISAs<sup>18</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.

<sup>18</sup> ISA 260, *Communication with Those Charged with Governance*



154. Such matters are often covered in written reports to those charged with governance. 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.
155. In relation to the quality and usefulness of communications, those charged with governance may particularly 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, including the operation of internal controls;
  - Recommendations for improvement to the entity's financial reporting process; and
  - Information that enable them to effectively fulfill their governance responsibilities.

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

156. 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.
157. 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 and systems;
  - Observations on regulatory matters; and
  - Global perspectives on significant industry issues or trends.

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

158. 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.
159. In such circumstances, the regulators are likely to give emphasis to the perceived value and timing of such reports when considering overall audit quality.

#### *2.1.5 The Audited Financial Statements*

160. 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, 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.

161. The need for an entity to restate its financial statements may, depending on the reasons for the restatement, cause users to conclude that there has been audit failure.

#### *2.1.6. Reports from Those Charged With Governance, including Audit Committees*

162. In a number of countries, those charged with governance have specific responsibilities for a degree of oversight of the auditor or aspects of the audit process. This is often undertaken through an audit committee. 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.

163. 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>19</sup> are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

#### *2.1.7. Reports from Audit Regulators*

164. 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.

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

#### *2.2.1. Transparency Reports*

165. 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>20</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.

166. 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.

#### *2.2.2. Annual Reports*

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<sup>19</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>20</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.



167. 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.

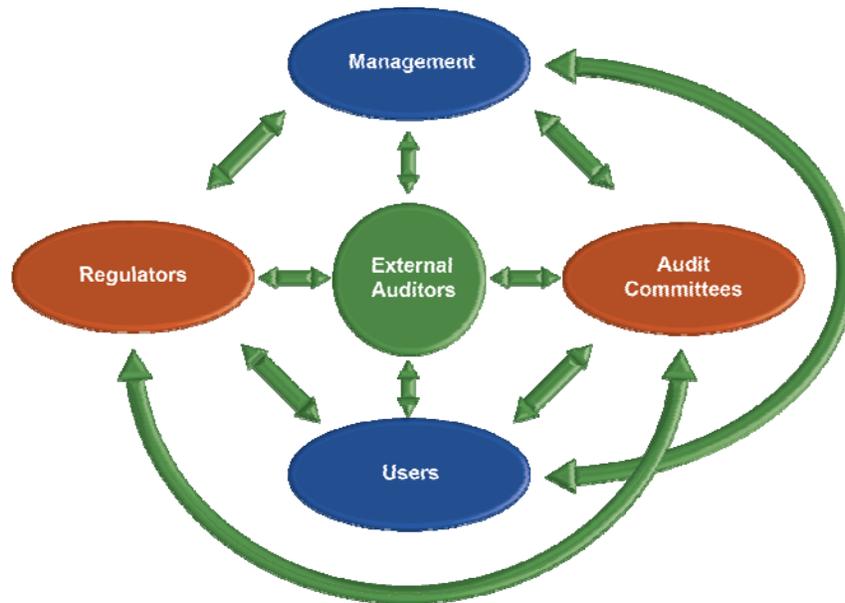
### 2.2.3. *Reports from Audit Regulators*

168. 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 other countries, reports are published for separate audit firms.

169. The publication of individual audit firm inspection reports may play an important role in relation to enhancing audit quality, including the perception of audit quality by key stakeholders (especially investors and users of audit reports). 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 those charged with governance 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.

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

170. In its 2008 report *Financial Reporting Supply Chain: Current Perspectives and Directions*,<sup>21</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.”
171. 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.
172. 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.
173. Some of the more important interactions<sup>22</sup> with regard to audit quality are described below.



#### 3.1 Interactions between Auditors and Management

174. 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>21</sup> The report can be accessed at: <http://web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf>.

<sup>22</sup> This section deals only with external—that is, outside of the audit engagement team—interactions. Interactions within the audit engagement team are discussed in Section 3.



175. 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 quality audit can be performed efficiently.
176. 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.
177. 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.
178. 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.

### 3.2 Interactions between Auditors and Those Charged with Governance

179. 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.
180. Effective two-way communication with auditors can assist those charged with governance fulfill these responsibilities. In particular, those charged with governance will 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 to conclude on the fair presentation of the financial statements, especially if the auditor has concerns which have not been acted upon by management.
181. It is customary for the auditor to communicate with those charged with governance, including 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.
182. 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.

### 3.3 Interactions between Auditors and Financial Statement Users

183. 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 quality audits.
184. 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.

### 3.4 Interactions between Auditors and Regulators

185. There are three main types of regulators that impact the audit: regulators of the financial markets and financial market participants ("financial regulators"); 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.

#### 3.4.1 Financial and Prudential Regulators

186. 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.
187. 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 with assurance on specific matters.
188. 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.
189. 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.

**Areas to Explore – 8. Achieving improved two-way communication between auditors and financial and prudential regulators, particularly in the financial services sector. (Refer Appendix 1)**

### 3.4.2 Audit Regulators<sup>23</sup>

190. 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.
191. Open communication between audit firms and the audit regulators will assist regulators to undertake their activities effectively. Furthermore, clear communication of the findings of audit inspections will enable audit firms to better understand the root causes of deficiencies identified and respond to them in a positive manner.

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

192. 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.
193. 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.
194. 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.

### 3.6 Interactions between Management and Regulators

195. 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

<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.



undertake direct supervisory activities which involve interaction with management. These activities can have a positive effect on financial reporting and the auditor needs to understand the interactions that have occurred.

### **3.7 Interactions between Management and Financial Statement Users**

196. 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.
197. 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.

### **3.8 Interactions between Those Charged with Governance and Regulators**

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

### **3.9 Interactions between Those Charged with Governance and Financial Statement Users**

200. In a number of countries, those charged with governance, including audit committees have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. Users' perceptions of audit quality are likely to be enhanced by the active involvement of a high-quality, transparent audit committee. However, there is considerable variability in the degree to which audit committees communicate to users the way in which they have fulfilled their responsibilities.

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

201. 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.

#### 4. Contextual Factors

202. In some countries, business practices may be relatively informal and commercial law relatively less well developed. 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. There may also be broader cultural issues that affect financial reporting within a country.
203. 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.
204. Contextual factors, include:



##### 4.1 Business Practices and Commercial Law

205. 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.
206. Commercial law will affect the formality with which businesses undertake transactions. In particular, contract law determines when rights are established and obligations created as transactions are completed. Where commercial laws are less developed, it can be challenging for management to assert ownership claims and assess the adequacy of provisions for liabilities.
207. In some circumstances, the terms and conditions of transactions may be vague or unrecorded and agreements may be subject to oral amendment. In such circumstances it will be difficult to



segregate responsibilities and the effectiveness of internal control systems will be reduced creating opportunities for fraud and corruption. The lack of adequate documentation in these circumstances will present significant challenges for those charged with governance in understanding the economic substance of the transactions and determining whether they have been fully and appropriately accounted for.

208. Attitudes to tax compliance also vary. In some environments, management may seek to minimize tax liabilities through such measures as deferring issuing invoices even when performance obligations have been met. In other environments; more than one set of accounting records may be retained—one showing the “economic” position and one the “tax” position—which may create some confusion. Such circumstances are likely to create complexity and necessitate reserving for a contingent tax liability, which is usually subject to considerable measurement uncertainty.

#### 4.2 Law and Regulations Relating to Financial Reporting

209. As well as providing a general framework for the way that business is conducted, law and regulations can directly 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;
- Encourage compliance with financial reporting requirements through surveillance and enforcement mechanisms;
- Impose obligations on management to cooperate fully with auditors, including providing auditors with all necessary information and access; and
- Provide for punitive actions against management for providing misleading information to auditors.

210. 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.

#### 4.3 The Applicable Financial Reporting Framework

211. The financial reporting framework is a critical factor in the quality of financial reporting. A clear framework assists management with accounting decisions and provides consistency of performance. However, an overly complex 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.

212. 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.

213. The nature and complexity of the financial reporting framework can also influence perceptions of audit quality. 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



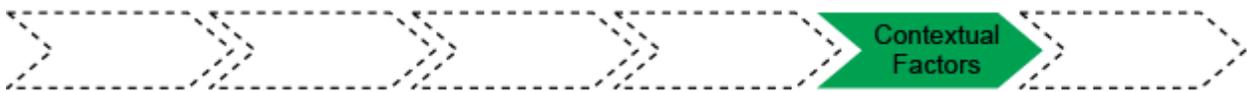
over-emphasis on rules encourages a strict compliance approach to financial reporting, which may mean that it is difficult for auditors to focus on the substance of transactions and challenge the fair presentation of the financial statements.

214. 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 hedging and risk management strategies. 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. Audit challenges include the following:

- Ensuring that an appropriate amount of the time of senior members of the audit team is allocated to the direction, supervision and review of the audit work, rather than a disproportionate amount being taken up with dealing with accounting complexities.
- Gathering necessary information and making appropriate judgments when recognition, measurement and disclosure decisions 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.
- Confirming management's intent, particularly if management has not faced identical circumstances in the past, when the applicable financial reporting framework provides 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).
- Verifying the fair values of financial instruments when there is not an active market and measurements are based on unobservable inputs. In such circumstances fair value calculations can involve complex models and highly judgmental assumptions, often requiring specialized expertise.

215. 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.
- 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.



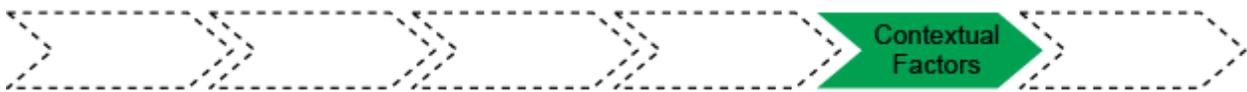
#### 4.4 Corporate Governance

216. 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.
217. 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.
218. Audit committees exist in many entities—especially 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. Differences in the strength of corporate governance arrangements can impact the approach taken to the audit, and interactions with management and those charged with governance.
219. 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 to establish that there is appropriate interaction between the work of the external auditor and the internal audit function.
220. Audit committees also usually have specific responsibilities regarding the appointment or reappointment of the external 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 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 audit quality from that of the audit committee.
221. Quality audits are likely to be encouraged if audit committees have a direct responsibility to consider audit quality either as part of the process for the reappointment of auditors or when considering audit fees. Audit committee consideration of audit quality is likely to be assisted if guidance or criteria are made available to assist them.

**Areas to Explore – 9.** *Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit.* (Refer Appendix 1)

222. User perception of audit quality is likely to be increased if they believe that the audit committee is made up of members that are independent from management and have an appropriate degree of financial literacy. Confidence in the audit is also likely to be increased if users are made aware, perhaps in the form of an annual report, of the activities that the audit committee has undertaken, the main issues that they have addressed and the reasons for their conclusions.

**Areas to Explore – 10.** *Encouraging audit committees to provide more information to users of the financial statements of the work they have undertaken, the main issues they have addressed and the reasons for their conclusions.* (Refer Appendix 1)



#### 4.5 Information Systems

223. Sound information systems are necessary to support high quality financial reporting. Some jurisdictions have specific legal requirements and standards relating to accounting systems and internal controls over them. Many, however, do not.
224. While the basic accounting systems of many entities may be 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 information may not be as well controlled as information from the accounting systems, and this can affect overall financial reporting quality.
225. Information systems are usually computerized. While computer systems will usually process information accurately, they can be subject to systemic weaknesses, security 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.
226. The importance of information systems extends beyond financial reporting and, increasingly, businesses are becoming dependent on complex systems and the technology that underlie them. For example:
- Many manufacturers depend on automated processes to manage 'just in time' production processes,
  - Many large retailers depend on automated stock and distribution systems,
  - Some retailers do business solely on-line; and
  - Most financial institutions and telecommunications companies and many important public sector entities rely on automated systems for undertaking and processing high volumes of transactions with speed and accuracy, often on a global basis.
227. Failure of automated systems within IT dependent entities can result in significant costs to the business and, in extreme cases, to business failure.

#### 4.6 Financial Reporting Timetable

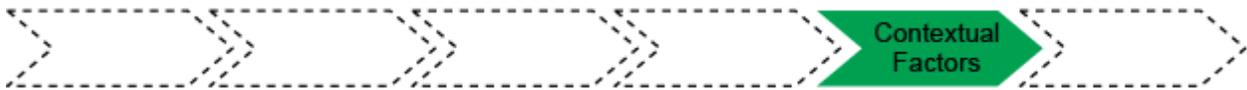
228. The timeframe within which the audit needs to be completed can influence financial reporting processes and the way that management and those charged with governance approve the financial statements. The advent of accelerated reporting regimes in many jurisdictions also limits the extent to which 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.
229. The timing for the preparation of financial information is also influenced by the need for listed companies 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, management may be resistant to adjustment of misstatements identified by the auditor after the date the preliminary results have been released.

#### 4.7 Broader Cultural Factors

230. National cultures are likely to have a direct effect on the attitudes of management and those charged with corporate governance to financial reporting, and an indirect effect on the nature and extent of laws and regulations that apply.
231. Differences in business practices and cultural factors can present practical challenges in a multi-national entity context in relation to the preparation and audit of group financial statements. However, group management may decide to take specific steps to 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.
232. The group auditor needs to be well acquainted with differences in business practices and broader cultural factors with respect to the planning and conduct of the audit in different jurisdictions, in order to ensure consistent audit quality.
233. Cultural differences that may have a particular impact on the attitudes of management to financial reporting and their interactions with auditors are:
- Deference to authority;
  - Conservatism; and
  - Transparency.

##### 4.7.1 *Deference to Authority*

234. 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.
235. 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 apply it as intended by auditing standards, especially if those environments have a culture that makes it difficult for auditors to question authority. In such countries, auditors will need to plan and conduct audits with this in mind, as their reluctance to challenge management may adversely impact on audit quality.



#### 4.7.2 *Conservatism*

236. Aspects of cultural differences that have been identified include uncertainty aversion, and individualism. Research indicates a correlation between these factors and attitudes towards risk taking and its converse, conservatism. Conservatism is likely to influence business strategies and internal conduct as well as the judgments inherent in financial reporting.

#### 4.7.3 *Transparency*

237. A further aspect of culture that may have an influence on financial reporting and 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 make it more difficult for auditors to obtain the necessary understanding of the entity in order to properly identify and assess the risks of material misstatement in the financial statements. In such an environment auditors need to be cognizant, when planning and conducting an audit, of the impact this has on gathering sufficient appropriate audit evidence and evaluating the completeness and adequacy of disclosures.

## 5. Considerations Relating to Specific Audits

238. The Framework for Audit Quality 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 public sector audits and audits of smaller entities.

### 5.1 Considerations Specific to Public Sector Audits

239. 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.

#### 5.1.1 *Inputs*

240. Values, Ethics and Attitudes – Engagement Level. The consideration of threats and safeguards when determining independence for public sector audits is as important as for audits in the private sector. However, some of the potential threats may differ. For example, it is less likely that auditors in the public sector 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.

241. 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.

242. Knowledge, Experience and Time – Firm Level. In many 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 certain audit institutions to recruit and retain sufficient numbers of high quality staff to consistently achieve audit quality.

#### 5.1.2 *Outputs*

243. 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.

244. 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.

245. 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 changes to general laws and regulations concerning government entities.

246. National Level. In many countries, public sector entities are often not-for-profit organizations and, as a result, 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.

### 5.1.3 Interactions

247. 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.

### 5.1.4 Contextual Factors

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

## 5.2 Considerations Specific to Audits of Smaller Entities

### 5.2.1 Inputs

249. Values, Ethics and Attitudes – Engagement Level. Smaller entities 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 that need to be mitigated by safeguards. In some jurisdictions the auditor is prevented from providing accounting assistance.

250. 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. Depending on the tone, this could be either a strength, or a weakness, of the small firm environment.

251. 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. SMPs can face challenges in

relation to consultation external to the firm, providing technical support and using independent staff in quality monitoring processes. Developing close working relationships with other SMPs can assist in these areas.

252. Values, Ethics and Attitudes – Firm Level. A culture of consultation is important for sole practitioners and SMPs, which may use external technical resources available to them, whether through their professional accountancy organizations, their relationships with other firms, or suitably resourced third-party organizations.
253. 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.
254. 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.
255. 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.
256. Audit Process – Firm Level. As the audits are relatively simple, audit methodologies need not be overly complex.

### 5.2.2 *Outputs*

257. 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; although the auditor must be cognizant of the familiarity threats to independence that may arise. The relationship between the engagement partner and senior management is often very strong and communications direct and frequent.

### 5.2.3 *Contextual Factors*

258. Business Practices and Information Systems. The business undertaken by smaller entities is sometimes less complicated, with few sources of income and activities. In such cases, accounting systems are usually simple and utilize relatively less complicated technology.
259. 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.
260. Applicable Financial Reporting Framework. The business undertaken by smaller entities often means that the accounting is less complicated. Often, the applicable financial reporting framework applied by smaller entities is less complex than that mandated for larger entities.
261. 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.

### Areas to Explore

While developing the Framework the IAASB has identified, at times with the input of stakeholders, 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:

**1 Establishing global guidance against which audit firms can assess their governance arrangements (refer page 23).**

Governance arrangements within audit firms have evolved in different ways over the years and are often not transparent to their clients or the users of their services. The development of global guidance would allow audit firms to understand how to improve their own arrangements and, if external disclosure is improved, may help to foster increased confidence in the auditing profession.

**2 Establishing a common understanding of competence, and how it is demonstrated and assessed, as it relates to audit quality for use by audit firms when recruiting, evaluating, promoting and remunerating partners and staff (refer page 24).**

Audit firms often use competency frameworks to assist with evaluating the performance of partners and staff. However, the extent to which the competencies used directly 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 specification of the necessary 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 quality audits.

**3 Improving information sharing between audit firms when one firm decides to resign from, or is not reappointed to an audit engagement (refer page 27).**

There can be many reasons why an audit firm may cease to act as an entity's auditor. Reasons include, among others, concern about the entity's business practices, accounting policies and the integrity of management and/or those charged with governance. Knowledge of such reasons could influence another audit firm from accepting the engagement or, if it is accepted, significantly impact the audit approach.

Ethics standards normally require an incoming auditor to determine whether there are reasons for not accepting an audit engagement; however an outgoing auditor may believe that the duty of client confidentiality may prevent the communication of relevant information. In some countries there are specific laws or regulations that impact information sharing and, the extent to which shareholders are made aware of relevant circumstances. Consideration could usefully be given to how information sharing 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.

**4 Considering whether audit inspection activities can do more to improve audit quality and to make audit quality more transparent to users (refer page 39).**

Independent audit inspection is a relatively new activity in many territories and inspection practices are evolving. At a minimum inspection involves reviewing a sample of completed audits for compliance with auditing standards. Some national inspection groups consider audit quality more widely and others have been innovative in developing the ways in which they report their findings. While checking for compliance with standards is an important activity there may be value in reviewing national practices and exploring the extent to which there can be greater international harmonisation in audit inspection activities so that the contribution they make to audit quality is maximised and so that audit quality is made more transparent to users.

**5 Exploring whether there would be value in national authorities responsible for determining sanctions on auditors exchanging information with a view to evaluating the relative effectiveness of their different arrangements (refer page 40).**

Arrangements for taking disciplinary actions on auditors have evolved in a national context and are likely to be closely linked with the underlying national legal framework. That said, the sharing of information on matters such as the criteria that define an audit failure, the thresholds for sanctions, and available sanctions may assist to improve these arrangements.

**6 Consideration of 'root causes' and best practices by regulators, audit firms, and the wider audit profession in order to learn from past audit deficiencies and to address systemic issues (refer page 40).**

Investigations into possible audit failures are likely to identify areas of audit weakness. To the extent that such weaknesses could be systemic it is important that action is taken to eliminate them as soon as practicable. Formal analysis of the 'root causes' of audit failings may assist action being taken to stop them recurring.

Audit firms and professional accountancy organizations would also benefit from self-examinations and internal inspections and investigations that lead to improving audit methodologies and approaches.

**7 Increasing the information value of audit reports and improving perceptions of the value of the audit (refer page 42).**

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, including the addition of 'Auditor Commentary'.

Improvements in audit reporting in general, and the addition of 'Auditor Commentary' in particular, may impact both audit quality and perceptions of audit quality.

There are many potential options for improved reporting 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 future content and format of audit reports is still under discussion, the IAASB supports the need to enhance the quality, relevance and communicative value of auditor reporting on an international basis.

**8 Achieving improved two-way communication between auditors and financial and prudential regulators, particularly in the financial services sector (refer page 49).**

While it is recognized that the timely sharing of appropriate information between regulators and auditors can both enhance the regulatory process and contribute to audit quality, such information sharing is sometimes inhibited by timing and confidentiality issues. To improve information sharing clear criteria for what is to be communicated and the process for such communications need to be established either in law or by means of formal agreements or protocols.

**9 Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit (refer page 54).**

While some countries expect audit committees to have a 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<sup>24</sup>, giving the potential for uncertainty as to the scope of this remit.

**10 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 (refer page 54).**

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 audit committees, the main issues they have addressed, and the reasons for their conclusions will assist users of the financial statements.

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<sup>24</sup> 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."