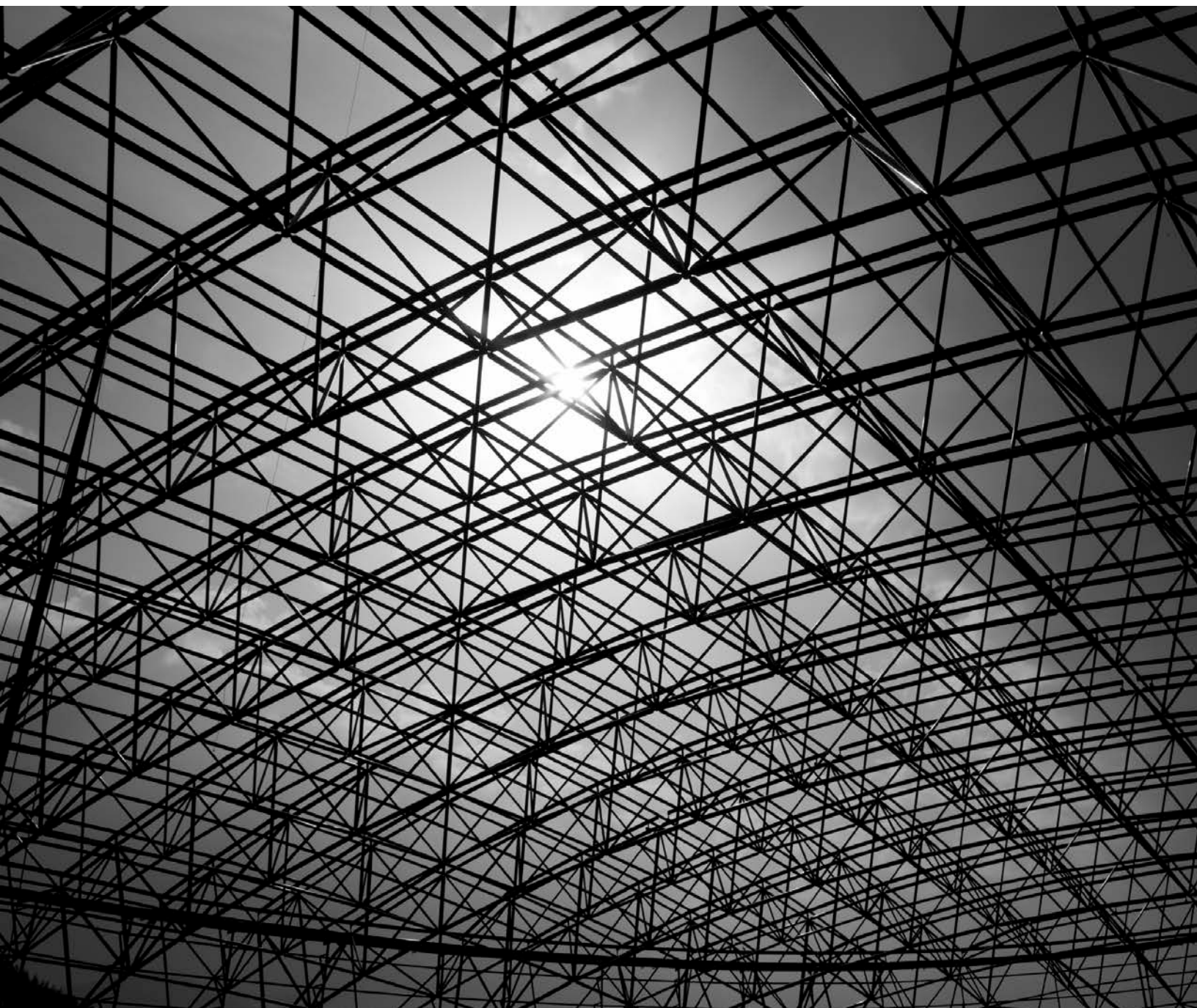


# Agenda Item 3-B



International Auditing  
and Assurance  
Standards Board

### **The 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 to achieve 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

Financial information should be relevant, timely and reliable to meet the needs of users. National law and regulations often require an external audit of some elements of the financial information to give users confidence that the information can be trusted. For an external audit to fulfill its objective the users of audited financial statements must have confidence that the auditor has worked to a suitable standard and that “a quality audit” has been performed.

The term “audit quality” is frequently used in debates among stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting. Audit quality is a complex subject and, as outlined in Appendix 1, there is no definition or analysis of it that has achieved universal recognition.

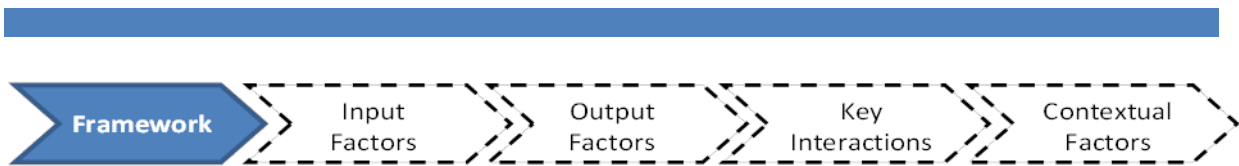
For this reason, the International Audit and Assurance Standards Board (IAASB) has undertaken a project to develop a Framework for Audit Quality (the Framework) that describes the input and output factors that contribute to audit quality at the engagement, audit firm and national levels, for financial statement audits. 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, international networks of audit firms, 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 among 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, the 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, both internationally and at a national level. For example, the IAASB will use it when it revises the International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1.<sup>1</sup> 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 among 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.

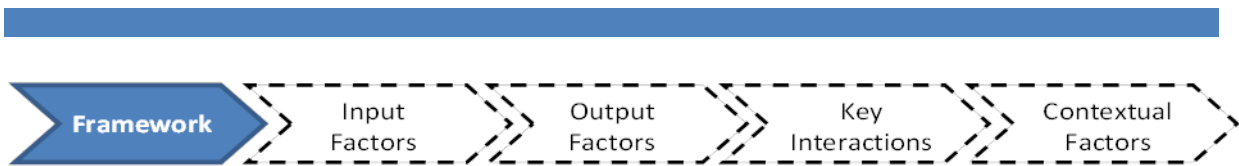
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<sup>1</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements*, requires audit firms to establish and maintain 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.

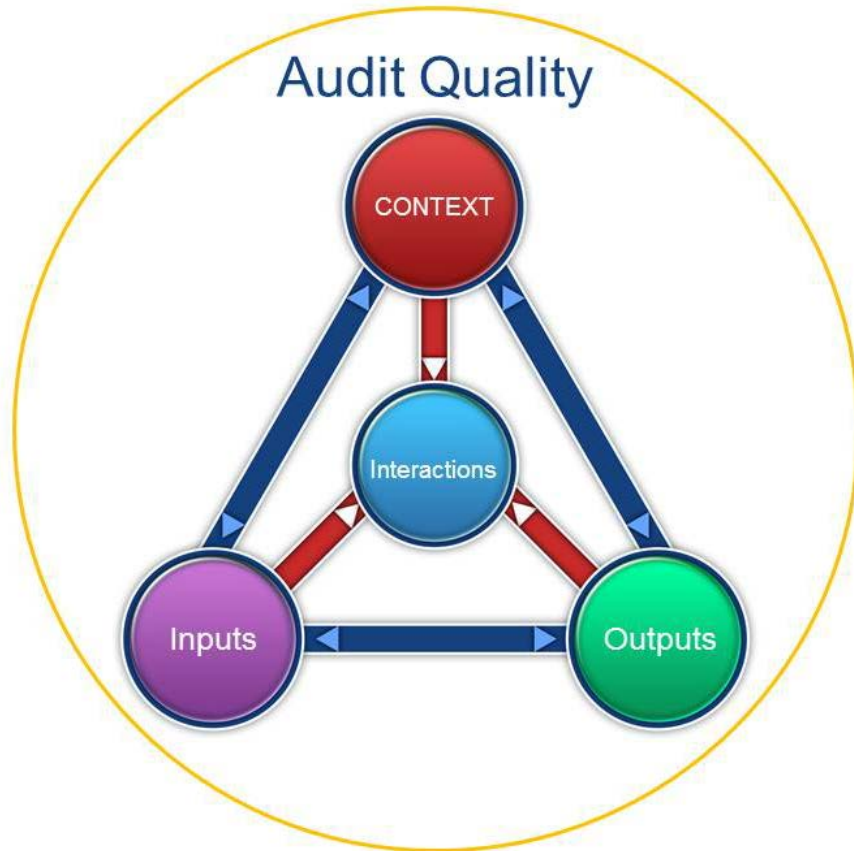


## The IAASB Framework for Audit Quality

1. Auditors are responsible for the quality of the financial statement audits they perform. **A quality audit** is likely to be achieved when the auditor's opinion on the financial statements is based on sufficient appropriate audit evidence about whether material misstatements exist, obtained by an engagement team that:
  - Exhibited appropriate values, ethics and attitudes;
  - Was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work;
  - Applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
  - Provided useful and timely reports; and
  - Interacted appropriately with relevant stakeholders.
2. The concept of **audit quality** captures the key elements that create an environment within an audit firm and a jurisdiction which maximizes the likelihood that quality audits are performed on a consistent basis. Audit quality is influenced by the firm level and national level attributes described in this Framework.
3. The IAASB believes there is value in describing the factors relating to both a quality audit and audit quality and thereby encouraging auditors, audit firms and other stakeholders to challenge themselves about whether there is more they can do to increase audit quality in their particular environments.
4. The Framework applies to audits of all entities regardless of their size, nature, and complexity. It also applies to all audit firms regardless of size, including audit firms that are part of a network or association. However, the attributes can vary in importance and affect audit quality in subtly different ways. In particular, public sector auditors (due to their societal role and constitutional mandate) and auditors of smaller entities may give specific emphasis to certain factors.
5. 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.
6. 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.

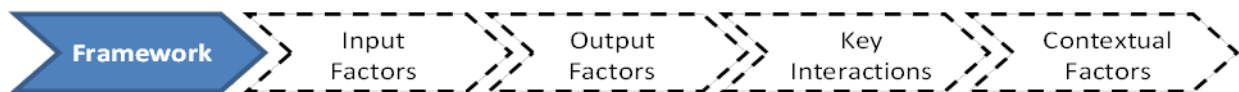


7. The Framework distinguishes the following elements:



### ***Inputs***

8. 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, skills, 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.
9. 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.
10. A separate guide(s) that describe the input factors have been prepared for the engagement, firm, and national levels, and are available on the IAASB website ([www.iaasb.org](http://www.iaasb.org)) to assist in using this Framework.
  11. 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**

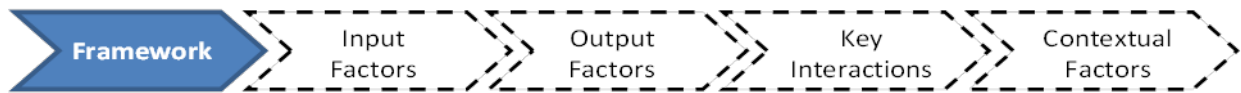
12. Outputs include reports and information that are formally prepared and presented by one party to another, as well as outputs that arise from the auditing process that are generally not visible to those outside the audited organization. For example, these may include improvements to the entity's financial reporting practices and internal control over financial reporting, that may result from auditor observations.
13. The 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.

### **Interactions Among Key Stakeholders**

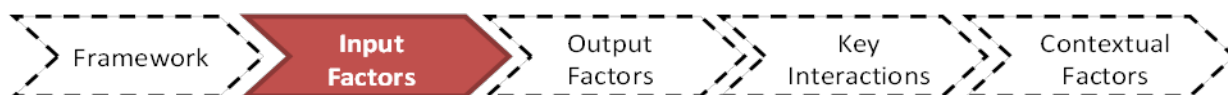
14. While each separate stakeholder in the financial reporting supply chain plays an important role in supporting high-quality financial reporting, the way in which the stakeholders interact can have a particular impact on audit quality. These interactions, including both formal and informal communications, 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 the audit committee of a listed company 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). In contrast, for privately owned businesses, there may be close proximity to the owners during the course of the audit. In these circumstances, there may be frequent informal communications, which contribute to audit quality.

### **Context**

15. There are a number of contextual factors that can facilitate financial reporting quality, including corporate governance and the applicable financial reporting framework. These contextual factors help shape the interactions among key stakeholders, as well as the arrangements within the audited entity and the audit firm. They can also impact the risk of material misstatements in the financial statements and the nature and extent of audit evidence required. Where appropriate, auditors need to respond to these issues when determining what constitutes sufficient appropriate audit evidence, and this may have an impact on the efficiency of the audit process.



16. There are also contextual factors that relate more directly to audit quality, including regulation and the financial reporting timetable.



## Input Factors

17. Quality audits involve auditors:

- Exhibiting appropriate values, ethics and attitudes;
- Being sufficiently knowledgeable, skilled, and experienced and having sufficient time allocated to them to perform the audit work; and
- Applying a rigorous audit process and quality control procedures that comply with law, regulation and applicable standards.

18. 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>1</sup> level. Each attribute and level is described in separate sections.

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

19. The audit engagement partner<sup>2</sup> is responsible for an audit engagement and therefore directly responsible for audit quality. In addition to taking responsibility for the performance of the audit, the audit engagement partner has a critical role in ensuring that the engagement team exhibits the values, ethics and attitudes necessary to support a quality audit, including skepticism. Key attributes are:

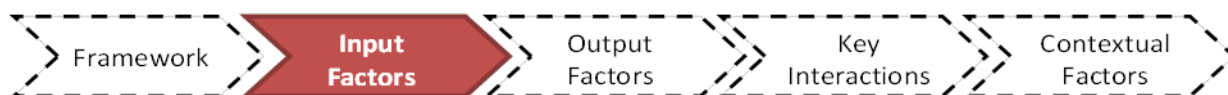
	Engagement Level	Firm Level	National Level
Values, Ethics, and Attitudes	Section 1.1	Section 1.2	Section 1.3
Knowledge, Experience, and Time	Section 1.4	Section 1.5	Section 1.6
Audit Process and Quality Control Procedures	Section 1.7	Section 1.8	Section 1.9

- The engagement team recognizes: that the audit is performed in the wider public interest; and the importance of complying with ethical requirements.<sup>3</sup>
- The engagement team exhibits objectivity and integrity.
- The engagement team is independent.
- The engagement team exhibits professional competence and due care.
- The engagement team exhibits professional skepticism.

<sup>1</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.

<sup>2</sup> 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

<sup>3</sup> The IESBA *Code of Ethics for Professional Accountants* identifies five fundamental principles of professional ethics for professional accountants: integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.



## 1.2. Values, Ethics and Attitudes – Firm Level

20. 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 often commercial entities. Each firm's culture will be an important factor in determining how its partners and staff function in the public interest and how this is satisfactorily aligned with the firm's commercial goals.

	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

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

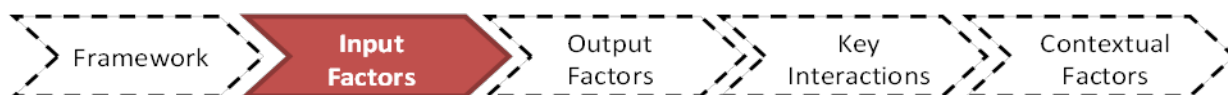
- Governance arrangements are in place that establish the appropriate “tone at the top”, and which recognize and promote the importance of independence.
- The firm has appropriate appraisal and reward systems essential to audit quality.
- Financial considerations do not drive actions and decisions that may reduce audit quality to an unacceptable level.
- The firm emphasizes the importance of providing partners and staff with continuing professional development opportunities and 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.

## 1.3 Values, Ethics and Attitudes – National Level

22. 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	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

- Ethics requirements are promulgated that 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.



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

23. The audit engagement partner is responsible for being satisfied that the engagement team collectively has the appropriate competences and that the team has sufficient time to be able to obtain sufficient appropriate audit evidence before issuing the audit opinion.

	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

24. Key attributes are:

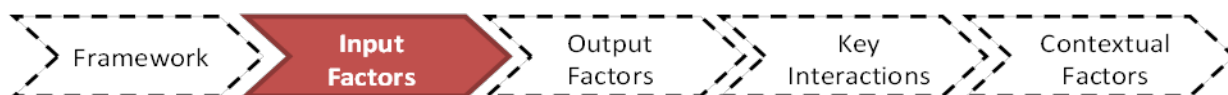
- Partners and staff have the necessary competences.
- Partners and staff understand the entity’s business.
- Partners and staff make reasonable judgments.
- The audit engagement partner is actively involved in risk assessment, planning, supervising, and reviewing the work performed.
- Staff performing 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 audit engagement partner and other experienced members of the audit team are accessible to management and those charged with governance.

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

25. 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	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

- Partners and staff have sufficient time to deal with difficult issues as they arise
- Engagement teams are properly structured.
- 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.



## 1.6 Knowledge, Experience and Time – National Level

26. National activities can impact the competences of auditors and the time spent. Key attributes are:

- Robust arrangements exist for licensing audit firms/individual auditors.
- Education requirements are clearly defined and training is adequately resourced and effective.
- Arrangements exist for briefing auditors on current issues and for providing training to 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	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

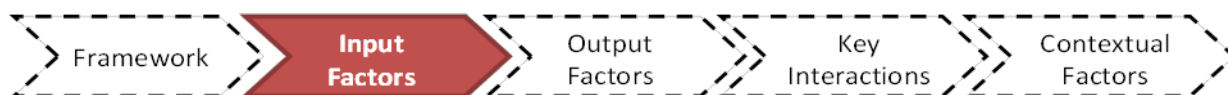
## 1.7 Audit Process and Quality Control Procedures – Engagement Level

27. 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 ISQC 1. 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	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

28. 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 audit firm's quality control procedures.
- The engagement team makes appropriate use of information technology.
- There is effective interaction with others involved in the audit including, where applicable, internal auditors.
- There are appropriate arrangements with management so as to achieve audit efficiency.
- There is appropriate audit documentation.



## 1.8 Audit Process and Quality Control Procedures – Firm Level

29. The audit firm's policies and procedures will impact the audit process. Key attributes that contribute to audit quality 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 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	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

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

30. National audit regulatory activities can impact the audit process.

31. ISAs are issued by the IAASB. The International Ethics Standards Board for Accountants (IESBA) sets high-quality ethical standards for professional accountants through the development of a robust, internationally appropriate Code of Ethics for Professional Accountants; while the International Accounting Education Standards Board (IAESB) develops and enhances professional accountancy education—encompassing knowledge, skills, values, ethics, and attitudes—through the promulgation of International Education Standards (IESs). There is widespread adoption of these standards at a national level. Key attributes are:

- Auditing and other standards are promulgated that 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 audit failure and taking disciplinary action when appropriate.

	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
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## 2 Output Factors

32. Different stakeholders receive different outputs from an audit. These outputs are likely to be evaluated in terms of their usefulness 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.
33. 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, information provided by audit committees, may provide useful information on audit quality to external users.
34. Relevant outputs may include:

Level	Outputs
<b>2.1 Engagement Level</b>	<p><b>From the Auditor</b></p> <p>2.1.1 Auditor's report to users of audited financial statements</p> <p>2.1.2 Auditor's reports to those charged with governance</p> <p>2.1.3 Auditor's reports to management</p> <p>2.1.4 Auditor's reports to financial and prudential 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 Providing information on 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 and other reports</p> <p><b>From Audit Regulators</b></p> <p>2.2.3 Providing an aggregate view on the results of audit firm inspections</p>



## 2.1 Outputs – Engagement Level

### 2.1.1 Auditor's Reports to Users of Audited Financial Statements

35. The primary output 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 about the reliability of the financial information. The value of this signal may be influenced by a number of factors, including the reputation of the audit firm<sup>1</sup> that has conducted the audit, and an assumption about the effectiveness of the audit process employed.
36. The auditor's report provides an opportunity for the auditor to provide information to give users some insights about the auditor's work and findings and therefore into the quality of the audit performed. However, this opportunity is not always taken by auditors and the audit report has, over the years, been standardized. Other than in circumstances when the auditor's opinion is modified, information is not usually provided about the auditor's work and findings.
37. More information about the audit is usually provided by public sector auditors either in the main audit report or in a supplementary report that is publicly accessible. Additionally, public sector auditors sometimes 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 about their audits, for example, on an entity's business risks and internal controls.
38. In addition to expanding the information contained in the auditor's report, its usefulness 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 Auditor's Reports to Those Charged with Governance

39. Auditing standards usually require the auditor to communicate with those charged with governance on specific matters on a timely basis. For example, ISAs<sup>2</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>1</sup> The audit firm's reputation is not specifically addressed in the Framework as it is not an element of audit quality but something that may emerge from sustained delivery of quality audits. There are a number of 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.

<sup>2</sup> ISA 260, *Communication with Those Charged with Governance*



40. 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.
41. 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 Auditor's Reports to Management

42. 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.
43. 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.
44. Management, in particular of smaller entities<sup>3</sup> where resources may be limited, may value the business advice of the auditor. In such circumstances, the auditor must be cognizant of the familiarity threats to independence that may arise.

<sup>3</sup> In its Glossary of Terms, the IAASB defines, a smaller entity as "An entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Few internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or
  - (vi) Few personnel, many having a wide range of duties.



#### 2.1.4 Auditor's Reports to Financial and Prudential Regulators

45. 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.
46. 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

47. Assurance enhances the credibility of financial reporting and potentially leads to improvement in the quality of financial reporting. For example, the audit may result in management making changes to the draft financial statements. These changes may be quantitative or qualitative in nature, such as clarification of note disclosures. While such changes are not usually transparent to users, faced with what they perceive to be 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.
48. In some jurisdictions entities are required to re-issue audited financial statements that had been found to contain material misstatements. The need for an entity to restate its financial statements may, depending on the reasons for the restatement, cause users to believe that there has been an audit failure.

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

49. In a number of countries, those charged with governance—in particular, audit committees of listed companies—have specific responsibilities for a degree of oversight of the auditor or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.
50. 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 are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

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These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics."



### 2.1.7 *Regulators Providing Information on Individual Audits*

51. 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*

52. Audit firms may provide generic information on audit quality. A number of countries have introduced requirements for audit firms to provide transparency reports that provide information about audit firm governance and quality control systems.<sup>4</sup> Making such information publically available may assist those users of audited financial statements who have no proximity to the audit process to understand the characteristics of individual audit firms, and the drivers of audit quality in those firms. Where key stakeholders cannot evaluate audit quality directly this information may assist entities in selecting a new audit firm.
53. Transparency reports also provide an opportunity for audit firms to distinguish themselves by highlighting particular aspects of their policies and approach to audits 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 the firm's commitments.

### 2.2.2 *Annual and Other Reports*

54. 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.
55. In addition, public sector bodies may issue other reports that 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.

### 2.2.3 *Providing an Aggregate View on the Results of Audit Firm Inspections*

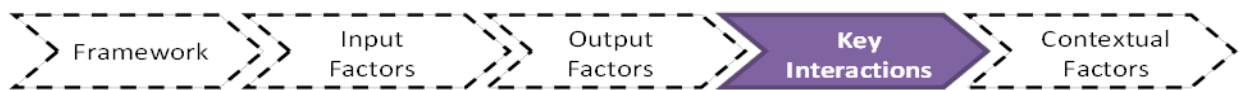
56. In many countries, audit regulators report annually on the outcome of audit inspection activities. The level of detail provided in such reports varies. In some countries, the reports aggregate the results of inspections of all audit firms; in other countries, reports are published for separate audit firms.

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<sup>4</sup> For European Union 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.

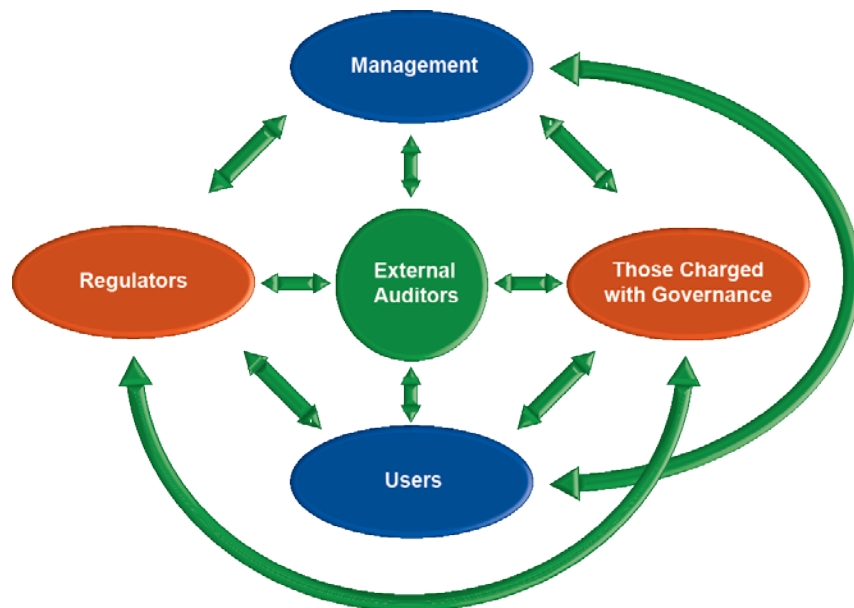


57. The publication of individual audit firm inspection reports may play an important role in relation to enhancing audit quality, including the perception of audit quality by key stakeholders (especially investors and users of audit reports). The debate on whether it is beneficial for audit regulators 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.



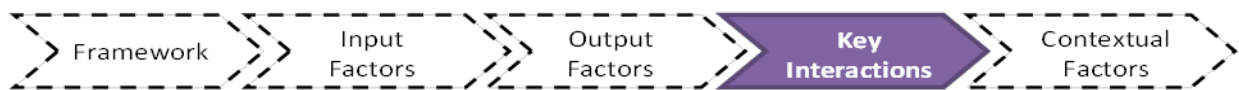
### 3 Key Interactions within the Financial Reporting Supply Chain Influencing Audit Quality

58. In its 2008 report *Financial Reporting Supply Chain: Current Perspectives and Directions*,<sup>1</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.”
59. 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.
60. 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.
61. The interactions described in the following sections are one-to-one interactions. However, there may be benefits to audit quality when auditors, key stakeholders, and other interested parties meet together to discuss matters relevant to audit quality.
62. Some of the more important interactions<sup>2</sup> with regard to audit quality are described below.



<sup>1</sup> The report can be accessed at: [web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf](http://web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf).

<sup>2</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 1.



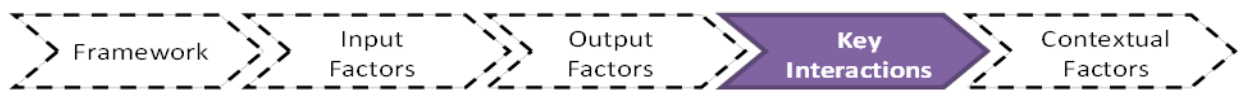
### 3.1 Interactions between Auditors and Management<sup>3</sup>

63. 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.
64. 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.
65. 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.
66. 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 legal and regulatory matters.
67. An open and constructive relationship between the auditor and management needs to be distinguished from one of over-familiarity, especially when auditors spend extended periods at the same audit client. 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

68. 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.
69. Effective two-way communication with auditors can assist those charged with governance in fulfilling these responsibilities. In particular, those charged with governance may benefit from the auditor's views on such matters as the financial reporting risks faced by the entity, the main areas

<sup>3</sup> In many smaller entities there is little distinction between management and those charged with governance. An owner-manager will usually fulfill both roles.

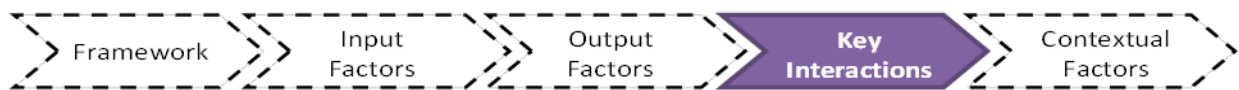


of management judgment in the financial statements, and insights into the quality of the entity's financial reporting process including weaknesses in its internal financial controls. This information can assist those charged with governance to conclude on the fair presentation of the financial statements, especially if the auditor has concerns which have not been acted upon by management.

70. The auditor is required to communicate with those charged with governance, including the audit committee where one exists, both before the audit commences (to discuss planning matters) 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. For smaller entities communication between the auditor and those charged with governance is often likely to be more frequent and less formal.
71. 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;
  - considering independence issues and assessing their resolution;
  - assessing how management was challenged by the auditor during the audit, particularly with respect to the assessment of fraud risk, management's estimates and assumptions, and the choices of accounting policies; and
  - 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

72. 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 the general meeting. Shareholders may also have the right to question the auditor on any significant matters pertaining to the audit in the general meeting. These interactions can provide an added motivation for auditors to perform quality audits.
73. 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 changes are made publicly available on a timely basis.
74. 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 of government-owned companies), as well as providing them with:
  - unbiased and politically neutral insights into the operations and financial reporting practices of the entity; and



- 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.

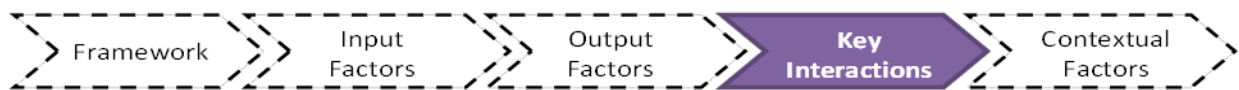
75. The auditing profession, in particular professional accountancy organizations, might at times organize forums, conferences, and other high level meetings and discussions, where auditors can engage with groups of financial statement users—who are not specific to engagements on which the auditor has worked—to discuss matters of relevance to audit quality.

### **3.4 Interactions between Auditors and Regulators**

76. 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**

77. 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.
78. 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 conclusions on specific matters.
79. 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.
80. 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.



### 3.4.2 Audit Regulators<sup>4</sup>

81. 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.
82. 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.
83. Dialogue between audit regulators in different countries, with the aim of promoting consistency of inspection approaches, will potentially strengthen global audit quality.<sup>5</sup>

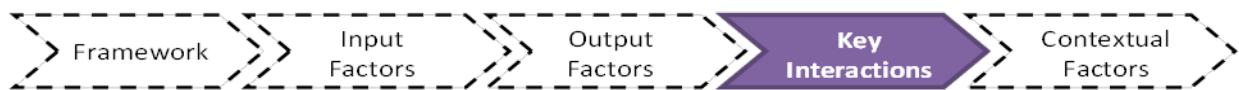
### 3.5 Interactions between Management and Those Charged with Governance

84. A strong commitment to honesty and integrity within an entity has a positive bearing on the quality and reliability of its financial reporting process. 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.
85. 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 relating to 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.
86. If the auditor has concerns about the 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 weaknesses in the relationship 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.

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<sup>4</sup> In the public sector, public sector audit institutions are usually not subordinated to external regulatory oversight. They answer to parliament, legislatures, or the equivalent, who from time to time may question the quality of audit activities.

<sup>5</sup> In an international context, the activities of the International Forum of Independent Audit Regulators (IFIAR) facilitate knowledge sharing and promote greater coordination among audit regulators. The IFIAR [Core Principles for Independent Audit Regulators](#) include that "the Principles are intended to support cooperation between regulators and promote greater consistency of audit oversight." Further information about its activities can be found on its website: [www.ifiar.org](http://www.ifiar.org)



87. In extreme cases, where the auditor has serious concerns about the relationship between management and those charged with governance, the auditor needs to consider whether an effective and efficient audit can be conducted, and therefore whether to continue the client relationship.

### **3.6 Interactions between Management and Regulators**

88. The extent to which financial regulators interact with management in relation to financial reporting varies between countries and industry sectors. Some financial regulators establish and enforce the financial reporting frameworks and may raise questions with management about aspects of the financial statements. Furthermore, in some sectors such as banking, prudential regulators may undertake direct supervisory activities that 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**

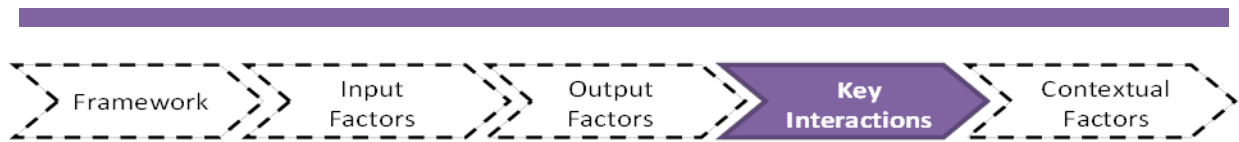
89. Aside from issuing the financial statements themselves, management may interact with users, particularly investors, in a number of other ways, including through issuing press releases announcing significant transactions or events, and holding analyst briefings and other meetings with investors. Interactions between management and users provide opportunities 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.
90. More generally, users, such as institutional investors, can reinforce the importance of 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**

91. As with management, the extent to which financial regulators interact with those charged with governance varies between countries and industries.
92. While to date there has been 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, 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**

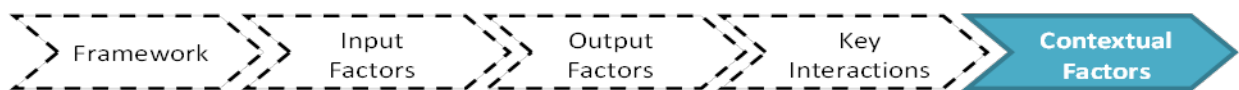
93. In a number of countries, those charged with governance, including audit committees where they exist, have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. Users' perceptions of audit quality are likely to be enhanced by the active involvement of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



which those charged with governance communicate to users the way in which they have fulfilled their responsibilities.

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

94. 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

95. There are a number of financial reporting and audit quality contextual factors.

### 4.1 Financial Reporting Quality

96. 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 its speed and reliability continually 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.

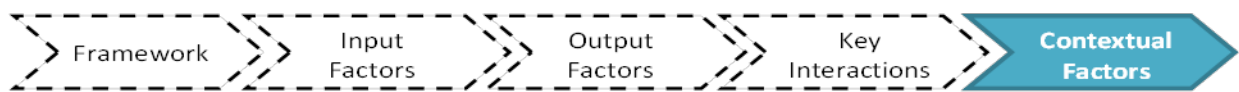
97. Collectively, these environmental factors – or contextual factors – are likely to impact the nature and quality of financial reporting. Where appropriate, auditors need to respond to these issues when determining what constitutes sufficient appropriate audit evidence, and this may have an impact on the efficiency of the audit process.

98. Contextual factors include:



#### 4.1.1 Business Practices and Commercial Law

99. 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.

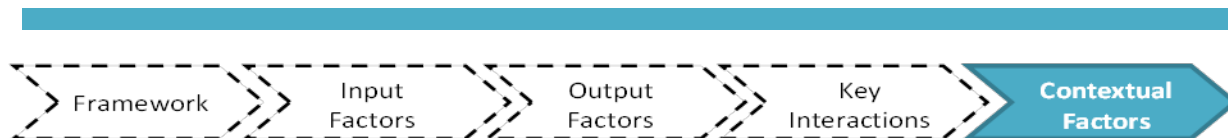


Environments exist where trading parties primarily involve related parties, such as entities owned by family members of management or entities that are government controlled.

100. 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.
101. 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.
102. 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.

#### 4.1.2 *Laws and Regulations Relating to Financial Reporting*

103. Laws and regulations relating to financial reporting are generally developed in response to the accountability that businesses have to stakeholders. For listed entities where there is a lack of proximity between the owners and management, regulations and financial reporting disclosures are designed to protect the interests of shareholders that do not have access to internal financial information. In contrast, the extent of regulation and financial reporting disclosures in other entities are likely to be set at a lower level, given that stakeholders have access to any information they require.
104. As well as providing a general framework for the way that business is conducted, law and regulations can directly impact the nature and extent of financial reporting information provided to particular stakeholder groups, especially if they are rigorously enforced. In these circumstances, 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.

105. 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.

#### 4.1.3 *The Applicable Financial Reporting Framework*

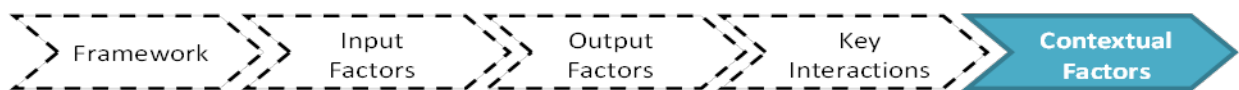
106. The financial reporting framework is a critical factor in the quality of financial reporting. A clear framework assists management with accounting decisions and provides consistency of application. However, an overly complex financial reporting framework can make it difficult for management to understand the accounting requirements and for those charged with governance to provide effective oversight of the financial reporting process.

107. These difficulties 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 the standards are applied by different entities.

108. The nature and complexity of the financial reporting framework can also influence perceptions of audit quality. Some believe that a financial reporting 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. 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.

109. 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 such financial information as it is less objectively verifiable as financial statements items such as cash. Audit challenges include the following:

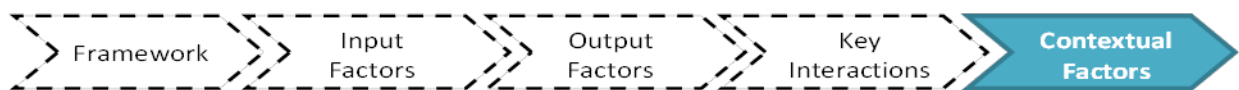
- Ensuring that an appropriate amount of the time of senior members of the audit team is allocated to the direction, supervision and review of the audit work, rather than a disproportionate amount being taken up with dealing with accounting complexities.
- Gathering necessary information and making appropriate 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.
  - Financial reporting frameworks do not usually set out requirements and guidance for management to obtain appropriate evidence to support their accounting judgments and document it.
110. 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, as well as the entity itself, are going concern.

#### 4.1.4 Corporate Governance

111. Notwithstanding the detailed requirements 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.
112. 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.
113. 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 and audit committees are less common.
114. 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

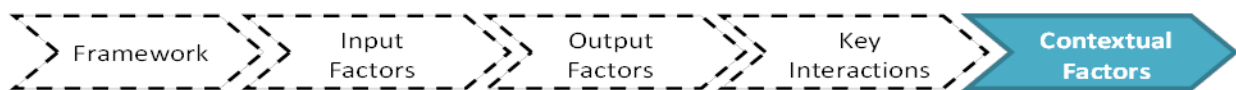


governance arrangements can impact the approach taken to the audit, and interactions with management and those charged with governance.

115. 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. Those charged with governance may have oversight of the internal audit function and are likely to be interested in establishing that there is appropriate interaction between the work of the external auditor and the internal audit function.
116. User perception of the quality of an entity's financial reporting 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 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.

#### 4.1.5 Information Systems

117. 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.
118. 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 systems that are not normally a part of the accounting system. Such information may not be as well controlled as information from the accounting systems, and this can affect overall financial reporting quality.
119. 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 or management as appropriate, about the reliability of the entity's information systems.
120. 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 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.

121. Failure of automated systems within IT dependent entities can result in significant costs to the business and, in extreme cases, to business failure.

122. 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, and sometimes formal internal controls may be limited.

#### 4.1.6 *Broader Cultural Factors*

123. 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.

124. 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.

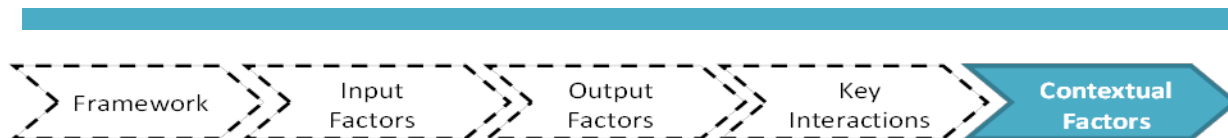
125. The group auditor needs to be well acquainted with differences in business practices and broader cultural factors with respect to the planning and conduct of the audit in different jurisdictions, in order to ensure consistent audit quality.

126. 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.

##### 4.1.6.1 Deference to Authority

127. Traditionally, 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.

128. 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 a reluctance to challenge management may adversely impact audit quality.

#### 4.1.6.2 Conservatism

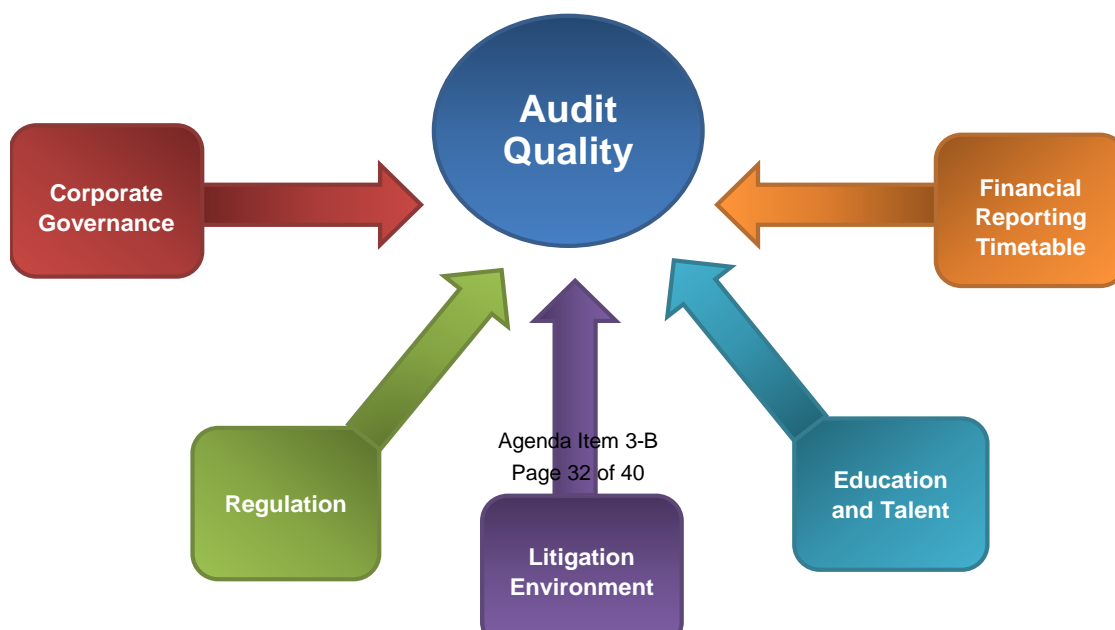
129. Other cultural differences include uncertainty aversion, and individualism. Research indicates a correlation between these factors and attitudes towards risk taking and its converse, conservatism. Both are likely to influence business strategies and internal conduct as well as the judgments inherent in financial reporting.

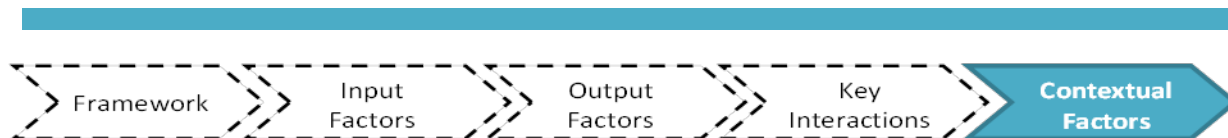
#### 4.1.6.3 Transparency

130. 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.

### 4.2 **Audit Quality**

131. In addition to those factors impacting the quality of financial reporting there are contextual factors that have a direct impact on audit quality. These include:



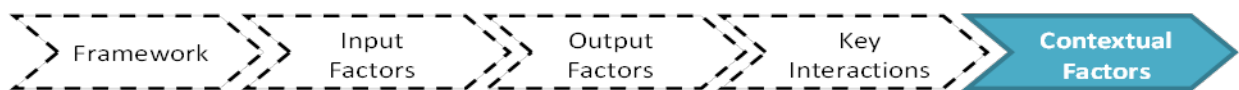


#### 4.2.1 *Corporate Governance*

132. The attitude of the leaders of an entity, typically the directors of a company, is of fundamental importance. Some may consider audit as only a regulatory necessity, the cost of which needs to be minimized. Others may value the audit as a rigorous process that gives them confidence that published financial information is reliable as well as an opportunity to obtain insightful comments from a knowledgeable independent observer in relation to risks the entity faces, its control environment, and its financial reporting process.
133. Those charged with governance of an entity can provide a positive influence on the quality of an audit by demonstrating an active interest in the auditor's work, and taking action when they do not consider that the appropriate quality has been provided.
134. In larger entities, especially listed companies, audit committees often exist to oversee the relationship between the entity and the auditor. This can include the appointment of the auditor, the assessment of the independence of the auditor (including the provision of non-audit services), and the approval of audit fees. As long as they are motivated to maximize the quality of an audit rather than minimize cost, audit committees provide a way of helping to ensure that sufficient, appropriate resources are allocated to the audit.
135. Some audit committees also have a responsibility to consider audit quality directly and do this as part of the process for the reappointment of auditors or when considering audit fees. This can be assisted if the audit committee has a formal process and criteria for describing the attributes of audit quality. Audit committee consideration of audit quality will be influenced by the interactions with the auditor (see paragraphs 67 to 70) and in particular by an assessment of the skepticism applied.
136. There is usually a direct relationship between the quality of an audit and the level of resources used in its performance; this will usually be reflected by the audit fee. It is important that audit committees consider whether sufficient audit time is planned. This is especially important when audit fees are negotiated directly with management. Management are often highly influential in determining audit fees, and may have a different perspective on audit quality from that of the audit committee.

#### 4.2.2 *Regulation*

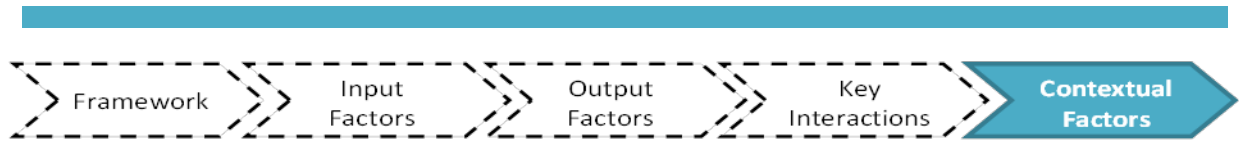
137. Regulation involves the licensing of firms and individuals to undertake audit, the designation of standards, the inspection of audits for quality, and disciplinary action in the event of audit failures. These functions are commonly undertaken at a national level by independent regulators, professional accountancy organizations, or a combination of the two.
138. Law, and auditing and ethical standards, provide the foundation for many aspects of regulation. While auditing and ethical standards are prescribed at a national level, increasingly national standards draw upon international standards set by IAASB and IESBA.



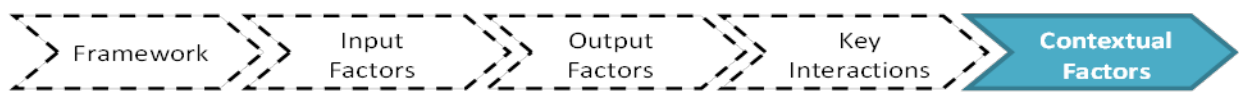
139. The requirements of auditing and other relevant standards are most effective if they are properly enforced. This involves the legal status of standards, inspection of audits, the investigation of allegations of audit failure, and where appropriate, disciplinary action being taken.
140. The inspection of audits is usually undertaken at a national level 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 regulators. 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.
141. External audit inspections provide an important mechanism for evaluating auditors' compliance with auditing standards, and depending on the mandate, other aspects of audit quality. Actions taken by audit firms to address weaknesses identified by audit inspectors can lead to improvements in audit quality. Over a period of time, relevant findings from external audit inspections need to be captured and fed back to standard setters.
142. The results of audit inspections are often published (see paragraphs 55 and 56). Publication of the results of audit inspections will lead to greater awareness amongst stakeholders about audit quality issues.
143. 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. Effective disciplinary arrangements involve those responsible for investigation and disciplinary functions having a clear mandate and sufficient resources to undertake their work.
144. 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.
145. 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.
146. 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 issues. These may include fines and mandatory retraining.

#### 4.2.3 *Litigation Environment*

147. In addition to direct costs incurred in performing an audit, there is a possibility that the audit firm will be required to compensate a litigant for the consequences on an audit failure. Litigation risk and its impact on audit quality varies between different countries.
148. Some believe that litigation risk will improve audit quality as it will cause the auditor to minimize the chance of an audit failure. Others believe that litigation risk will have an adverse impact on audit



quality as it will result in a “checklist” mind-set rather than a willingness to think about ways of addressing audit risk in an innovative manner.



#### 4.2.4 *Education and Talent*

149. Auditing is a demanding intellectual activity requiring the application of good judgment, an inquiring mind, and a considerable amount of business, financial reporting and auditing specific knowledge. While the profession endeavors to equip auditors with the necessary competence, the effectiveness of this will inevitably be influenced by the caliber of recruits.
150. In many countries university graduates form the majority of the recruits and many of these will have specialized in accounting and business. This background can provide both relevant knowledge and appropriate ethical attitudes.
151. Recruiting the right caliber of staff to the auditing profession is essential to audit quality in the medium term. However, the attractiveness of the auditing profession varies between countries and will be influenced by factors such as the reputation and status of the profession, as well as more direct factors such as comparative remuneration levels and perceptions about likely work effort.
152. If there is a shortage of suitably educated potential recruits, which is the case in some developing countries, it can be difficult to recruit the right quality of candidate.

#### 4.2.5 *Financial Reporting Timetable*

153. 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.
154. 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.
155. 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 less common for smaller entities to release earnings estimates prior to completion of the audit. However, it is not unusual for smaller entities to provide annual, monthly or quarterly unaudited financial statements to banks and other providers of capital.

## The Challenges of Defining Audit Quality

1. The term “audit quality” is frequently used in debates among 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.
2. The reasons why it is challenging to define audit quality are discussed in the following paragraphs that describe the challenges of defining audit quality.
3. 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. Often, 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, in accordance with the applicable financial reporting framework.
4. 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.
5. 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<sup>14</sup> 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.
6. 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.
7. 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.

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<sup>14</sup> Refer to paragraph 11 of ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing:

*In conducting an audit of financial statements, the overall objectives of the auditor are:*

- (a) *To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and*
- (b) *To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor’s findings.*

- 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 among stakeholders.
- There is limited transparency about the work performed and audit findings.

*The Existence, or Lack, of Material Misstatements in the Audited Financial Statements Provides Only a Partial Insight into Audit Quality*

8. 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 there may have been no material misstatements to detect.
9. 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 obtain reasonable, 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.
10. The audit model, that reflects inherent limitations of an audit, and is designed to obtain 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 were not detected as a result of the overall audit model or failings in the quality of the individual audit concerned.
11. 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*

12. No two entities are exactly the same and therefore the audit work and judgments required will necessarily vary. What is considered to be “sufficient appropriate audit evidence” is therefore, to a degree, a matter of professional judgment, reflecting the size, nature, and complexity of the entity, the industry and associated regulatory framework in which it operates, as well as the auditor’s assessment of the risks that the financial statements prepared by management are materially misstated.
13. Audit firms are usually profit-making entities and the profitability of an audit firm is usually linked to the relationship between the audit fees charged and the cost involved in gathering sufficient appropriate audit evidence. 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 additional challenges in ensuring that the amount of work performed is appropriate.

*Perspectives of Audit Quality Vary Among Stakeholders*

14. The perspectives of audit quality vary among 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; and the value that is placed on an audit varies among different stakeholders.
15. Stakeholders in listed entities do not have access to audit communications except for those available to the public. In contrast, stakeholders in other entities may often have direct access to auditors and receive both formal and informal communications, which directly influence their perspectives of audit quality
16. Some 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.
17. 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.
18. Balancing these different views suggests that a quality audit involves an effective audit being performed efficiently, 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, the auditor appointment, and audit fees.

*There Is Limited Transparency About Audit Work Performed and Audit Findings*

19. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly. However, many stakeholders, including the shareholders of listed companies, or finance providers for any business, do not usually have detailed insights into the work performed in the audit and the issues that were identified and addressed. Therefore, users of financial reports, who are external to the entity being audited, often cannot directly evaluate audit quality.
20. Information about the auditor's work and findings could be provided in the auditor's report. However, many auditors' reports are standardized, and other than in the relatively unusual circumstances when the auditor's opinion is modified, information is not usually provided about the auditor's work and findings.
21. Users have challenged IAASB about whether more information should be provided in auditor's reports and the IAASB has responded by proposing changes to the structure, wording and content of the auditor's report including, for the audits of listed companies, the inclusion of Key Audit Matters. The IAASB hopes that changes to the auditor's report, and in particular the inclusion of Key Audit Matters, will provide useful information to users of the financial statements to enhance their understanding of those matters that, in the auditor's professional judgment, were of most significance in the audit.
22. The IAASB hopes that its initiative will provide users with some insight into the quality of the audit especially if there is an opportunity for there to be further discussion about it with audit committees

or the auditor. However, IAASB recognizes that such additional information will inevitably be only a relatively small portion of the total information known by the auditor and that may be relevant to a full appreciation of audit quality.