

Raising the bar

International Auditing and Assurance Standards Board (IAASB) chairman Arnold Schilder explores the future of audit and the challenges facing the profession

With the key role it plays in underpinning public confidence in financial reporting, the value of audit is incontrovertible. But

the world economy has come under stress as a result of the financial crisis, and anxiety about economic stability has been driven by a loss of financial confidence.

So while it is right to say that audit failure, as such, did not contribute to the crisis, questions remain about the relevance of the auditor's role going forward. Auditors, say the critics, missed something fundamental in not spotting the crisis developing sooner. It's an irksome question, but also a kind of compliment: the world puts a great deal of faith and trust in auditors.

Even though auditors are watchdogs rather than bloodhounds, the crisis has raised fundamental questions about the future of audit, its role and relevance.

Clearly, external audit is key to the quality and credibility of financial information, and thereby market confidence. Over the years, external audit has also become a critical pillar of the regulatory and supervisory infrastructure. Many policy initiatives have reinforced its value, and the role of audit is highly respected in the regulatory structures that have multiplied in the past decade.

Failure to deliver high-quality audits has adverse consequences for economies and societies. While it's pleasing to see the value of audit so widely recognised, that recognition raises expectations as well as the concomitant risk of not satisfying those expectations.

THE QUESTION OF QUALITY

So how can the bar on audit quality be raised further? A substantial amount of research and policy analysis has been carried out on audit quality, and the first thing of note to emerge is that practitioner compliance with the standards is good evidence of quality and demonstrates that the audit lives up to some highly praised standards. But it's not enough to say that audit work conforms to, say, the new clarified International Standards on Auditing (ISAs). That's not to demean standards, but they are just one element in the world's perception of audit quality, and auditors cannot rest on their laurels.

Just as important are the messages that the auditors communicate. Does what auditors say make sense to the users of the company accounts? Does it help those users or add value? Quality is not just about the standards but also about the effectiveness of those standards and their effective application. Perceptions of audit quality are influenced by

responses from users and any debate about the auditor's findings in committees and among the main shareholders. Ultimately, the issue of audit quality is complex but the only way to make progress is to address all these factors. I really would like to commend ACCA's leadership in this respect. I am aware of your roundtable discussions and the policy papers you have presented, asking and exploring these pertinent questions.

ROCKY ROAD TO ISAs

The IAASB helps by setting high-quality standards. Under the able leadership of my predecessor, John Kellas, all ISAs have been redrafted in the 'clarity' style. Moreover, about half have also been thoroughly revised. This whole suite of clarified ISAs is a major contribution to audit quality. The revised standards deal with important issues, such as communications to those charged with governance and alerting them to control deficiencies, estimates and fair value, related parties, the role of experts, group audits and so on, all of which demonstrate the board's audit quality ambitions and expectations.

So the standards have been produced – but where are the customers? Will practitioners use ISAs? Adoption is about getting the national organisations to incorporate them into national or regional standards. But there are 21 official languages in the EU alone, and until the clarified ISAs have been translated into all of them they cannot be adopted by the European Commission. (There are also regional variations of languages that may require different translations.)

Implementation is an even harder nut to crack. Will practitioners use these standards in the way they are intended? If not, then what can be done about it? Capacity, training and education are key issues here. All the network firms are working on methodologies, programmes and manuals, but how will smaller practitioners cope? How can they be helped? Can they benefit from what others have already done? The IAASB has established an implementation monitoring task force to help here.

MEETING EXPECTATIONS

The expectations gap is real, and auditors have to deal with many users and regulators, so it's important to find out what those users and auditors expect and how those expectations change over time.

Regulators share our aims and sophistication, so the IAASB has established a regular dialogue with the International Forum of Independent Audit Regulators (IFIAR) and others.

Arnold Schilder is chairman of the International Auditing and Assurance Standards Board (IAASB), the international audit standard setter. He was a member of the managing board of the Dutch central bank from 1998 to 2008. He has also served as chairman of the Basel Committee on Banking Supervision's Accounting Task Force, been a member of the Public Interest Oversight Board, served as president of Dutch accounting body Royal NIVRA and worked as an international audit partner at PwC. In addition he has been a part-time professor of auditing at the Universities of Amsterdam and Maastricht.



Users are perhaps a harder group to satisfy, but they are the people the accounts and audit reports are written for and for that reason they matter enormously.

One investor recently remarked to me: 'We care more about the soft stuff in reports, all the estimates and assumptions and uncertainties and judgments and qualitative disclosures.' In the past, disclosures were principally an explanation of the numbers that came up in the balance sheet and the profit-and-loss account. But the disclosures part is now so extensive there is a risk that it runs to as many as 400 or 500 pages. The soft stuff is important, but investors want more relevant information.

IAASB-commissioned academic research on auditor reporting found that the external auditor's report has a positive symbolic value. Even a qualified opinion matters.

But there's not much of communicative value in the audit reports – a lot of boilerplate but no specific messages. In the UK, having more of the boilerplate on a website rather than in the audit report is helpful. But we could learn from France, where they have justification of

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assessments. In the disclosure part of an annual report the board and management explain a number of the softer issues, the judgments they have made and why they came to certain estimates and the underlying assumptions. That will be picked up in the auditor's report and commented on. It's a reinforcing process: the board knows the auditor is going to make reference to these disclosures, so the directors make certain the financial statements provide a thorough explanation, and it also reinforces the quality of the auditor's work.

So it's not just the auditor's report that matters but also the broader area of disclosures. The risk of opaque disclosures has been addressed but not in a very meaningful way. There are a lot of professional judgment and

materiality decisions involved, so the IAASB has decided to re-examine the auditor's responsibilities relating to disclosures. There is a specific project on the revision of ISA 720, and another project is under consideration to look at the broader question about the quality of disclosures and their audit.

ASSURANCE FOR SMEs

There have been national developments that affect small and medium-sized enterprises (SMEs), including increasing thresholds for exemption from statutory audits. If SMEs volunteer for an audit, that's fine, but the profession must be able to provide other services, too, that are geared towards SMEs. So the IAASB is prioritising the development of standards for other, non-audit, assurance and related services.

Two standards are relevant: reviews and compilations. We can gauge how their revision responds to SMEs' needs but some perspective must also be gained on the likes of hybrid products.

A practitioner can, of course, give a compilation report with some assurances. Some sophisticated users want to know more specifically about debtors or inventories in a subsidiary; just do that work, they say, and the results will show us what we want to know.

How does that fit in this broader perspective? Formally, a compilation engagement does not provide assurance, but it still generates a perception of assurance because the practitioner will have compiled the report. I once tried to explain to a banker that we had issued a compilation report only, so there was no audit opinion and no assurance. He said: 'Well, Mr Schilder, as long as I see your signature behind that, it's fine for me.'

There are more questions about whether there is an even broader assurance role for the profession, and if there should be related assurance standards accordingly. A lot of investor demand for non-financial information falls in a risk-management framework, so are risk management, internal controls and business models areas that auditors should address more? The IAASB will soon start its consultation process on the strategy for 2012–14, and we are keen to receive input on these broader questions.

Other assurance developments include a project on complex financial instruments, derivatives and so on, with consultation on the revision of practice statement IAPS 1012; we hope to issue an exposure draft in September.

This article is based on a speech that Arnold Schilder gave to ACCA's council in March 2010.