

Comment Letter to the IAASB

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Answers and suggestions to the questions as raised by the
International Auditing and Assurance Standards Board (IAASB)
by
the University of the Witwatersrand (Johannesburg, South Africa)
Auditing Masters Class

Table of Contents

1.	Introduction.....	1
2.	Whether the strategic objectives identified are considered appropriate for the period 2015–2019.....	1
2.1	Develop and Maintain High-Quality ISAs that Are Accepted as the Basis for High-Quality Financial Audits.....	2
2.2	Ensure the IAASB's suite of Standards Continues to be Relevant in a Changing World by Responding to Stakeholder Needs	2
2.3	Collaborate and Cooperate with Contributors to the Financial Reporting Supply Chain to Foster Audit Quality and Stay Informed.....	3
3.	Whether the factors included in Appendix 2 represent a reasonable basis for the IAASB to use in developing its Work Programs beyond the Work Program for 2015–2016.....	3
4.	The appropriateness of the topics chosen as the focus for the Work Program for 2015–2016 (see paragraph 4 and Table A) in light of the strategic objectives set out in the IAASB's Strategy for 2015–2019.	4
4.1	Quality Control	4
4.2	Professional Scepticism	5
4.3	Special Consideration relating to financial institutions	7
4.4	Monitoring by the INFO Working Group.....	9
4.5	Post-implementation Review	9
5.	Whether there is an action(s) or project(s) that has not been included in the Work Program for 2015–2016 that you believe the IAASB should address during that period.	10
6.	Whether there are alternative approaches for the IAASB to consider in order to enhance the IAASB's ability to address calls from stakeholders for IAASB efforts on a variety of important topics, in light of the constraints of available resources and the need for due process to be applied in the development or revision of standards.	10
7.	The IAASB invites any other comments that you believe are important to provide input to the IAASB for the purpose of developing its future work programs.	11
7.1	The ISAs in their Current State.....	11
7.2	The Expectation Gap and Information Gap	12
7.3	Independence of the Auditor.....	12
7.4	Strict Application of the ISAs.....	14
7.5	Audit Transparency.....	14
7.6	Expressing an Opinion on Controls	16
7.7	Revision of ISA 402.....	16
8.	References.....	16

1. Introduction

Dear International Auditing and Assurance Standards Board (IAASB), this comment letter has been compiled by the 2014 Auditing Masters class of the University of the Witwatersrand. The University of the Witwatersrand, located in Johannesburg, South Africa, is a university with a strong commitment to accounting and auditing. Within the School of Accountancy, the University offers a Master of Commerce degree specialising in accounting, with one of the modules of the degree being an auditing module. This module is facilitated by Professor Linda de Beer who holds, among others, the position of Chairwoman of the Consultative Advisory Group of the IAASB.

During the module, multiple pertinent and topical areas were examined, analysed and debated, including: the expectation and information gap, improvements to auditor reporting, professional scepticism and auditor judgement, audit quality, auditor ethics, and the future of the auditing profession.

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As the Auditing Masters class of 2014, we endeavour to assist in the enhancement and betterment of the profession. Please see below for our responses to the questions raised by the IAASB.

2. Whether the strategic objectives identified are considered appropriate for the period 2015–2019.

Scandals and crises have highlighted flaws in various sectors and professions, including the auditing profession (Sikka, 2009). It is therefore exceptionally important that the auditing standards develop

more effective auditors and promote higher quality audits (in the fact that they actually serve to promote the public interest), and that they respond to the mercurial nature of the requirements of stakeholders and the complexity of transactions and the financial reporting frameworks.

The IAASB has identified three strategic objectives for 2015-2019, which are explored in detail below:

2.1 Develop and Maintain High-Quality ISAs that Are Accepted as the Basis for High-Quality Financial Audits

Firstly, it has been stressed that the profession needs to report in the best interests of the public, and this can be achieved by the governance and regulation of future standard setting (Humphrey, Loft and Woods, 2009). This issue can be dealt with by minimising the expectation gap and reporting more in the best interests of the public.

A suggested enhancement is that an ISA be developed which requires auditors to describe the control weaknesses discovered during the audit and report on said weaknesses. Users tend to value this information and, through disclosure, would improve the relevance of the auditor's report and decrease the information gap (McEnroe and Martens, 2001).

2.2 Ensure the IAASB's suite of Standards Continues to be Relevant in a Changing World by Responding to Stakeholder Needs

Disclosure of non-financial information has become increasingly popular due to, inter alia, the emergence of dominating industries, tougher competition, developments in information technology, the internet, and globalisation (Bukh, Nielsen, Gormsen and Mouritsen, 2005; Deloitte, 2011; Watson and Monterio, 2011). This is an indication that the needs of stakeholders and investors has evolved, and since it is the responsibility of the auditing profession to report on information which is most

beneficial to users, then the current audit report needs to be improved. However, this has been seen as a shortcoming of accounting and auditing reporting, especially now with the emphasis placed on integrated reporting, which considers not only financial but also corporate social responsibility information (Flöstrand and Ström, 2006).

This issue will be dealt with via the enhancement of the relevance of the standards and the profession. We commend the IAASB on the release of the exposure draft regarding the revision of reporting standards so as to result in the audit report achieving relevance in the current corporate reporting climate.

2.3 Collaborate and Cooperate with Contributors to the Financial Reporting Supply Chain to Foster Audit Quality and Stay Informed

Lastly, due to globalisation it would be important for standard setters to be in sync with global trends such that the standards result in comparable audits, irrespective of the location of the audit. Given the lack of overall resources of regulators and other stakeholders, the suggestion here is that resources and experience be combined which can ameliorate audit quality and enhance understanding of the determinants of audit quality.

3. Whether the factors included in Appendix 2 represent a reasonable basis for the IAASB to use in developing its Work Programs beyond the Work Program for 2015–2016.

We agree that the factors included in Appendix 2 deal with issues that are currently highlighted as deficient in the profession and that are highly topical. They, therefore, represent a reasonable basis for inclusion in the work program for 2015-2016. These should be addressed in order to restore faith in the profession and enhance the overall ability of the profession.

4. The appropriateness of the topics chosen as the focus for the Work Program for 2015–2016 (see paragraph 4 and Table A) in light of the strategic objectives set out in the IAASB’s Strategy for 2015–2019.

4.1 Quality Control

Academic literature is widely divided in relation to the definition of audit quality (Bonner, 1999). Each firm and regulator attributes a different meaning to audit quality. Collaboration with the users of financial statements and academics can assist in streamlining the definition of audit quality to allow for comparability across the profession. This appears to be in accordance with the strategy of the IAASB, as high quality audit standards must be either developed to address the uncertainty, or existing standards must be clarified and expanded. However, the lack of consensus on a definition and the fact that there are no authoritative measurement criteria leaves audit quality largely subjective.

In addition to amendments to ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and ISA 220, *Quality Control for an Audit of Financial Statements*, that result in clarifications to their applicability and implementation, there must be the advancement of a measurement framework. We commend the IAASB for the step forward in 2014 in the publication of the *Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*. The principles in this framework must now be extended so as to codify the criteria that affect audit quality, and which can be measured to reach an objective determination of audit quality. Another ISQC (proposed: 'International Standard on Quality Control: Measurement of Audit Quality') could be developed. The implementation of a quality control measurement framework can also form part of the enhancements to ISQC 1 and ISA 220, requiring mandatory audit quality measurement at a firm or audit level. This would incentivise

audit firms to focus on complying with said standards to be able to obtain a passable score on measurement, and therefore be able to continue operating in the profession, and also avoid penalties, fines, and sanctions.

The inclusion in the work programme of activities relating to supporting the use of the IAASB's *Framework for Auditing Quality* is vital and necessary in ensuring that the framework achieves recognition and its implementation assists in bringing some measure of definition to audit quality and the profession.

In addition, the IAASB should, in collaboration with academics and regulators, determine the efficacy of the so-called indirect measures (also known as surrogates or proxies) that are used to determine audit quality.

The inclusion of the fact that the IAASB will review the clarity of provisions relating to using the work of a specialist and an auditor's expert is welcome. Increased emphasis on the use of experts and specialists can result in increased audit quality, given that the move to Integrated Reporting (which entails reporting on the 'capitals' that are not limited to a financial nature (International Integrated Reporting Council (IIRC), 2013)) and requisite assurance on this report requires skills other than those that auditors possess.

4.2 Professional Scepticism

The relevance and importance of professional scepticism has sharply increased as a result of the current complexity of the financial reporting environment. This is seen in the fact that, in order to facilitate the provision of more relevant information to the users of financial statements, management is involved in the determination of estimates for corporate reporting purposes (for example relating to

fair value measurements, and specifically impairment of goodwill, impairment of other intangibles, and future cash flows) which leads to increased subjectivity and judgement on the part of management. Such estimates must be sceptically analysed to determine appropriateness, in order to lower detection risk to an appropriate level.

The main deficiency of many auditing terms and definitions in the ISAs is that there is no single way in which they can be measured, professional scepticism included. There are varying definitions for professional scepticism and how to apply it adequately in the auditing process. This lack of clarity results in varying interpretations by auditors, which could fall short of the expected outcomes predicted when defining it in the ISA 200, *Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing*.

Training has been shown to enhance scepticism in the short-term (Fullerton and Durtschi, 2004). Similarly, research by Hurtt, Eining, and Plumlee (2010) and Payne and Ramsay (2005), showed that training should be implemented at different stages of the auditor's career in order to help them to better understand the concept and execution of professional scepticism. The IAASB could mandate compulsory training, and an International Auditing Practice Note (IAPN) or ISA could elaborate on such requirements, for example, those that are used in forensic auditing courses worldwide.

A common issue raised is that professional scepticism depends, ultimately, on the nature and characteristics of the individual. Research by Gillian (2007) has shown that human nature influences decision making and determines the conclusions that we, as human beings, reach. Furthermore, professional scepticism is also difficult to measure. However, a measurement framework by Hurtt (2010) espoused the use of factors such as the questioning mind of the individual, the ability of the

individual to suspend judgement, the individual's sense of curiosity, and the interpersonal understanding of the individual to measure professional scepticism. Further review of this framework and other factors could contribute to the determination of a universal method to measure professional scepticism.

In the event that a measurement standard is developed, one could require that the auditor disclose their level of professional scepticism in the audit report, as this would incentivise auditors to ensure that they do comply with the professional scepticism requirements.

A contentious solution to this issue could be the requirement that prospective auditors be psychologically evaluated and, if insufficiently sceptic, are not permitted to practice as an auditor.

4.3 Special Consideration relating to financial institutions

Given the recent collapse of financial institutions in the United States of America and elsewhere, the widely believed notion that the auditor had failed in his/her duties (Freidman and Friedman, 2009), and the increasing complexity of financial institution reporting in terms of International Financial Reporting Standards (IFRS), this is a relevant and topical inclusion into the IAASB 2015-2016 work program. The failures do indicate to a certain degree that audit quality is a concern, hence the consideration of specific matters relating to financial institutions is in line with the strategic objective of developing and maintaining a high quality audit. The reporting changes and complexity practically mandate the consideration of this item to enable future relevance of the ISAs and profession.

The most difficult aspect relating to financial institutions is the accurate and proper measurement of the fair value (as set out in IFRS 13) of complex financial instruments. To enable an accurate approach, there must be a greater focus on the strategic objective of enhancing collaboration with

contributors to the financial reporting supply chain, as this will allow for greater insight and understanding into the transactions. Revisions to ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, could also be considered to ensure that greater emphasis is placed on the evaluation of management assumptions and inputs into estimates, stressing the need for professional scepticism.

Before a new ISA/IAPN relating to financial institutions is evaluated, IAPN 1000, *Special Considerations in Auditing Financial Instruments*, must be addressed. IAPN 1000 deals with special considerations in auditing financial instruments, and therefore it may be prudent and efficient to expand on these for financial institutions. The case here, though, is made for the guidance in the IAPN to be codified in an ISA, so as to ensure that auditors must comply, as opposed to merely considering compliance.

Banks, however, are different in that they are subject to greater regulation (Basel III (Bank for International Settlements, 2011) and the Banks Act No. 24 of 1990 in South Africa (Reserve Bank, 1990)), and thus require more direct audit considerations. The Basel Committee on Banking Supervision is a key role-player in the regulation of banks and greater co-operation with the IAASB (shared information and goals, such as around going concern evaluations and the Committee's insights into the industry) can enhance audit quality and ensure that the relevant specific auditing challenges are overcome. However, care must be taken to avoid the loss of relevance of the IAASB due to a failure to ensure proper guidance in the banking sector. The IAASB should work with the Basel Committee to develop standards so as to ensure that the auditors of banks are still governed by the IAASB.

4.4 Monitoring by the INFO Working Group

As there is a global shift in corporate reporting away from the cumbersome annual report to a more relevant and user-friendly Integrated Report, it is imperative that specific standards be crafted so as to provide direct requirements for assurance over such Integrated Reports.

In a South African context, the King III Report and Code on Governance in South Africa (Institute of Directors, 2009), requires that assurance be provided over the integrated report (on an ‘apply or explain basis’) in terms of International Standard on Assurance Engagements (ISAE) 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, and AccountAbility (AA) 1000 AS. However, these standards are not well suited to integrated reporting, due to the perception that all the information is assured, which gives rise to an expectation gap. What is also clear is that these standards are unable to prescribe the assurance to be provided over forward-looking information. The crux is that there is a lack of guidance around integrated reporting assurance.

Consequently, the monitoring by the INFO Working Group of the IIRC is vital to allow for the exact determination of the auditing profession's approach to integrated reporting. Notwithstanding the monitoring taking place, more emphasis must be placed on collaboration with the IIRC so as to develop a standard that will specifically address the needs of auditors in auditing integrated reports. This is usually a lengthy process, and the earlier the IAASB begins the process, the earlier greater clarity and quality will be achieved due to codified requirements.

4.5 Post-implementation Review

The IAASB have raised the issue of monitoring the implementation of new and revised standards. This is a welcome development, as it is commonly found that the standards are not effectively and

correctly implemented in practice. However, the scope should be broadened in that the implementation of all standards should be monitored, and not just new or revised standards, as this will, ultimately, aid in identifying possible improvements to those standards and highlight other issues regarding the implementation of the standards, which must be addressed to ensure that the goals and requirements are met.

5. Whether there is an action(s) or project(s) that has not been included in the Work Program for 2015–2016 that you believe the IAASB should address during that period.

The topics listed in Appendix 1 are important and must be considered, however, audit quality, professional scepticism and financial institution auditing are currently of greater importance in the current financial climate, hence we would not support the prioritisation of any of the Appendix 1 topics sooner than what is listed in the 2015-2016 work program.

6. Whether there are alternative approaches for the IAASB to consider in order to enhance the IAASB's ability to address calls from stakeholders for IAASB efforts on a variety of important topics, in light of the constraints of available resources and the need for due process to be applied in the development or revision of standards.

We would propose a suggestion here in the spirit of a shared world. Due to globalisation and the fact that a large number of companies are now multi-national, it is evident that there must be greater co-operation between governments, regulators, and public sector auditors.

The issues as identified by the IAASB, and which have been included in the work program are global issues, and affect every individual in the auditing profession. Thus, we propose greater collaboration and a shared workload between the IAASB, the American Public Company Accounting Oversight Board (PCAOB), the South African Independent Regulatory Board for Auditors (IRBA), the International Organization of Supreme Audit Institutions (INTOSAI) and other regulators, including

members of the International Federation of Independent Audit Regulators (IFIAR), to enable enhanced resources to be applied in solving the issues.

INTOSAI is specifically mentioned because the public sector may have valuable insight, which will, together with that of the IAASB, create synergies, and allow for expedited research regarding shared issues, which are bound to be many. A singular example of such insight is the practice in the public sector of performance auditing (see International Standard of Supreme Audit Organisations (ISSAI) 3000, *Standards and Guidelines for Performance Auditing based on INTOSAI's Auditing Standards and Practical Experience*), which will be of value to the IAASB, and users.

7. The IAASB invites any other comments that you believe are important to provide input to the IAASB for the purpose of developing its future work programs.

7.1 The ISAs in their Current State

In the focus areas proposed in the prospective IAASB strategy, it is mentioned that attention will be given to standards that need to be developed in order to improve the current audit process. In our opinion, in addition to the creation of new standards in order to improve the quality of the audit, thought should be given to providing implementation guidance to supplement the current standards. The current ISAs do not provide enough guidance to auditors on the application of the requirements and provisions therein.

One example, which should be used by the IAASB for direction in implementing such guidance, is IAPN 1000. This practice note provides clear guidance on the implementation of certain standards regarding the audit of financial instruments. More practice notes on other standards, similar to IAPN 1000, will greatly assist auditors in implementing the ISAs and will enhance the relevance of the

audit function due to uniformity of the application of the standards as opposed to the application of differing interpretations by auditors.

7.2 The Expectation Gap and Information Gap

The literature is clear on the fact that public and user understanding of the responsibilities of the auditor and of management is lacking (McEnroe and Martens, 2001). In essence, an expectation gap still exists as a result of the perception that the auditor is responsible for certain tasks, when in actual fact they are not. There is a call for the education of users, and for the clarification of the responsibility paragraphs contained in the ISA 700-compliant auditor's report. The IAASB should devote resources focus to educating the users of financial statements, for example by issuing explanatory memorandums or public notices

In a similar vein, there currently exists a great disparity between information that the auditor reports and that which users would like to see, generally called the information gap. The extant literature (Sexton, 2011) describes that users would like to see the reporting by auditors of information reported to those charged with governance (generally the audit committee in public companies). ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, which is to address this gap, will be a welcome addition for users, and as such should be fast-tracked for implementation as part of the 2017-2018 work program.

7.3 Independence of the Auditor

Another key matter is the lack of independence. Auditors are required to be independent in both mind and appearance, but the perception is that the auditor is neither. This is corroborated by the perceptions that long auditor tenure and the provision of non-audit services impairs and auditor's independence.

However, regarding auditor tenure, the one view is that it definitely compromises independence (Ghosh and Moon, 2005), contrasted with the view that the quality of the audit is actually strengthened by the long-association as the auditor has a more in-depth understanding (Jackson, Moldrich and Roebuck, 2008).

The collapse of Enron in 2001 and the subsequent discovery that its auditor, Arthur Andersen, had shredded audit documents after notification of a Securities and Exchange Commission (SEC) investigation of Enron sent shock waves through the financial markets, and drew attention to the effect of non-audit services on independence. Exacerbating this situation was the revelation that besides Andersen's \$25 million audit fee, Andersen earned another \$27 million from Enron for consulting, thus raising questions about conflict of interest (Tackett, Wolf and Claypool, 2004).

The empirical evidence around the effect on independence of non-audit services is, however, unclear, as Bédard and Paquette (2011) showed that there is a clear perception by knowledgeable audit committee member that tax non-audit service does influence independence. There must be research undertaken to construct a framework for independence that can serve to attempt to quantify and rank the independence of the auditor, to give some comfort over actual levels.

It is suggested that the IAASB engage much more assertively with the International Ethics Standards Board for Accountant (IESBA), in order to properly and authoritatively implement stronger independence requirements.

The IAASB, in conjunction with regulators and the IESBA, in addressing this crucial independence issue, should encourage regulators to apply strict application of Company law, and to ensure that there exists a process whereby non-compliance can be reported and the proper response taken.

In South Africa, the Companies Act (2008) restricts the provision of non-audit services to audit clients, and incentivising strict application of the law could be carried out by the implementation of severe penalties for non-compliance thereof. The involvement of regulators is pivotal in this quest to ensure that all auditors comply with this requirement.

7.4 Strict Application of the ISAs

The IAASB has to work together with regulatory bodies to ensure that all audit firms adhere to the current ISAs and ensure that no steps are taken by these firms, either individually or as a group, to contravene the current standards by the IAASB. Non-compliance with the ISAs undermines the value of the profession, and more specifically, it impairs the confidence users have in an audit performed in terms of the ISAs. The IAASB should encourage regulators to disclose instances of non-compliance with auditing standards, and the culprits thereof, so as to disincentivise a lack of adherence to the standards.

If the IAASB wishes to achieve the enhancement of the respect from the general public, it is imperative that they highlight these contraventions by the audit firms and in actual fact penalise them and name them in public. This should be done to ensure the public believe that the IAASB are in fact actually still working for the interest of the public as a whole.

7.5 Audit Transparency

To improve further the audit function, the IAASB should focus on enhancing audit transparency.

Audit transparency can be improved by enhancing disclosure about the participants in the audit,

including disclosure about the partner in charge of the audit, as well as other firms involved in the audit (Doty, 2011).

Currently, the audit report in terms of the ISAs does not provide for any disclosure relating to the audit partner in charge. The confidence of users could be enhanced if this information was disclosed. Information about the independence of an audit partner is currently an internal consideration within the firm and it is up to the users to assume that the auditor is independent. Should the auditor's independence be made public knowledge, perhaps the users can find more relevance in the audit opinion. In the exposure draft by the IAASB, this issue has been taken into account, however, it is of critical importance that it does find its way into the ISAs and is thus, codified.

Certain jurisdictions only allow for local auditors to audit entities within that jurisdiction, and sometimes, due to resource limitations and in most cases, unfamiliarity with the laws and regulations under certain jurisdictions, it is difficult for one audit firm, which audits a multinational company to audit all components of this client. Therefore, auditors usually make use of component auditors, who audit specific sections of the client. Ultimately, only one audit report is issued by the group auditor, taking into account all the findings and work of component auditors. However, there is no disclosure of the fact that component auditors were used, nor the identities of these component auditors.

The release of such information will allow for investors to gain a better understanding of the audit conducted and, in consequence, allow them to make better decisions as to how to use the audit report (Doty, 2011). As with the independence aspect of the group auditor, the independence and competence of the component auditors remain an internal consideration, and users are not privy to this important information. A requirement to disclose all these aspects by the IAASB would

definitely increase the reliability of the audit report, and therefore the relevance of the auditing profession.

7.6 Expressing an Opinion on Controls

Research has shown that users would much rather value an opinion issued on the controls implemented in an entity (Sexton, 2011), inter alia. Much of the information requested by users involves information which auditors are already required to obtain during the audit process. Therefore, it would not be impractical to consider that auditors should also be required to report on these types of information. By requiring auditor's to report on the internal controls and risk management of an entity, it would not only increase the relevance of the current auditor's report but would also improve the quality of work carried out by auditors when they are gaining an understanding of the entity and their internal controls. Reporting on internal controls would also encourage entities to improve their internal control procedures as the efficiency of their systems would become public knowledge

7.7 Revision of ISA 402

The clarification of ISA 402, *Audit Considerations Relating to Entities Using Service Organizations*, should be prioritised, so as to enhance quality of the audit clients with a service organisation. The standard is complex, such that it is not clear which services entities would qualify as a service organisation.

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