

1. Introduction

1.1 Background

1. The global financial crisis has highlighted the critical importance of credible, high-quality financial reporting and the need for effective interactions between the participants in the financial reporting supply chain.
2. The external audit plays a major role in supporting the quality of financial reporting around the world, in the context of not just the capital markets, but also the public, private and not-for-profit sectors. Audit quality is therefore a matter of significant public interest.
3. The IAASB is most directly involved in supporting audit quality through its International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC). These standards provide an important foundation supporting high-quality audits. ~~However, it is important to recognize that audit quality is a broader concept than quality at the audit engagement level. The concept of audit quality encompasses the broader environment, including the independence and competence of auditors, the actions of others in the financial reporting supply chain, and the legal, regulatory and business environments in which audits are performed. Properly complying with the requirements of ISAs requires the auditor to exercise professional judgment and plan and perform an audit with professional skepticism. Judgment and skepticism are personal behavioral traits that are determined by the attitudes and ethical values of the people undertaking the audit, as well as their understanding of the entity and the industry in which it operates. Personal behavioral traits and knowledge are, in turn, influenced by the training and experience of the engagement partner and the rest of the audit team.~~
4. ~~There have been a number of attempts to define audit quality in the past and questions continue to be asked as to whether it can be quantified. None of this activity has resulted in a definition that has achieved universal recognition and acceptance, although there seems to be a growing consensus that audit quality cannot be measured with any degree of accuracy.~~
5. ~~Audit quality is, in essence, a complex and multi-faceted concept. Difficulties in defining audit quality arise for a number of reasons, including:~~
 - ~~No two audits are exactly the same and therefore the work performed will rightly vary. Furthermore, the work performed and conclusions reached will be based on the auditor's professional judgment.~~
 - ~~Business activities and the way entities account for them continually evolve. Audits need to be responsive to this and address new threats to the reliability of financial reporting as they arise.~~
 - ~~Perspectives of audit quality vary amongst stakeholders depending on their level of direct involvement in audits and on the "lens" through which they assess audit quality.~~
4. Because of the difficulties in defining audit quality ~~Audit quality is therefore a broader concept than just compliance with standards. It encompasses considerations of the personal characteristics of auditors. It is also influenced both by the interactions between the auditor and others involved in the financial reporting supply chain, and the~~

legal, regulatory and business context in which audits are performed including the entity's financial reporting framework.

5. The complex and multi-faceted nature of audit quality makes it a challenging subject but, the IAASB has agreed believes there is value in developing —to develop an international a framework that describessets out the elementskey attributes of audit quality. The IAASB also believes that such a framework will assist stakeholders in better understanding what audit quality is and considering whether there is more that can be done to increase audit quality in their environments—will be such that audit quality will likely be achievable and therefore that audit firms⁺ will be well placed to provide quality audits.
6. The IAASB hopes that strengthening the environments in which audits are performed will lead to systemic improvements in audit quality. However, the IAASB notes that poor quality audits can occur in an audit firm even when the environment provides strong support for the achievement of audit quality. Conversely, weaknesses within an environment need to be mitigated through the performance of appropriate audit procedures in an individual audit.
- ~~6.7.~~ While ~~the~~ framework includes key attributes at the level of an audit engagement, it is not designed for the evaluation of the quality of an individual audits, which. This will be more dependent on the nature and extent of audit evidence obtained in response to the risks of material misstatement in a particular entity and, the appropriateness of the relevant audit judgments made and compliance with relevant standards.
- ~~7.~~ Weaknesses within an environment can be mitigated in the context of an individual audit; equally, poor quality audits can occur in an audit firm even when the environment seems well placed to enable the achievement of audit quality. An understanding of the causes of poor quality audits can provide valuable feedback to assist continual improvement in the audit environment.

1.2 Purposes of an International Audit Quality Framework

8. The IAASB envisages that an audit quality framework would help serve the following purposes:
 - *In relation to stakeholders generally*

The framework could be used to facilitate closer working relationships and dialogue between the IAASB and key stakeholders as well as amongst the key stakeholders themselves. In particular:

 - Given the importance of building strong working relationships between the IAASB and various stakeholders, it would be helpful to have a framework in place as a basis for constructive discussions on audit quality. Also, from the perspective of oversight bodies, a framework may be of assistance in harmonizing approaches to regulatory inspections around the world.
 - A framework could be of high impact in helping to raise the level of awareness and understanding amongst stakeholders of the important

⁺ ~~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.~~

elements of audit quality, particularly in developing countries or emerging economies, or in jurisdictions where there has been little or no debate on audit quality.

- A framework would enable stakeholders to recognize the elements of audit quality that may deserve priority attention to enhance audit effectiveness, and better understand how auditing standards fit into the audit quality equation. Additionally, a framework could be used to better inform those charged with governance about audit quality and encourage them to think about the right questions to ask in the context of the audit.
- *In relation to IFAC's standard-setting Public Interest Activity Committees (PIACs)*²

Given that standard setting is an evolving process, a framework could act as input to each of the standard-setting PIACs' ongoing assessment of whether it has the appropriate set of standards. For example, it could facilitate IAASB consideration of whether there are areas within ISQC 1³ and ISA 220⁴ that may require attention. More generally, a framework could assist the IAASB, IESBA and IAESB in thinking through the implications of new standard-setting proposals.

- *In relation to firms and professional bodies*

A framework could help firms when reflecting on how to enhance the consistent application of auditing standards or internally-developed guidance within the firms or across their networks. It could also help facilitate the communication of information about audit quality by firms and professional bodies.

- *In relation to academics*

A framework may help to stimulate relevant academic research on the topic.

9. In addition, the IAASB also hopes that use of the framework by users of audited financial statements (e.g., investors), those charged with governance, regulatory and oversight bodies, and audit firms will help identify areas for potential collaborative action that will benefit audit quality. For example:

- [Expansion of the role of audit committees ~~those charged with governance~~ to cover the evaluation of the effectiveness of the external audit and the reporting in annual reports of the work that is performed.]
- [Audit firms considering the competence framework in IES 8⁵ when evaluating, promoting and remunerating partners and staff.]
- [Others]

² IFAC's PIACs are subject to oversight by the Public Interest Oversight Board.

³ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

⁴ ISA 220, *Quality Control for an Audit of Financial Statements*

⁵ International Education Standard (IES) 8, *Competence Requirements for Audit Professionals*

2. 1.3 The Nature of Audit Quality

10. The term “audit quality” is frequently used in debates amongst stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting, amongst other contexts. However, it is a complex subject and there is no single analysis of audit quality that has achieved universal recognition. There are a number of reasons why this is so, including the following:

- The absence of material misstatements in the financial statements is one, but not the only, indicator of audit quality. However, financial reporting involves a degree of imprecision which, in some circumstances, can make it difficult to establish whether financial statements are materially misstated.
- Audits provide reasonable assurance, not absolute assurance.
- Judgment is needed in evaluating whether deficiencies in audit work are sufficiently serious to threaten overall audit quality.
- Entities, and audits of them, are idiosyncratic. What is sufficient appropriate audit evidence to support an audit opinion is judgmental and could be influenced by commercial considerations.
- Perspectives of audit quality vary amongst stakeholders.
- There is limited transparency about the work performed on an audit and its findings.

These are further discussed below.

The Nature of Material Misstatements in the Financial Statements and Audit Quality

11. The objective of an audit is to provide assurance to users of financial statements that the financial statements do not contain material misstatements. While the absence of material misstatements in the financial statements is likely to be an important indicator of audit quality it cannot, of itself, be the only measure of audit quality. Management may have prepared the financial statements such that there were no material misstatements to detect; however, the audit performed was flawed and would not have detected certain material misstatements even if they had existed.

12. While the nature of a material misstatement is likely to be influenced by the financial reporting framework applied by the entity, financial reporting usually involves management making subjective decisions and assessments and there may be a range of acceptable interpretations and judgments. Accordingly, financial reporting involves a degree of imprecision and there can be different perspectives about what a material misstatement comprises.

Audits are Reasonable Assurance Engagements

13. Because of cost and time constraints, as well as other inherent limitations in an audit,⁶ an audit does not provide absolute assurance that the financial statements do not contain material misstatements.

⁶ Paragraph A45 of ISA 200 states the following: “The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which

14. The difference between a process designed to provide absolute assurance and one designed to provide reasonable assurance means that a risk of undetected material misstatement is to be anticipated in a proportion of audits. However, when material misstatements are identified that were not detected by the audit, it is difficult to determine whether they arise as result of the overall audit model (which might therefore be anticipated) or failings in the quality of the individual audit (and which therefore represents an audit failure).

Judgment is Needed in Evaluating Whether Deficiencies in Audit Work are Sufficiently Serious to Threaten Overall Audit Quality

15. Audits can be very large and complex undertakings. Sometimes they involve hundreds of people, taking thousands of individual actions and making a very large number of individual judgments. Audits are performed by people. People are not infallible and even the best audits are likely to involve some actions or judgments that are sub-optimal. Judgment is therefore needed in evaluating whether deficiencies in audit work are sufficiently serious to threaten overall audit quality. While in some circumstances a poor action or judgment may not detract from overall audit quality, in other circumstances, and particularly with the benefit of hindsight, it might. For example, a failure to properly follow up on a non-response to a receivables circularization may not be considered as a fatal flaw unless the receivable involved was fictitious and was being used to hide a major fraud.

Audits are Idiosyncratic, What is Sufficient Appropriate Audit Evidence is Judgmental and could be Influenced by Commercial Considerations

16. No two entities are exactly the same and therefore the audit work and judgments required will rightly vary. In order to provide reasonable assurance about the reliability of the entity's financial statements, auditors are required to obtain sufficient appropriate audit evidence. However, the nature and extent of "sufficient appropriate audit evidence" are a matter of judgment and will vary from one audit to another. Auditors' judgments as to whether they have obtained sufficient appropriate audit evidence can be challenged if a material misstatement in the financial statements is subsequently identified.

17. Audit firms are usually profit-making entities. The profitability of an audit firm is usually linked to the relationship between the audit fees charged⁷ and the cost involved in gathering sufficient appropriate audit evidence. In the short term, this relationship may provide an incentive to firms to limit the work performed, although, in the longer term, sustained audit quality is needed to protect the firm's reputation and to avoid adverse regulatory or legal actions.

result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

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

⁷ While the audit fee charged is often a reflection of the skills and experience of the audit engagement team and the time that they spend on the audit, there may be other factors affecting the actual audit fee charged including competitive forces, the audit firm's cost base, and the number of years that the firm expects to undertake the audit.

Perspectives of Audit Quality Vary amongst Stakeholders

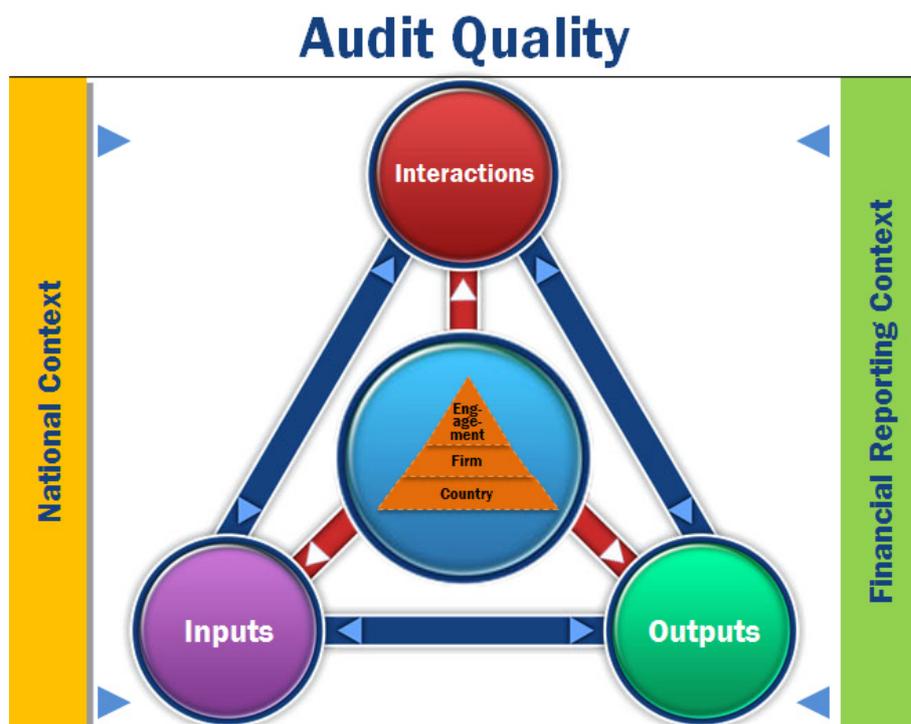
18. Different stakeholders are likely to have different perspectives about the nature of audit quality. For example, users of the financial statements are likely to view audit quality as the auditor’s collection of extensive audit evidence and the provision by the auditor of a robust challenge to management. Management themselves may see audit quality as being more related to the efficiency of the audit, given their interest in ensuring that the cost of the audit is controlled and that it is completed in a reasonable timeframe.
19. Through their interactions with the auditor, those charged with governance are well placed to evaluate the auditor’s work. They therefore have an important role to play in ensuring that ultimately a quality audit is performed for a realistic fee. For this reason, in many jurisdictions, those charged with governance have direct responsibilities for approving, or recommending for approval, audit fees.

Limited Transparency of Audit Work Performed and Audit Findings

20. Many services are relatively transparent to those for whom they are performed and users can evaluate the quality of them directly. However, the main users of an audit (i.e., the entity’s shareholders) do not usually have insight into the work performed and the issues that were identified and addressed. They therefore cannot directly evaluate audit quality. Perversely, these insights are often available to management but management’s motivations may differ from the shareholders’. In particular, management may wish to minimize the audit effort rather than incur the costs of a high quality audit.
21. Difficulties caused by this lack of transparency to users are exacerbated by the importance of audit judgments. High quality audit judgments require business understanding, objectivity and skepticism. Business understanding is, however, a relative term. No one can be expected to know everything about an entity or the industry in which it operates. Further, the extent to which objectivity and skepticism are applied in practice can be difficult to evaluate especially in retrospect. Managing audit staff involves providing them with sufficient incentives to demonstrate the right behaviors to overcome the temptations that might exist in not doing so.

2.1 A Representation of Audit Quality

- ~~10.22.~~ The international audit quality framework (“Framework”) described in this paper, which takes into account perspectives of different stakeholders, can be summarized by the following schematic:



11.23. Conceptually, one can view audit quality in terms of the following four fundamental aspects.

Inputs

24. There are many inputs to audit quality, including the:

- The values, ethics and attitudes of individual auditors and the culture prevailing within the audit firm, the auditor's personal attributes (including skills);
- The knowledge and experience and ethical values, of auditors and the time allocated to perform the audit; and
- The effectiveness of the audit process.

12.25. The inputs will be influenced by the context, the interactions and the outputs. For example, regulations (context) may require specific reports (output) that influence the skills (input) utilized.

Interactions amongst Key Stakeholders

13.26. While each separate link in the financial reporting supply chain plays an important role in supporting high quality financial reporting and audit quality, the way in which they 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 will have a dynamic relationship with both the input and output elements of the framework. For example, discussions between the auditor and the audit committee those charged with governance at the planning stage can influence

the use of specialist skills (an input) and the form and content of the auditor's report to the ~~audit committee~~those charged with governance (an output).

Outputs

~~14.27.~~ Outputs from the audit are often determined by the context, including legislative requirements, and will be influenced by the inputs. While some stakeholders can influence the nature of the output (for example, through interactions with ~~audit committee~~those charged with governance) others ~~are~~wield less able to influence. Indeed, for some stakeholders the auditor's report is all that is visible.

Context

~~15.28.~~ There are a number of contextual factors that influence ~~both~~audit quality and also financial reporting quality ~~and audit quality~~. For example, sound corporate governance facilitates both the preparation and fair presentation of financial statements and influences the quality of the audit of those financial statements. The contextual factors, including legislative requirements, shape the interactions amongst key stakeholders and the inputs to, and outputs from, the audit.

2.2 Hierarchical Relationship

29. The inputs, outputs and interactions can also be classified between those that apply directly at:

- The audit engagement level;
- The level of an audit firm, and therefore indirectly to all audits undertaken by that audit firm; and
- The national (or jurisdictional) level and indirectly to all audit firms operating in that country and the audits they undertake.

30. Furthermore the contextual factors can be classified between those that apply directly to audit quality at a national level and those that indirectly impact audit quality through the impact they have on the quality of financial reporting.