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AUDIT QUALITY

AN IAASB PERSPECTIVE

December 2010

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CONTENTS

	Page
Chairman’s Message	3
Reflections on Audit Quality	
I. Perceptions of Audit Quality	4
II. Important Influences on Audit Quality	5
III. Contribution of IAASB Standards to Audit Quality	6
The Road Ahead on Audit Quality	8

CHAIRMAN'S MESSAGE

The turbulent events of the global financial crisis have highlighted the critical importance of credible, high-quality financial reporting. They have also highlighted the importance of considering the role of audit quality in the broader context of quality financial reporting. Achieving quality financial reporting depends on the integrity of each of the links in the financial reporting supply chain.

As one of those links, the external audit plays a major role in supporting the quality of financial reporting around the world, whether in the context of the capital markets, the public sector or the private or non-public sector. It is an important part of the regulatory and supervisory infrastructure, an activity of significant public interest. The quality of the external audit – audit quality – is therefore a matter of high importance for the IAASB.

The IAASB is most directly involved in supporting audit quality through its International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC). However, while these standards form a foundation supporting high-quality audits, it is important that they be recognized and understood as one of several components influencing audit quality. Other influences, including user perceptions, the skills and competencies of auditors, the actions of others in the financial reporting supply chain, and the legal, regulatory and business environments, also play important parts in the debate on audit quality.

Because the context in which an audit is undertaken is continually evolving to keep pace with changes in the business environment, financial reporting standards, regulation and technology, intrinsically an audit is an activity that evolves over time. The pursuit of audit quality, therefore, is not a program with a definitive outcome. Rather, it is a process that ensures that, through continual improvements in its elements, audit quality evolves with the environment in which audits are performed. This means that the achievement of any particular success on audit quality should not represent an end in itself, nor should the improvement of any one element of audit quality preclude efforts to seek further improvements in audit quality.

In truth, audit quality will depend as much on the IAASB's efforts in setting high-quality ISAs and ISQCs as the willingness and ability of other stakeholders—in particular, preparers, investors, regulators, auditors, those charged with governance, and other standard setters—to effectively contribute to a collective effort directed toward enhancing audit quality. In the end, achieving success on audit quality will depend on all stakeholders engaging in the continuing debate on audit quality, a willingness to learn about the perspectives of others on the topic and to seek consensus, and a shared vision regarding audit quality.

This publication introduces a specific initiative of the IAASB to evaluate how it can best contribute to the debate on audit quality. It highlights several important perspectives on audit quality, as a means to stimulate thoughts and discussions amongst stakeholders in the financial reporting process. It also provides an indication of substantive work that the IAASB plans to undertake in the near future on the topic of audit quality.

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REFLECTIONS ON AUDIT QUALITY

I. Perceptions of Audit Quality

There have been a number of attempts to define “audit quality” in the past. However, none has resulted in a definition that has achieved universal recognition and acceptance. Audit quality is, in essence, a complex and multi-faceted concept.

Audit quality is subject to many direct and indirect influences. While some may place more emphasis on the direct influences of audit quality, this perspective alone is not sufficient to address the question of whether audit quality has been achieved in the broader context. Perceptions 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.



Illustration 1: Possible perception of audit quality through lenses applied by an investor



Illustration 2: Possible perception of audit quality through lenses applied by an audit committee member

Variations in stakeholder perspectives of audit quality suggest that no single element should be assumed as having the dominant influence on audit quality. This implies that a broader and deeper understanding of the complexities and nuances of the topic needs to be developed through studying audit quality more holistically. It also implies that individual stakeholders should consider more carefully whether actions they endorse might have detrimental effects on others' perspectives of audit quality. Therefore, understanding each other's views and how one's actions may impact on others' perceptions of audit quality is critical to efforts to enhance audit quality.

II. Important Influences on Audit Quality

Auditing standards are a key influence of audit quality. However, high quality auditing standards alone cannot achieve audit quality. Conceptually, one can view audit quality in terms of three fundamental aspects: inputs, outputs, and context factors.

There are many inputs to audit quality apart from auditing standards. One important input is the auditor's personal attributes such as auditor skill and experience, ethical values and mindset. Another important input is the audit process. The audit process concerns such matters as the soundness of the audit methodology, the effectiveness of the audit tools used, and the availability of adequate technical support, all geared toward supporting execution of a quality audit.

Outputs of the audit also are important influences on audit quality because often the outputs are considered by stakeholders in their assessments of audit quality. For example, the auditor's report is likely to be viewed as positively influencing audit quality if it clearly and meaningfully conveys the outcome of the audit. Equally, auditor communications to those charged with governance on matters such as qualitative aspects of the entity's financial reporting practices and deficiencies in internal control can positively influence audit quality.

More broadly, there are contextual factors that also influence audit quality. For example, sound corporate governance facilitates audit quality, especially if it creates a climate of transparency and ethical behavior within the entity. Regulation also can positively influence audit quality if, inter alia, it creates a framework within which the audit can be effectively conducted, and it establishes an effective regime for monitoring the quality of auditors' work. Equally, the applicable financial reporting framework can influence audit quality. For instance, use of a financial reporting framework that does not promote robust and transparent disclosures may adversely affect audit quality as well as related external perceptions.

These are not one-way influences. For example, what the auditor communicates to those charged with governance may influence the actions and perspectives of those charged with governance relative to matters pertaining to the audit. In turn, those charged with governance may influence the nature and focus of actions the auditor may take during the audit. Likewise, regulators may have a direct influence over the process of setting auditing standards; in turn, the quality of auditing standards may affect the nature and extent of regulation and oversight. Clearly, these influences are interrelated, directly or indirectly affecting the extent to which each bears on audit quality.

In addition, the attitudes of those charged with governance and the importance they place on constructive dialogue with auditors matter in the quest for improvements to audit quality, as do the attitudes of institutional players, such as regulators and standard setters, in understanding and reacting to changes in the environment.



Illustration 3: Influences on Audit Quality

III. Contribution of IAASB Standards to Audit Quality

The ISAs play a pivotal role in contributing to audit quality through providing globally recognized and accepted benchmarks for performance of audits. They are developed on the basis of a robust and transparent due process that, at its core, features extensive stakeholder input and consultation.¹ This, together with independent oversight over the IAASB's standard-setting process by the Public Interest Oversight Board (PIOB), ensures that the standards are of a high quality.

In March 2009, the IAASB completed its Clarity Project. This project involved a comprehensive review and redrafting of all 36 ISAs and ISQC 1² to improve their clarity and understandability and, thereby, facilitate their consistent application.³ In addition to improving the clarity of the ISAs, the IAASB substantively revised approximately half of the legacy standards. Broadly, these efforts led to improvements in the ISAs in the following areas:

¹ A description of the IAASB's due process can be accessed at http://web.ifac.org/download/PIAC-Due_Process_and_Working_Procedures.pdf.

² ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

³ The clarified ISAs became effective for audits of financial statements for periods beginning on or after December 15, 2009.

- The general approach to the audit, to instill a focus on objectives, promote a thinking audit, and emphasize the importance of professional skepticism;
- Those aspects of financial statements that generally pose a higher risk of material misstatement, for example, estimates and fair values, and related party transactions;
- The quality of audit evidence, particularly with regard to external confirmations and written representations;
- Using the work of others, particularly in the context of group audits, to ensure that auditors are satisfied that there is an appropriate basis on which to use the work of others, and to use others only when it is appropriate to do so; and
- Auditor communications and reporting, to emphasize the importance of open and constructive dialogue between on the one hand, auditors, and on the other hand, those charged with governance and management, and to help ensure that important matters are brought to users’ attention in a clear and meaningful way.



Illustration 4: Areas within ISAs that have been substantively revised

In a broader context, ISA 220⁴ and ISQC 1 establish a framework for quality control in two specific dimensions – at the audit engagement level and at the firm level, respectively. Together, these two standards address a variety of areas where auditors and their firms can take specific action to promote and safeguard audit quality. These areas include, in particular:

- Leadership responsibilities for quality within the firm;
- Compliance with relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

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

Compliance with the ISAs within this quality control framework is the essence of achieving the objective of performing high-quality audits.

However, achieving the objectives of the ISAs rests on one important determinant – the people who carry out the audit. It is their understanding and implementation of the ISAs that can make a real difference in audit quality. Importantly, effectively executing on many of the requirements in the ISAs relies on a key personal competency – professional judgment. Achieving the goal of a high-quality audit very much depends on auditors exercising appropriate and sound professional judgment throughout the engagement. This calls for having the right people on the job who are not only properly trained but also continue to enhance their competence through ongoing professional development. Such people considerations are areas where it may be fruitful for stakeholders to further explore in the debate on how to enhance audit quality.

THE ROAD AHEAD ON AUDIT QUALITY

The completion of the Clarity Project has provided a solid foundation for the performance of high-quality audits. However, the Clarity Project does not mark the end of the IAASB's efforts to seek to further enhance audit quality. Maintaining the quality and robustness of the ISAs is, and will remain, a core objective of the IAASB. With the release of the clarified ISAs, the IAASB has embarked on a project to gather information to help it evaluate the effective and consistent implementation of the clarified ISAs around the world. While it is important to maintain a stable platform during this period of implementation, the IAASB also has begun exploring other areas within the ISAs that are, or may be, in need of further improvement. In particular, the IAASB has initiated projects to revise the ISAs dealing with using the work of internal auditors and the auditor's responsibilities relating to other information in documents containing audited financial statements. In addition, the IAASB recently commenced studying matters relative to the auditor's work on financial statement disclosures as well as auditor communications embodied within the auditor's report.

However, the continued enhancement of audit quality depends not only on the IAASB's efforts but also on the active engagement of all stakeholders in the debate. In particular, this highlights the importance of ground-level engagement amongst those stakeholders that have immediate responsibilities for audit quality – auditors, regulators and those charged with governance – on such practical matters as gathering and sharing insights on audit quality, and exploring how best interactions amongst them can be facilitated. It also highlights the need for institutional players and policy makers such as standard setters and regulators to seek greater engagement with end users such as investors.

As a specific contribution to advancing audit quality, the IAASB plans to launch a public consultation in the near future on the development of an international audit quality framework. This initiative recognizes that the lack of international consensus on the key drivers of audit quality has been an impediment to past and current efforts to identify common solutions to audit quality matters. The absence of a common audit quality framework also has given rise to fragmented and inconsistent approaches and practices around the world relative to the assessment and promotion of audit quality. The IAASB envisions that such an international audit quality framework could not only provide a mechanism to continually assess whether its standards are appropriate, but also act as a catalyst for participants in the financial reporting process to take substantive actions to further enhance audit quality.

Audit Quality—Proposed Thought Piece
IAASB Main Agenda (December 2010)

The IAASB hopes that this initiative will be of particular interest to stakeholders and looks forward to their participation in the consultation.