

Comments on:

ENHANCING AUDIT QUALITY IN THE PUBLIC INTEREST

“Documents create a paper reality we call proof.” Manson Cooley

I am concerned that the document conflates good documentation with audit quality. A well-documented audit is not necessarily a good audit. A well-documented professional judgement is not necessarily a good judgement. I also worry that the intense focus on documentation will produce ADMs that produce good documentation at the expense of doing the audit well.

Inspectors and other firmly believe that file inspection of pretty documentation will be able to determine if the audit was well done. It may not.

A poorly documented audit could be a well done audit; you would just not be able to prove that to a person who believes that pretty documentation is proof of a good audit.

The difficulty with measuring audit quality

There are many possible proxies for audit quality.

Errors subsequently found

Certainly the correct way to measure audit quality is to measure whether the audit found and corrected all material misstatements. There are practical problems with this.

1. You have to wait. It may take several years for errors to become evident, so the measure is not timely.
2. There may have been no material misstatements in the first place. If no errors were present, distinguishing a badly done audit from a well done audit would not be possible using this measure.
3. An audit cannot be expected to and will not find all misstatements. An audit is even less likely to find fraudulent financial reporting. Subsequently finding an error does not mean that the audit was badly done – though regulators and inspectors and standards setters never reflect on that when a material misstatement or fraud is subsequently found. The audit is automatically assumed to have been badly done. There is always a call for improvements to standards to prevent that from ever happening again. Lately, the call is not for better auditing, but for better documentation – which misses the point.
4. Many times errors correct themselves in a following year without detection. So perhaps an audit was badly done – because it did not find the error – but as the error is never detected, it is never known that the audit might have been badly done.

Documentation as a proxy for quality

There are even more problems with using good documentation as a proxy for quality. The most fundamental of these is that a well-documented audit may be badly done. For all the reasons noted above, this may never be detected. The correlation between good documentation and a good audit is probably coincidental, not causal.

The problems with using documentation as a proxy for quality include the previous four and two more as follows:

1. As with using errors found, you have to wait. Documentation may be pretty, but a misstatement may subsequently be found. There are examples of entities where the file had been repeatedly externally inspected, with no deficiencies found, only to have large misstatements found after that. Successful inspection of documentation is not a guarantee of a good audit, only a guarantee of good documentation.
2. As with using errors found, there may have been no material misstatements in the first place. If no errors were present, distinguishing a badly done audit from a well done audit would not be possible using documentation as a measure. The only distinction is between well documented or not.
3. As above, an audit cannot and will not find all misstatements and is even less likely to find fraudulent financial reporting. Subsequently finding an error that an audit could not have uncovered does not mean that the audit was badly done. Reference to professional standards is needed, not documentation.
4. Also as above, many times errors that exist in financial statements correct themselves in a following year without detection. So perhaps an audit was badly done – because it did not find the error – but as the error is never detected, this is never known that the audit might have been badly done. Looking at the documentation will not detect this.
5. Placing a greater emphasis on documentation will induce audit staff (whether the firm wants them to or not) to direct their limited resource – time – to time spent on documentation, not time spent on auditing.
6. It is difficult to determine if well documented audit was indeed well done. The audit thought process is not driven by documentation, but by the thought process. Once you get good at the process of documentation – and are rewarded with praise from practice inspectors – it is an easy additional step to produce the documentation without the critical thought process. Inspection or review of the file will never be able to determine that and will probably reward the well documented but badly done audit and punish the badly documented but well done one. Staff will quickly learn where to spend their time.

The seductive advantage of documentation is that it is measurable, reviewable and inspectable. There is an entrenched belief that file review produces a good audit, and that file review can spot all indications that the audit was not properly done. File reviewers are firmly convinced that tracking through the file

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documentation constitutes re-performing the audit. It does not. All auditors know of cases where beautiful documentation was found to be baseless in a subsequent client visit.

Perhaps the only advantage to documentation as a proxy for audit quality is that once the requirement for documentation is perfected, and auditor who meets the standard should be found to have done a good audit – because the documentation was good, even if a misstatement is subsequently found, and whether or not the audit was actually badly done.

Further, the emphasis on documentation may lead staff to spend their time producing documentation that makes it appear as if a good audit was done, when it was not.

The inspection of documentation allows a conclusion to be drawn on audit quality, whether or not the conclusion is correct. Inspectors report that audit quality has increased, when perhaps the only conclusion they should come to is that the attractiveness of audit documentation has improved.

Standard setters need to reflect on the push for documentation, because it certainly increases the cost of an audit to the shareholders, perhaps without a concomitant increase in quality – finding errors if they indeed exist. Time spent looking for misstatements will be replaced with time spent preparing documentation that makes it look as if the audit was well done.

The following table summarizes the problem:

	Audit Well Done	Audit Poorly Done
File Well Documented	Box #1 Good – and the most expensive.	Box #2 As long as there were no underlying errors that later appear (often the case) indistinguishable from a well done audit – Box #1. Slightly less expensive perhaps than Box #1.
File Badly Documented	Box #3 As good as above, but will be grounds for criticism by all. And correcting the problem – spending more time on documentation and perhaps less on doing the audit - may move to Box #2 and earn the praise of inspectors. Cheapest. Client is happy, inspectors are not.	Box #4 No need to comment

The document attempts to solve a behavioural problem with paper.

Tone at the top

All the “transparency” reports I read document an excellent tone at the top in audit firms. But there also needs to be consideration of the “tone at the bottom” and the “tone at the middle.”

Tone at the bottom

Many current ADMs mean that audits are conducted by the most junior staff. They are motivated to meet budget and produce documentation. The culture at the bottom, and much of the learning, is driven by those who are a year or two senior.

Tone at the middle

The tone at the middle is again driven by budget and by a belief that reviewing documentation can determine if a good audit was done. And that perfecting documentation produces a good audit. As discussed above, this is not the case. Documentation that is not pretty, or that may indicate a problem can be deleted and replaced with prettier documentation. And the problem is probably forever buried. All encouraged and reinforced by standards and inspectors.

Comments on specific paragraphs

Paragraph 4 – Enhancing the quality of judgements with documentation

The exercise of professional judgement/skepticism must mean that two practitioners faced with the same or similar circumstance may (will probably) come to different conclusions. Standards setters sometimes recognize this but, alternatively, sometimes seem to imply that the proper exercise of judgement/skepticism will always mean that everyone will come to the identical “right” conclusion.

The thrust of the ITC is to better document decisions, not to make better decisions. Following a checklist to document a decision is certainly easy and will produce acceptable documentation. But not necessarily a better judgement.

Paragraph 18 – Audit inspections find inappropriate application of skepticism

First, I suspect this is just a way for inspectors to say, with hindsight, that they think the auditor did a bad job. And second, the eventual proposed solution is – paragraph 20 - documentation. See above.

More clearly documenting what skepticism means in standards won't help either. As noted above, application of skepticism/judgement will necessarily mean that different practitioners will come to different conclusions – faced with the same or similar facts. Even with more documentation, regulators and inspectors will still probably disagree (they have the privilege of the passage of time – hindsight - which always allows for a better decision.) But hindsight does not prove that the judgement was wrong at the time, or that insufficient skepticism was applied.

The document on the application of judgement/skepticism document prepared by Canada and Australia provided an excellent checklist of how to document the application of judgement and skepticism. But it

does not improve the process, only the documentation. Practitioners are encouraged to exercise proper documentation, not skepticism.

Inspectors are part of the problem. They complain that auditors insist on black letter disclosure, and then complain that auditors should use judgement to eliminate immaterial disclosures that clutter the financial statements and obscure “important disclosures” and then complain when any item of disclosure – no matter how trivial - is overlooked. We had an inspection where the bottom line criticism (that we were required to fix in “our” note disclosure in “our” financial statements) was that certain numbers in a note were not double underlined. And it is not our disclosure and they are not our financial statements. And then regulators say that audit firms should ignore some of their observations while implementing them all.

Negative impacts of the emphasis on documentation

Staff respond to what supervisors emphasize. If preparing documentation that shows a good audit was done (whether it was or not) is emphasized, this is what staff will concentrate their efforts on - documentation. This will take time away from actually doing the audit. And as long as it appears that the audit was properly done, supervisors and inspectors will all be happy. Again 26 and 27 emphasize documentation, not making good judgements.

Paragraph 31

	Sentence	Analysis
1	It is important to acknowledge, however, that other factors related to the audit can inhibit auditors’ application of professional skepticism.	
2	Examples of such factors include tight financial reporting deadlines, and heavy staff workloads, as well as time and resource constraints more generally.	These are not factors that inhibit skepticism. They are instead important factors that can result in an audit being badly done.
3	Our stakeholders have suggested that auditors may approach an audit with a skeptical mindset at first, and appropriately identify issues that need attention, but may not always apply professional skepticism in following through with appropriate actions (i.e., revising risk assessment, designing and performing responsive audit procedures or properly documenting their findings and conclusions).	Not revising a risk assessment because of time pressure is not a failure of skepticism. And being more skeptical – or properly skeptical – will not fix the negative consequences of time pressures. And further, spending time filling out a checklist that documents that you were really skeptical does not fix any of the problems.
4	This may ultimately call into question whether professional skepticism was appropriately applied in the audit.	Not fixed by documentation of skepticism.

An important paragraph, with the exception of the last sentence. More important to address these concerns that to produce documentation.

The last sentence of the paragraph incorrectly conflates failing to do the audit properly (not revising a risk assessment as necessary) with professional skepticism. And is says that not preparing proper

documentation is inappropriate application of professional skepticism. It is confusing to incorrectly use professional skepticism as code for any time the audit is not done properly.

The paragraph actually makes it clear that the problem is anything other than the application of skepticism.

Paragraph 37 second bullet

The first paragraph says that auditing highly judgemental areas (estimates for instance) harder will make the estimates better. Standards are clear that this will not happen. 240.6, 200 A46. Documentation is again proposed as a solution for the inherent uncertainty in financial statements. Presumably now, a KAM paragraph will now be present for all “highly subjective or judgemental areas” in which the auditor will note that the numbers may change in the future (is probably wrong.) This should solve the problem for the auditor when the number subsequently – with the addition of more information - is found to change.

And documentation of professional skepticism is proposed as a solution for the failure to apply professional skepticism. Last part of second bullet point.

Paragraph 58 and paragraph 70 in the ITC – Also ITC 78, 79, and third last bullet point in 85, 94

The most important point in the documents. Partner involvement is paramount. Many ADMs attempt to pass partner responsibility down to the lowest level. And a level tasked mostly with preparing pretty documentation.

ITC 98 and 99

I question whether transparency dilutes responsibility. The audit report used to be clear. To exaggerate, it said “I have done a good audit and the financial statements are OK.” It is increasingly difficult to find this statement in transparency reports. Transparency reports, and indeed the financial statements, iterate all (too many?) areas where items could be wrong.

The only new information in an audit report is the auditor’s opinion. All the KAM items are probably known from the prior year or from information released by the company during the year.

KAM paragraphs highlight that, for instance, a company may have been paying bribes. Presumably this was reported by the company when the possibility came to light. The company may (or may not) have to pay some undetermined amount of fines sometime in the future. Having the auditor recite this provides no new information to users. The KAM may only serve to protect the auditor when the matter is subsequently resolved, because they provided a warning.

ITC 137

Again, robustness of documentation. Not robustness of the audit.

ITC 140

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Auditing public companies requires a different mindset than auditing a private company – particularly if there is a single shareholder and no lender. SMPs have a different responsibility for different issues in an SME than in a listed company. That is, some matters would be very important to the owner of an SME that might be trivial to a listed entity.