

IAASB

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ENHANCING AUDIT QUALITY

AUDIT QUALITY

AN IAASB PERSPECTIVE

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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 demonstrated 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, and thus an activity of significant public interest. 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). These standards provide a foundation supporting high-quality audits. However, it is important that the standards be recognized and understood as only 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 improvement of any one element of audit quality should not preclude efforts to seek further improvements in other elements.

Different stakeholders are likely to have different views about what audit quality is and how it can be enhanced. The IAASB believes that it is important to try to reach a common vision about this through stakeholders—in particular, preparers, investors, regulators, auditors, those charged with governance, and other standard setters—sharing their particular perspectives, and understanding and commenting on the perspectives of others.

This publication introduces a specific initiative of the IAASB to 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 the IAASB's plans to consider pursuing a future project on audit quality.





REFLECTIONS ON AUDIT QUALITY

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.

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.

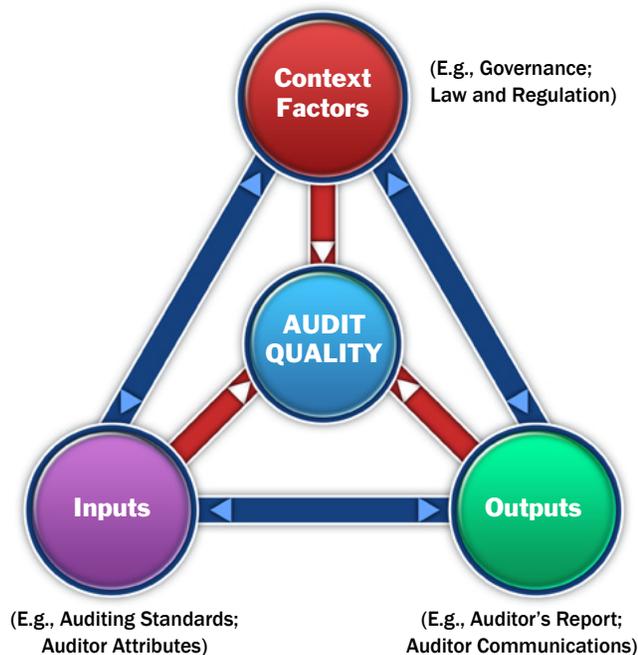
Possible perception of audit quality through an investor’s lens



Possible perception of audit quality through an audit committee member’s lens



Important Influences on 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 are also 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 conveys the outcome of the audit. Equally, auditor communications to those charged with governance (TCWG) 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 context 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. Law and regulation also can positively influence audit



quality if, inter alia, it creates a framework within which the audit can be effectively conducted, as can regulatory oversight if it establishes an effective regime for monitoring the quality of auditors' work and there is effective dialogue between auditors and regulators. Equally, the quality of 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 TCWG may influence the actions and perspectives of TCWG relative to matters pertaining to the audit. In turn, TCWG 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 TCWG and the importance they place on constructive and transparent dialogue with auditors can facilitate improvements to audit quality, as can the attitudes of institutional players, such as regulators and standard setters, in understanding and reacting to changes in the environment.

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 standards. Broadly, these efforts led to improvements in the ISAs in the following areas:

- ✦ 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.
- ✦ Auditor communications and reporting, to emphasize the importance of open and constructive dialogue between auditors and TCWG and management, and to help ensure that important matters are brought to users' attention in a clear and meaningful way.

Areas within ISAs that have been substantively revised⁴

Objectives and overarching responsibilities	Risk assessment and evidence gathering in riskier areas	Quality of audit evidence/Reliance on others	Auditor communications
Overall Objectives and Conduct of ISA Audit	Estimates and Fair Values	Group Audits	Communication with TCWG
Materiality	Related Parties	External Confirmations	Communicating Deficiencies in Internal Control
Evaluation of Misstatements	Service Organizations	Using Work of Experts	Modifications to Audit Opinion
		Written Representations	Emphasis of Matter and Other Matter Paragraphs



In a broader context, ISA 220⁵ 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.
- ✦ Monitoring.

Compliance with the ISAs in the context of quality control systems at the firm level is an important element of audit quality.

However, fully achieving the objectives of the ISAs rests on one important determinant – the people who carry out the audit. It is their knowledge and experience and their understanding of the client 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 involved on the engagement who not only are properly trained but also continue to enhance their competence through ongoing professional development. It may be fruitful for stakeholders to further explore these people considerations in the debate on how to enhance audit quality.



THE ROAD AHEAD ON AUDIT QUALITY

The IAASB believes that the completion of the Clarity Project has provided a very useful contribution to audit quality. However, this does not mark the end of the IAASB's efforts 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.

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. This highlights, in particular, the importance of engagement amongst auditors, regulators, TCWG and standard setters 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.

The IAASB believes that more can be done to further contribute to the debate on audit quality. The IAASB will therefore consider in 2011 how to best take forward a specific project on audit quality – one that necessarily must be on a collaborative basis recognizing the importance of international consensus. In this regard, the IAASB will discuss in 2011 an initiative to launch a public consultation on the development of an international audit quality framework. Such a framework could not only assist the IAASB to continually assess whether its standards are appropriate, but also prompt other participants in the financial reporting process to take further actions to enhance audit quality.

The IAASB will use this present publication in its various outreach activities to generate debate on the topic of audit quality, within the context of its current consultation on its proposed strategy for 2012–2014.⁶ Perspectives on audit quality and views on key audit quality issues are welcomed by the IAASB at any time. They may be submitted in writing to one or more of the key IAASB contacts.

ENDNOTES

1. A description of the IAASB's due process can be accessed at: 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. For further information, visit the IAASB Clarity Center at: www.iaasb.org/clarity-center.
4. This diagram excludes the ISA 800 series, which has also been substantively revised.
5. ISA 220, *Quality Control for an Audit of Financial Statements*
6. The consultation paper *Proposed IAASB Strategy and Work Program for 2012–2014* can be accessed at: www.ifac.org/Guidance/EXD-Details.php?EDID=0151.

KEY CONTACTS

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ABOUT THE IAASB

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the PIOB, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by IFAC.



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