

IAASB CAG PAPER
IAASB CAG Agenda (September 2011)
Agenda Item C.1
Draft Paper—Audit Quality: An International Framework

DRAFT
FOR DISCUSSION PURPOSES ONLY

AUDIT QUALITY: AN INTERNATIONAL FRAMEWORK
AUGUST 2011

Note

This paper sets out a possible Audit Quality framework (“Framework”) developed by a task force of the IAASB. While the IAASB has discussed elements of the Framework, it has not concluded its deliberations. Indeed, the IAASB expects that the Framework will evolve through collaboration with others at this relatively early stage of the project before it is issued for consultation.

The current plan is that the IAASB will consult publicly on the Framework during 2012.

As part of the project, the IAASB is exploring whether to prepare a summary of the main threats to Audit Quality and the safeguards to address them. A draft of such a summary, prepared for illustrative purposes, is attached.

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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 a 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
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.
6. Because of the difficulties in defining audit quality, the IAASB has agreed to develop an international framework that describes the elements of audit quality. The IAASB believes that such a framework will assist stakeholders in considering whether their environments

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will be such that audit quality will likely be achievable and therefore that audit firms¹ will be well placed to provide quality audits. The framework is not designed for the evaluation of the quality of individual audits, which will be more dependent on the nature and extent of audit evidence obtained in response to the risks of misstatement in a particular entity and the audit judgments made.

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:

(a) 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 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.

(b) In relation to IFAC's standard-setting Public Interest Activity Committees (PIACs)

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

¹ 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.

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appropriate set of standards. For example, it could facilitate IAASB consideration of whether there are areas within ISQC 1² and ISA 220³ 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.

(c) 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.

(d) 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 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 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 8⁴ when evaluating, promoting and remunerating partners and staff.]
- [Others]

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

³ ISA 220, *Quality Control for an Audit of Financial Statements*

⁴ International Education Standard (IES) 8, *Competence Requirements for Audit Professionals*

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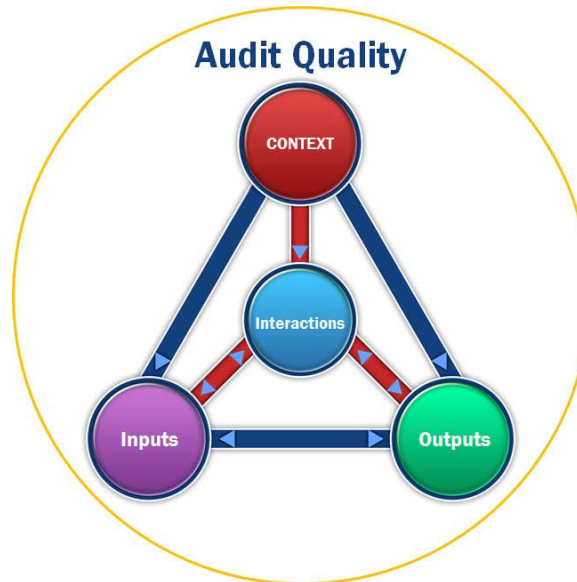
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1.3 A Representation of Audit Quality

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

Context

12. There are a number of contextual factors that influence both 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.

Interactions amongst Key Stakeholders

13. 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 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 (an output).

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Inputs

14. There are many inputs to audit quality, including the culture prevailing within the audit firm, the auditor's personal attributes (including skills, experience and ethical values), and the effectiveness of the audit process. 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.

Outputs

15. 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 committees) others are less able to. Indeed, for some stakeholders the auditor's report is all that is visible.

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2. Key Interactions within the Financial Reporting Supply Chain Influencing Audit Quality

16. In its 2008 report,⁵ IFAC describes the financial reporting supply chain as “the people and processes involved in the preparation, approval, audit, analysis and use of financial reports.”
17. IFAC observed that all the links in the chain need to be of high quality and closely connected to supply high-quality financial reporting. While each separate link in the supply chain plays an important role in supporting high quality financial reporting, the nature of the connections, or interactions, between the links can have a particular impact on Audit Quality.
18. It is through these interactions, including both formal and informal communications, that participants in the supply chain can influence the behavior and views of others and thereby contribute to improvements in Audit Quality. The nature and extent of the interactions will be influenced both by the objectives of the individuals involved and the context in which the interactions take place.
19. Some of the more important interactions with regard to Audit Quality are described below.



2.1 Interactions between Auditors and Management

20. Management is responsible for the preparation of the financial statements and for such internal control necessary to ensure that the information for preparing the financial statements is reliable and available on a timely basis. Management is also responsible for ensuring that the financial statements comply with the applicable financial reporting framework and, where relevant, represent the underlying transactions and events in a manner that achieves fair presentation.

⁵ The report can be accessed at: <http://web.ifac.org/media/publications/9/financial-reporting-supply/financial-reporting-supply.pdf>.

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21. Auditors need full and timely access to relevant information and individuals both within and outside the entity. A quality audit can be jeopardized if management does not provide such access. Furthermore, an open dialogue assists the auditor identify, assess and respond to the risks of material misstatement, particularly with regard to complex or unusual transactions, or matters involving significant judgment or uncertainty. In the absence of cooperation and open dialogue it is unlikely that an efficient and effective audit can be performed.
22. An open and constructive relationship between auditors and management also helps create an environment in which management can benefit from auditors' observations on matters such as:
 - Possible improvements to the entity's financial reporting practices;
 - Possible improvements in internal control over financial reporting; and
 - The reasonableness of accounting estimates.
23. An open and constructive relationship between the auditor and management needs to be distinguished from one of over-familiarity. It is vital for audit quality that auditors remain skeptical and objective and are prepared to challenge the reliability of the information they are given.

2.2 Interactions between Auditors and Those Charged with Governance

24. Those charged with governance are responsible for overseeing the strategic direction of the entity and obligations related to the entity's accountability. This includes overseeing the entity's financial reporting process. Effective two-way communication between auditors and those charged with governance can positively influence audit quality and assist those charged with governance.
25. Specifically, those charged with governance can make an important contribution to audit quality through:
 - Providing views on financial reporting risks and areas of the business that warrant particular audit attention;
 - Considering whether sufficient audit resources will be allocated for the audit to be effectively performed and that the audit fee fairly reflects this; and
 - Creating an environment in which management is not resistant to being challenged by the auditors and not overly defensive when discussing difficult or contentious matters.
 - Ensuring the fair presentation of the financial statements, especially when the auditor has concerns which have not been acted upon by management.
26. In turn, constructive dialogue with the auditors on such matters as significant findings from the audit, the quality of the entity's financial reporting practices, and significant

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deficiencies in internal control may inform the actions and perspectives of those charged with governance regarding the entity's financial reporting process.

2.3 Interactions between Management and Those Charged with Governance

27. A strong commitment to honesty and integrity within an entity has a positive bearing on the quality and reliability of its financial reporting process, and therefore on audit quality. Such a culture, which is established and nurtured by those charged with governance working in conjunction with senior members of management, promotes the development and maintenance of appropriate accounting policies and processes as well as the open sharing of information that is necessary for high-quality financial reporting.
28. To achieve this, those charged with governance depend on a transparent and constructive relationship with management in assisting them to discharge their responsibility for oversight of the financial reporting process. This requires a willingness by management to come forward to discuss with those charged with governance matters such as:
- Identified, and potentially significant, issues on financial reporting, regulation and the audit;
 - Performance pressures relative to the achievement of market expectations and what responses may be appropriate; and
 - Areas where the financial reporting process may be strengthened.
29. In the absence of evidence of a transparent and constructive relationship between management and those charged with governance, the auditor needs to be especially alert for significant deficiencies in internal control, errors in the financial reporting process and fraud risks. It will also be important for the auditor to seek to understand the reasons behind such relationships as the nature of any audit responses will depend on the circumstances. For example, an audit response where those charged with governance doubt management's integrity will differ from one where management harbors reservations about the competence of those charged with governance.

2.4 Interactions between Auditors and Regulators⁶

30. There are two main types of regulators that impact the audit: regulators of the financial markets and financial market participants ("financial regulators"), and regulators with direct oversight of the audit function ("audit regulators").
31. In some countries, there are a number of financial regulators and it will be beneficial for them to coordinate their activities related to audit quality. There is also liaison between financial regulators and audit regulators both nationally and internationally. Again, the more coordination there is across the regulatory groups, the more likely it is that sustainable improvements in audit quality can be achieved.

⁶ In the public sector, Public Sector Audit Institutions are usually not subordinated to external regulatory oversight. They answer to parliament, who from time to time may question the quality of audit activities.

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Financial Regulators

32. Audited financial statements are an important element of the regulation of the capital markets. In addition, some regulators, such as banking regulators, expect to receive relevant information from auditors, especially in periods of economic uncertainty. Because of this, legislation in some countries requires auditors of financial institutions to report matters of material significance to regulators.
33. Financial regulators can assist audit quality through:
 - The establishment and enforcement of financial reporting and internal control requirements;
 - Communication to the auditors of information that they have obtained in a regulatory capacity that is relevant to the audit of the financial statements; and
 - Creating an environment where high-quality audit is valued, for example, through appropriate public communications and outreach emphasizing the importance of audit quality.

Audit Regulators⁷

34. The formation of national independent audit regulators in many parts of the world in recent years to undertake the inspection of the quality of individual audits provides an opportunity both for increasing audit quality and for making audit quality more transparent to users.
35. Open communication between audit firms and the audit regulators will assist regulators undertake their activities effectively. Furthermore, clear communication of the findings of audit inspections will assist audit firms understand the root causes of deficiencies identified and respond to them in a positive manner.

2.5 Interactions between Management and Regulators

36. The extent to which financial regulators interact with management in relation to financial reporting varies between countries and industry sectors. Some financial regulators establish and enforce the financial reporting frameworks. Furthermore, in some sectors such as banking, financial regulators may undertake direct supervisory activities. These activities can have a positive effect on audit quality, especially if the auditor is well informed about the interactions that have occurred.

2.6 Interactions between Regulators and Those Charged with Governance

37. As with management, the extent to which financial regulators interact with those charged with governance varies between countries and industries.

⁷ In the public sector, Public Sector Audit Institutions are usually not subordinated to external regulatory oversight. They answer to parliament, who from time to time may question the quality of audit activities.

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38. While to date there is relatively little interaction between audit regulators and those charged with governance, the potential for this exists. For example it is possible that at some stage in the future:
- Audit regulators might communicate the findings from inspections of individual audits to the audit committees of the relevant entities; or
 - Audit inspectors might seek the views of audit committees on the quality of individual audits as part of their inspection activities.

2.7 Interactions between Auditors and Financial Statement Users

39. The primary way in which auditors interact with financial statement users is through the auditor's report. The IAASB acknowledges that some users do not believe that the binary nature of the current audit reporting model fully meets their information needs. The IAASB is therefore undertaking a separate initiative to explore how to enhance the quality, relevance and value of auditor reporting.⁸
40. In addition to the auditor's report, in some countries, the regulatory framework provides users with an opportunity to interact, to some degree, with the auditors. These interactions can provide an added motivation for auditors to perform high-quality audits. For example, in a number of jurisdictions, proposals for the appointment, re-appointment or replacement of an entity's auditor are required to be approved by the entity's shareholders in general meeting. Shareholders may also have the right in general meeting to question the auditor on any significant matters pertaining to the audit.
41. More generally users, such as institutional investors, can act as a buttress to audit quality by taking an active interest in exploring with the entity matters on which the auditors have taken a public position – such as by modifying the audit opinion or issuing a statement to shareholders explaining relevant matters.
42. Users may also wish to probe the rationale for a change in auditor. This will be facilitated when information related to the reasons for the previous auditor withdrawing from the engagement, or not seeking reappointment, are made publicly available on a timely basis.

2.8 Interactions between Those Charged with Governance and Financial Statement Users

43. In a number of countries, audit committees have specific responsibilities for a degree of oversight of the auditors or aspects of the audit process. While users are likely to conclude that the active involvement of a high-quality audit committee will have a positive impact on audit quality, there is considerable variability in the degree to which audit committees communicate to users the way they have fulfilled these responsibilities.

⁸ In May 2011, the IAASB issued a consultation paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, setting out possible options for change to the auditor's report. The consultation paper seeks input as to whether such options might be effective in enhancing auditor reporting and the communicative value of the auditor's report. The consultation paper can be accessed at: www.ifac.org/Guidance/EXD-Details.php?EDID=0163.

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44. There is potential for fuller disclosure of the activities of audit committees to benefit both actual audit quality and user perception of it. Consequently, some countries⁹ are actively exploring whether to include more information in annual reports about the activities of audit committees in relation to the external audit.

2.9 Interactions between Audit Regulators and Financial Statement Users

45. External inspection of audit quality takes place in a growing number of countries as part of independent audit oversight arrangements. Audit regulators usually report publicly on their activities in overall terms and this can give users an impression of audit quality generally. Some oversight bodies report publicly on their findings relating to individual audit firms and this will provide users with more specific information.
46. The debate on whether it is beneficial for audit regulators to report publicly on individual audit firms is finely balanced. Some believe that providing transparency on the inspection findings relating to individual audit firms will assist audit committees fulfil their responsibilities, and will have a positive impact on audit quality (by giving firms the incentive to show year-on-year improvements in the quality of their work). Others believe that public reporting on audit-firm-specific findings may cause audit firms to adopt a more defensive approach to responding to the findings from inspections.
47. In at least one country, transparency is further enhanced by the audit regulator making its confidential reports on individual audits available to the audit committees of the entities concerned.

⁹ For example, the UK's Financial Reporting Council (FRC) is exploring an enhanced model of corporate governance reporting that could provide a platform for further reporting by those charged with governance to the entity's shareholders (or other external stakeholders), building on the existing two-way communication and dialogue about the audit between the auditor and the audit committee.

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3. Contextual Factors

48. Various environmental factors – contextual factors – can impact the robustness of the processes underlying the preparation of financial statements and audit quality. These contextual factors, some of which vary from one country to another, include:

- Business practices;
- Corporate governance requirements;
- The applicable financial reporting framework;
- Audit regulation;
- Industry, information technology and the general economic environment;
- The educational environment for accountants and auditors and respect for the role of audit; and
- Broader cultural issues.

3.1 Business Practices

49. Business practices can influence financial reporting and audit quality in a number of ways. For example, in some national environments it may be customary for entities to enter into transactions with other parties (often related parties or family members of management) on an informal basis, relying on relationships of trust. The terms and conditions of the transactions may therefore be vague or unrecorded, creating opportunities for fraud and corruption. The lack of adequate documentation in these circumstances will present significant challenges for auditors in understanding the economic substance of the transactions and determining whether they have been fully and appropriately accounted for.

50. The formality of the way business is undertaken will be influenced by law and regulations. Contract law in particular determines when rights are established and obligations created as transactions are completed. This provides a basis for management and auditors to make judgments about the recognition of assets and the existence of liabilities. The strength of the legal and regulatory framework in protecting investor and creditor rights is also an important contributing factor to the reliability of financial reporting and audit quality. Where the legal environment is weak, it can be challenging for auditors to obtain sufficient appropriate audit evidence about ownership claims and the adequacy of provisions for liabilities.

51. Law and regulation can also be an important aid to audit quality by establishing management's role relative to the financial reporting process and the audit. In particular, national law can usefully:

- Establish responsibilities for management regarding the preparation of financial statements;

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- Impose obligations on management to cooperate fully with auditors, including providing all necessary information and access; and
 - Provide for punitive actions against management for committing fraudulent financial reporting in general, or more specifically by willfully hampering the proper conduct of the audit, such as providing misleading information to auditors.
52. Given human nature, however, even the strongest laws and regulations will not completely eliminate poor attitudes to compliance or unethical business practices. Accordingly, there are limitations to how far the legal and regulatory framework can influence management behavior in a way that positively impacts audit quality.
53. In relation to auditors, the existence of punitive mechanisms within the legal and regulatory framework and legal action for professional negligence can be incentives to improve audit quality. Punitive mechanisms can include disciplinary action by professional bodies or audit regulators, resulting in fines and the withdrawal of licenses of audit firms and individuals.
54. However, some believe that excessive use of disciplinary mechanisms or an overly litigious environment can detract from audit quality by discouraging the proper application of professional judgment and diverting auditors' resources away from actions that enhance audit quality towards efforts to avoid disciplinary actions or reduce litigation risk. An overly litigious environment may also act as a disincentive for talented individuals to join, or remain in, the auditing profession and for auditors to develop innovative approaches that may enhance the value and relevance of the audit.

Multi-National Entities

55. Differences in business practices can present practical challenges in a multi-national entity context in relation to the preparation of group financial statements. Group management can, however, take specific steps to overcome, or at least mitigate the effects of, such challenges through the implementation and maintenance of effective group-wide controls over financial reporting. Such controls may include, for example:
- Consistent policies and procedures in all countries where the group operates;
 - Group-wide programs, such as codes of conduct and fraud prevention programs;
 - Internal auditors assessing the accuracy and completeness of financial information received from components;
 - Central monitoring of components' operations and their financial results;
 - Regular liaison visits from group management; and
 - Staff secondments.

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3.2 Corporate Governance Requirements

56. A robust corporate governance framework establishes responsibilities and expectations for behavior and provides motivation relative to the fulfillment of those responsibilities. An effective framework establishes specific responsibilities for those charged with governance for oversight of the financial reporting process. Weak corporate governance practices may jeopardize the reliability of the financial information that an entity prepares, and audit quality.
57. Though governance is a collective responsibilities, a subgroup such as an audit committee may be charged with specific tasks to assist the governing body in meeting its responsibilities. The existence of an audit committee may help the auditor interact effectively with those charged with governance.
58. In larger entities, especially listed companies, audit committees have become an important aspect of corporate governance and these usually have specific responsibilities with regard to the external audit.
59. As part of the development of this consultation paper, the IAASB undertook an informal survey on the role of audit committees in larger economies. The survey findings indicate that:
 - There are legal or regulatory requirements, or “comply or explain” provisions, for audit committees to be established for listed entities in the majority of larger economies;
 - In a number of the economies, there are also requirements for audit committees for other public interest entities, regulated entities in the financial services sector, and state-owned enterprises; and
 - For those economies where there are no explicit legal or regulatory requirements for audit committees, voluntary guidelines often exist or they are common practice for certain types of entities.
60. While audit committees in most of the larger economies have specific responsibilities regarding the appointment of the auditor and the determination and approval of audit fees, the survey showed that other responsibilities with regard to the external audit vary. In particular, some, but not all, also have a responsibility for evaluating the effectiveness of the audit. However, the way in which this responsibility is described varies, giving the potential for uncertainty as to the scope of this remit. Different expressions include:
 - Reviewing the effectiveness of the audit process;
 - Overseeing the auditor’s work;
 - Monitoring the statutory audit;
 - Reviewing the performance of the statutory auditors; and
 - Evaluating the appropriateness of the audit.

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61. There may be benefit in developing a more consistent international understanding of the role of the audit committee in relation to the external audit. There may also be benefit in exploring how the audit committee communicates how it has undertaken its role to users of financial statements. Currently, only a few of the countries covered by the survey require audit committees to report publicly on their work.

3.3 The Applicable Financial Reporting Framework

62. The financial reporting framework is a critical factor in the quality of financial reporting and can also influence audit quality. For example:
- Less auditor judgment will be involved where amounts are reported at cost rather than fair value;
 - Overly complex financial reporting frameworks can absorb a disproportionate amount of the time of senior members of the audit team dealing with accounting complexities.
 - Where the framework does not promote robust and transparent disclosures of related party relationships and transactions, it will be challenging for auditors to identify such transactions and determine whether they are appropriately accounted for and disclosed.
63. Some believe that an accounting framework that is overly principles-based allows management too much latitude to account for transactions in a manner that suits management's objectives and makes it difficult for auditors to challenge this.
64. On the other hand, others believe that over-emphasis on rules encourages a strict compliance approach to financial reporting, which may mean that it is difficult for auditors to focus on the substance of transactions and the fair presentation of the financial statements. Furthermore, over-complexity in the applicable financial reporting framework will likely make it difficult for management to understand the accounting requirements and for those charged with governance to provide oversight of the financial reporting process.
65. A related issue for audit quality is the timeframe within which the audit has to be completed. Timeframes are sometimes imposed by financial regulators or by market practice. However, there seems to be an ongoing trend for entities to wish to report their annual results more quickly sometimes through preliminary announcements of results.
66. There is a trade-off between very tight reporting deadlines and audit quality. Tighter deadlines drive greater reliance on audit procedures performed before the period end. In such circumstances there is greater need for reliance on internal control and less opportunity for detailed substantive work after the period end. Importantly, time pressures may increase the risk that auditors do not adequately consider significant financial reporting issues, discuss them with management and those charged with governance, and appropriately consult on them within the audit firm.

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3.4 Audit Regulation

67. In many countries, independent audit regulators are now responsible for inspecting audits. This involves evaluating auditors' compliance with auditing and ethical standards,¹⁰ and taking appropriate action to address any breaches of those standards. The publication of results of audit inspections in a number of jurisdictions has led to greater awareness amongst auditors and other stakeholders of areas of weaknesses.
68. In an international context, a positive development has been the establishment of the International Forum of Independent Audit Regulators (IFIAR) to facilitate knowledge sharing and promote greater coordination amongst audit regulators,¹¹ as well as the development by IFIAR of core principles for audit regulation.
69. IFIAR's core principles are that the responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation. In addition, audit regulators should:
- Be operationally independent;
 - Be transparent and accountable;
 - Have comprehensive enforcement powers;¹²
 - Ensure that staff is independent from the profession;
 - Have sufficient staff of appropriate competence;
 - Be objective and free from conflicts of interest, and maintain appropriate confidentiality arrangements;
 - Make appropriate arrangements for cooperation with other audit regulators and, where relevant, third parties;
 - As a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements and other laws, rules and regulations;
 - Ensure that a risk-based inspection program is in place;
 - Ensure that inspections include procedures for both firm-wide and file reviews; and
 - Have a mechanism for reporting inspection findings to the audit firm and ensuring remediation of findings with the audit firm.

¹⁰ The use of ISAs and the IESBA Code in a growing number of jurisdictions may help to provide a common set of benchmarks for audit inspections.

¹¹ Currently, IFIAR has over 40 members. Further information about its activities can be found on its website: www.ifiar.org.

¹² Including the capability to ensure that their inspection findings or recommendations are appropriately addressed: these enforcement powers should include the ability to impose a range on sanctions including, for example, fines and the removal of an audit license and/or registration.

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3.5 Industry, Information Technology and the General Economic Environment

70. Both financial reporting reliability and audit quality will be influenced by the nature of the business undertaken by an entity and the degree to which that business, and its financial reporting systems, are dependent on advanced information technology and the economic climate during and subsequent to the reporting period. For example:
- The nature of some businesses, such as those involved in long-term contracts or trading in financial instruments create particular risks for financial reporting and audit quality. Auditors need to respond to this by developing relevant competencies or using staff with specialist skills;
 - Businesses in industries with a high dependence on advanced information technology will also require auditors to develop or utilize specialized competencies; and
 - Rapidly changing and challenging economic conditions can result in increased difficulty in financial reporting and increased audit risk. Accuracy of financial reporting can be strengthened through:
 - Timely communication amongst all parties involved in the audit process; and
 - Audit firms providing partners and staff with sufficient time to deal with difficult issues as they arise and with high-quality technical support.

3.6 The Educational Environment for Accountants and Auditors and Respect for the Role of Audit

71. The knowledge, values and abilities of audit partners and staff are an important factor underlying audit quality. This influences both the ways that individual audits are performed and, in overall terms, the respect for the audit function itself.
72. There are likely to be a number of factors that will influence the quality of the individuals attracted to a career in the auditing profession including:
- The status of auditing as a profession in the national environment.
 - Perceptions of career opportunities and remuneration incentives; and
 - The quality of training provided.
73. The same factors are likely to influence the ability of audit firms to retain the best staff for an extended career in auditing. In some countries, there is a tendency for large numbers of newly qualified accountants to leave the audit firms and take jobs in business. While this may have a beneficial impact on financial reporting, it can limit the number of experienced staff available to audit firms and thereby jeopardize audit quality.
74. The strength of the educational system for accountants and auditors can therefore be an important factor contributing to quality financial reporting and to audit quality. This applies to all levels of education including primary, secondary and tertiary, as well as the specific training requirements related to obtaining an accountancy qualification.

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75. In addition to training related to an auditor's initial professional development (IPD), it is critical that more experienced auditors continue to develop their skills and knowledge related to auditing, and keep informed about changes in the accounting and regulatory requirements. Arrangements within a country for continuing professional development (CPD) are an important factor in contributing to audit quality.
76. The status of the auditing profession in a national environment can impact the ability to recruit and retain high-quality individuals. It can also have an impact the respect in which auditors are held and therefore the effectiveness of the audit function.
77. In environments where the audit profession is not well respected or given appropriate authority, auditors will be in a weaker position relative to management. In such circumstances, there may be a lower likelihood that auditors will probe management on significant matters or stand firm on significant audit issues. Conversely, where the profession is highly regarded or is conferred appropriate authority through the relevant mechanisms, it will be easier for auditors to demonstrate professional skepticism and undertake robust audits.

3.7 Broader Cultural Issues

78. Broad cultural differences are likely to impact the attitudes of both accountants in business and auditors, and in turn may impact the quality of financial reporting and audit quality. Two factors in particular are relevant:
 - Deference to authority; and
 - Transparency.
79. These broader cultural issues may to some extent be mitigated within a multi-national entity context through the development and establishment of the group's own culture and code of conduct across all its components in countries where it operates.

Deference to Authority

80. Some cultures value, or perhaps just tolerate, more junior people challenging the views of more senior people in organizations. In other cultures, it is difficult for junior people to challenge the views of senior people. Undue deference to authority can impact both the willingness of junior accountants in the entity to raise concerns with their supervisors as well as the effectiveness of an audit team involving less experienced staff.
81. Auditing is a process that requires a skeptical mindset. While the concept of professional skepticism is embedded in auditing standards, in certain environments it is possible that auditors may not interpret it and the concept of professional judgment as intended by auditing standards, especially if those environments do not have a culture of questioning authority. Reluctance by auditors to challenge management can adversely impact on audit quality.

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Transparency

82. A further aspect of culture that may have an influence on audit quality is the extent to which secrecy or confidentiality is expected in business dealings. A lack of openness or transparency by management may undermine auditors' ability to obtain the necessary understanding of the entity in order to properly identify and assess the risks of material misstatement in the financial statements. It may make it more difficult for auditors to gather sufficient appropriate audit evidence and to evaluate the completeness and adequacy of disclosures.

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4. Input Factors

83. While auditors cannot significantly change the contextual factors described in Section 3, they do have direct influence over the inputs to the audit itself. In this Section, the main inputs are described within the categories of:

- The culture within an audit firm;
- The knowledge and personal attributes and values of audit partners and staff; and
- The effectiveness of the audit process.

4.1 The Culture within an Audit Firm

84. The culture within a firm is an important input to audit quality because the environment in which the audit team works can materially affect the mindset of partners and staff, and consequently the way they discharge their responsibilities. While the audit is designed to protect the public interest, audit firms are commercial entities. Each firm's culture will be an important factor in determining the extent to which its partners and staff function in the public interest as opposed to merely achieving the firm's commercial goals.

85. Some of the principal indicators of whether a firm has an appropriate culture from the perspective of enhancing audit quality are described below.

Input	Indicators
The firm's leadership creates a culture where audit quality is valued.	<p>The firm's culture is likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Appropriate governance arrangements are in place. • The firm promotes the personal characteristics essential to audit quality. • Financial considerations do not drive actions and decisions that have a negative effect on audit quality. • Partners and staff have sufficient time and resources to deal with difficult issues as they arise. • Partners are accessible both to their own staff and to management and those charged with governance of the entities they audit. • The firm provides partners and staff with access to high-quality technical support. • The firm promotes a culture of consultation on difficult issues. • Robust systems exist for making client acceptance

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Input	Indicators
	<p>and continuance decisions.</p> <ul style="list-style-type: none"> Audit quality is monitored and appropriate consequential action is taken.

Appropriate Governance Arrangements Are in Place

86. It is important that a firm has effective internal governance arrangements to safeguard the public interest nature of the audit function and to avoid the firm's commercial interest in promoting other practice areas (such as tax, corporate finance and consultancy) to the detriment of audit quality.
87. The firm's leadership also has a vital role in avoiding situations that might compromise that firm's objectivity or independence. Creating an appropriate environment within audit firms includes encouraging adherence to the principles underlying ethical requirements that apply to auditors.

The Firm Promotes the Personal Characteristics Essential to Audit Quality

88. Appropriate personal characteristics including integrity, objectivity, professional competence and due care need to be nurtured and developed by the firm. This involves embedding them in recruitment and training programs and in promotion and reward systems. It also involves ensuring that audit partners and staff are not penalized for jeopardizing a client relationship by taking a robust position on audit issues.

Financial Considerations Do Not Drive Actions and Decisions that Have a Negative Effect on Audit Quality

89. Financial considerations both at the firm level (such as the financial target that a firm sets for the margin to be achieved on audit work and the willingness to invest in training and support systems for audit) and at the engagement level (such as the audit fee and the recovery rate) should not be allowed to prevent the performance of a robust audit that meets the public interest.
90. There should also not be:
 - Over-emphasis on winning audit appointments and on the retention of audit clients at the expense of the quality of audit judgments.
 - Over-emphasis on marketing non-audit services to entities that the firm audits.
 - Excessive cost cutting (including by reducing partners and staff) in the audit practice during times of economic downturn that damage the provision of audit quality.
 - A focus on improving client service to management at the expense of necessary training in technical competence and appreciation of the public interest aspect of auditing.

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Partners and Staff Have Sufficient Time and Resources to Deal with Difficult Issues as They Arise

91. Partners and staff usually work on a number of audits and undertake other activities for clients or within the firm. Sometimes, this leads to concentrated periods of activity. The need to work intensively on one activity means that time available to allocate to another activity will be limited. It is important that firms anticipate, as best they can, and manage possible time conflicts when allocating responsibilities. Firm management need to proactively monitor work levels to reduce the risk that an unacceptable burden is not put on individual partners or staff.
92. Resource allocation also needs to take account of audit risk. A danger exists that the most competent partners and staff will be allocated to the firm's largest, most prestigious, clients and as a result, will not be available to audit other clients where the risks that the financial statements are misstated may be greater.

Partners are Accessible Both to Their Own Staff and to Management and Those Charged with Governance of the Entities They Audit

93. As engagement partners are responsible for the audits they undertake, it is important that they are directly involved in planning the audit, evaluating the evidence obtained and in reaching final conclusions. While much of the detailed work may be delegated to less experienced staff, partners need to be accessible to them in order to provide timely input to the audit as it progresses. Such regular contact also assists staff develop their skills and knowledge.
94. It is also important that the audit engagement partner is accessible to senior members of management and those charged with governance. Regular contact allows the audit engagement partner to be well briefed on developments in the entity's business as well raise issues related with the audit on a timely basis.

The Firm Provides Partners and Staff with Access to High-Quality Technical Support

95. Auditing requires knowledge of a considerable number of technical areas including company and tax law, and financial reporting, auditing and ethical standards. It is important that audit firms have technical support arrangements to help individual partners and staff keep up to date with developments in these areas and to provide assistance on complex areas. In larger firms, audit quality can also be enhanced if an information infrastructure is developed that enables the firm to support audit judgments (for example, by assembling business- and industry-related databases), to track and appropriately address independence issues, and to plan and effectively manage the rotation of partners on audit engagements.

The Firm Promotes a Culture of Consultation on Difficult Issues

96. Auditing often involves difficult decisions and judgments to be made. Staff will discuss these issues within the audit team and with the audit engagement partners. Audit engagements partners will often wish to discuss difficult decisions and judgments with

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other partners or with technical specialists. This process will be facilitated if there is a culture of consultation and where those involved have sufficient time available to deal properly with issues as they arise.

97. A culture of consultation is also important for sole practitioners, and they may leverage external technical resources available to them, whether through their professional bodies, their relationships with other firms, or suitably resourced third-party organizations.

Robust Systems Exist for Making Client Acceptance and Continuance Decisions

98. Prior to accepting an audit engagement, and annually thereafter, it is important that audit firms consider whether they are competent to perform the engagement and have the capabilities and resources to do so. This includes whether the firm can comply with relevant ethical requirements.
99. Good client acceptance and continuance systems evaluate whether there is information to suggest that client management lacks integrity to the extent that it will not be possible to perform a quality audit. Having a rigorous client acceptance and continuance system is therefore important in helping an audit firm avoid engagements where there is a high chance of fraud or illegal acts and thereby maintain a reputation for providing high-quality audits.

Audit Quality Is Monitored and Appropriate Consequential Action Is Taken

100. Auditing involves compliance with standards and internal firm policies and procedures. It also involves difficult decisions and judgments made by staff at different levels of experience and sometimes under time pressure. Monitoring audit quality is an important aspect of ensuring that standards are being adhered to and that the partners and staff are performing appropriately. It is important that this is done on an international basis where network firms perform the audits of important components of a group audit.
101. It is important that the firm takes appropriate steps to address any shortcomings revealed by these internal monitoring activities as well as responding to the findings of any audit regulators.

4.2 The Knowledge, Experience, and Personal Attributes and Values of Audit Partners and Staff

102. Audit is a discipline that relies on competent individuals using their experience and their personal attributes and values of integrity, objectivity, rigor and skepticism to enable them to make reliable judgments on issues such as:
- Identifying and assessing the risks of material misstatement due to fraud or error;
 - Determining the audit work to be performed;
 - Evaluating the reasonableness of accounting estimates;
 - Evaluating the adequacy of audit evidence; and

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- Concluding whether the financial statements are fairly presented.
103. The qualities of perseverance and robustness are also important in ensuring that necessary changes are made to the financial statements in the face of persuasive and, possibly, intimidating client management, or that the auditor’s report is appropriately qualified.
 104. The auditor’s competence is a vital input to audit quality because the majority of the requirements in ISAs either provide a framework for the judgments made in an audit or need judgment to be properly applied. The auditor’s competence supports the auditor in making judgments that are of a high quality.
 105. Experience, competence and training are closely linked. Relatively inexperienced staff can be effective in some audit roles – but only if they are properly trained, directed and supervised.
 106. Some of the principal indicators of where the knowledge, experience, and personal attributes and values of audit partners and staff are likely to make a positive contribution to audit quality are described below.

Input	Indicators
The knowledge, experience, and personal attributes and values of audit partners and staff	<p>The knowledge, experience, and personal attributes and values of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Partners and staff understand their clients’ business. • Staff performing detailed “on-site” audit work have sufficient experience and are appropriately supervised by partners and more senior staff. • Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training. • Partners and staff have integrity, act objectively and comply with relevant ethical requirements. • Partners and staff demonstrate skepticism and professional competence. • Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized issues.

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Partners and Staff Understand Their Clients' Business

107. A sound understanding of the entity, its business and the industry in which it operates is key to the auditor being able to assess the risks of material misstatement in the financial statements as well as being appropriately skeptical and making appropriate judgments.
108. Industry knowledge, including an understanding of relevant regulations and accounting issues, can be especially important for clients in, for example, the extractive, financial services and retailing industries.
109. However, it is important that knowledge areas are not so narrow that they prevent the auditor seeing “the wood from the trees.” Auditors acquire general business knowledge from exposure to different clients in different industries. This allows them to stand back from the specifics of a particular entity’s business and reflect upon their wider knowledge of business issues, risks, and control systems.

Staff Performing Detailed “On-Site” Audit Work Have Sufficient Experience and Are Appropriately Supervised by Partners and More Experienced Staff

110. The structure of many accountancy firms is generally hierarchical – often described as a “pyramid structure” – and the make-up of audit teams for individual engagements generally reflects this structure. As a result, much of the detailed “on-site” audit work is likely to be performed by staff who are relatively inexperienced; indeed, many may still be completing their IPD, which may include completing an accounting qualification. Because of this, it is important that experienced managers and partners have the time available to supervise their teams, deal with significant technical and judgmental issues, and communicate effectively with senior client management.
111. It is essential that the person who is to take responsibility for the audit opinion to be issued is actively involved in risk assessment, planning and the work performed. Some believe that partners can be encouraged to take an active responsibility for the quality of work performed by signing auditors’ reports in their own names rather than, or in addition to, their firms’ names.

Partners and More Senior Staff Provide Less Experienced Staff with Timely Appraisals and Appropriate Coaching or “On-the-Job” Training

112. A firm’s appraisal process is an important aspect of developing an individual’s capabilities. Although it is difficult to measure, audit quality is likely to be improved if it is specifically addressed in the appraisals for both partners and staff. In the case of partners, this can be used to promote the exercise of good audit judgment, including consultation on difficult issues.
113. A distinction can usefully be made between staff appraisals and coaching or on-the-job training. While appraisals can be used to help identify the absence of an important skill or competence, coaching or on-the-job training can be used to help an individual develop that skill or competency. Coaching or on-the-job training is likely to be especially important in

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relation to developing key personal characteristics such as integrity, objectivity, rigor, skepticism, and perseverance as well as assisting less experienced staff deal with unfamiliar audit areas.

114. However, the number of people capable of providing coaching is limited. Such people may have other demands on their time, including “special” or non-audit work, or involvement in the internal management of the firm. Being able to coach effectively may also require additional skills, knowledge and experience. It is important that firms provide incentives to their more experienced staff to allocate the necessary time to undertake this important staff development role effectively and, as part of the appraisal process, evaluate them on whether this is achieved.

Partners and Staff Have Integrity, Act Objectively and Comply with Relevant Ethical Requirements

115. ISAs define relevant ethical requirements as those ethical requirements to which the engagement team are subject. These ordinarily comprise Parts A and B of the IESBA Code of Ethics for Professional Accountants (IESBA Code)¹³ together with national requirements that are more restrictive.
116. The IESBA Code establishes, and requires professional accountants to comply with, the following fundamental principles of professional ethics:¹⁴
- (a) Integrity – to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.¹⁵
 - (b) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
 - (c) Professional competence and due care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
 - (d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

¹³ In the public sector environment, the relevant ethical requirements may include the International Organization of Supreme Audit Institutions’ (INTOSAI) Code of Ethics or national ethical requirements applicable to public sector auditors that are at least as restrictive as the IESBA Code.

¹⁴ IESBA Code, paragraph 100.5

¹⁵ IESBA Code, Section 110

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- (e) Professional behavior – to comply with relevant laws and regulations and avoid any action that discredits the profession.
117. Auditors need to understand the fundamental principles of professional ethics and understand how to apply them in practice. An understanding of how to apply them in practice can be developed through internal communications within the audit firm, through coaching or on-the-job training, and through staff observing more experienced staff in action.
118. In addition, ISAs require auditors to comply with relevant ethical requirements relating to auditor independence. Section 290 of the IESBA Code describes the approach auditors should take, including:
- Identifying threats to independence;
 - Evaluating the significance of the threats identified, and
 - Applying safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.
119. Section 290 of the IESBA Code states that when the professional accountant determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.¹⁶
120. There can be a challenge in balancing knowledge of the client and objectivity. There is a risk of “client capture” where the relationship between the audit engagement partner and the client is so close that the partner’s objectivity is impaired. This may be caused by the partner working so closely with management over a period of time that sentiments of familiarity and confidence displace the skepticism and objectivity that are so fundamental to an effective audit. Client capture may also arise if partners believe that their remuneration and, indeed, their ongoing careers with the firm are dependent on maintaining good client relationships. To address this threat, the IESBA Code requires audit engagement partners of listed entities to change (or “rotate”) after 7 years. Ethical requirements in some countries mandate a shorter rotation period.

Partners and Staff Demonstrate Skepticism and Professional Competence

121. The necessary competencies for auditors are described in International Educational standards (IESs) as issued by IFAC’s International Accounting Education Standards Board (IAESB).
122. IESs are addressed to IFAC member bodies. They do not apply directly to audit firms but the IAESB believes that they will be helpful to other stakeholders who support the learning and development by professional accountants of professional values, ethics and attitudes.

¹⁶ IESBA Code, paragraph 290.7

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123. IES 8 requires that the skills requirement within the education and development program for audit professionals should include developing the following professional skills in an audit environment:¹⁷
- (a) Applying relevant audit standards and guidance;
 - (b) Evaluating applications of relevant financial reporting standards;
 - (c) Demonstrating capacity for inquiry, abstract logical thought, and critical analysis;
 - (d) Demonstrating professional skepticism;
 - (e) Applying professional judgment; and
 - (f) Withstanding and resolving conflicts.
124. Making sound professional judgments involves:
- Remaining objective;
 - Applying knowledge of business, financial accounting and reporting and information technology;
 - Gathering sufficient appropriate evidence to form a sound judgment;
 - Consultation, as appropriate; and
 - Preparing appropriate documentation.
125. Demonstrating professional skepticism is an important mindset for making professional judgments. Unless auditors are prepared to challenge management's assertions, they will not act as a deterrent to fraud nor be able to conclude, with confidence, that an entity's financial statements are fairly presented.
126. Demonstrating professional skepticism involves:
- Having a questioning mind and a willingness to challenge management assertions;
 - Assessing critically the information and explanations obtained in the course of their work;
 - Understanding management motivations for possible misstatement of the financial statements;
 - Keeping an open mind until appropriate audit evidence has been obtained;
 - Having the confidence to challenge management and the persistence to follow things through to a conclusion; and
 - Being alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.

¹⁷ IES 8, paragraph 42

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Sufficient Training Is Given to Audit Partners and Staff on Audit, Accounting and, Where Appropriate, Specialized Issues

127. The profession endeavors to equip auditors with the necessary competence through IPD, comprising completion of an accountancy qualification and practical experience, and CPD requirements.
128. Firms generally provide training in the technical aspects of audit and in the requirements of their audit methodologies. Firms also provide essential practical experience by including trainees in audit teams undertaking audit work.¹⁸ Merging learning about the technical aspects of auditing with gaining practical experience is important because formal training is only part, and perhaps only a small part, of the process by which auditors develop skills and experience.
129. Professional accountancy bodies have requirements relating to CPD and the development programs used by the firms have the potential to be an important contributor to an auditor's competence. Generally, however, such programs address a wide range of areas relevant to the firm's business as a whole, such as project management and communication skills, and are not necessarily concerned with the technical skills needed to support audit quality. It is important that firms dedicate sufficient time, resources and importance to technical training in audit and accounting matters.

4.3 The Effectiveness of the Audit Process

130. It is well recognized that the audits of most large entities, especially multi-national companies, have tight reporting deadlines and are increasingly complex. There is an ever-increasing need for auditors to have an effective process to enable quality audits to be performed.

¹⁸ IES 8, paragraphs 54 and 59, establishes requirements for practical experience for audit professionals.

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131. Some of the principal indicators of a high-quality audit process are described below.

Input	Indicators
The effectiveness of the audit process	<p>The audit process is likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • The engagement team is properly structured and there is adequate and timely involvement of partners and experienced staff. • The engagement team makes proper use of technology. • The audit methodology: <ul style="list-style-type: none"> ◦ Does not discourage individual team members from thinking creatively, applying skepticism, and exercising judgment. ◦ Requires an effective supervision and review of audit work. ◦ Requires appropriate audit documentation. • There is effective engagement with the auditors of other components in the group (where applicable). • There is effective engagement with the client's internal auditors (where applicable). • The audit process is adapted to developments in professional standards and is responsive to regulatory inspection findings.

The Engagement Team Is Properly Structured and There Is Adequate and Timely Involvement of Partners and Experienced Staff

132. An audit firm needs to allocate its resources such that audit teams have the expertise and experience to undertake particular audits, whilst at the same time complying with relevant ethical requirements (such as rotation of audit and other key partners). This involves structuring an audit team so that:

- It has individuals with appropriate knowledge of the industry in which the client operates and its applicable financial reporting framework;
- It has sufficient resources to enable:

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- Partners to be adequately involved in establishing the overall audit strategy, assessing risks and developing appropriate responses to audit issues, and evaluating audit evidence in important areas;
- Staff to carry out the audit work required in a considered way having regard to their level of experience and the timetable for completion of the audit work involved; and
- Partners and experienced managers to have the time necessary to review the staff's work and respond in a considered way to issues identified.

The Engagement Team Makes Proper Use of Technology

133. The automation of accounting systems allows auditors to spend less time obtaining audit evidence regarding the accuracy of transaction processing and enables them to devote more time to areas of greater potential risk. It has also provided an opportunity for auditors to gather audit evidence more effectively through the use of computer-assisted audit techniques, although sometimes these need the involvement of specialists and can be expensive to set up, especially in the first year.
134. Technology has also had an effect on the way audit teams communicate, both within the teams and with management and those charged with governance. While e-mail generally increases accessibility, especially on an international basis, they can sometimes be prone to being misunderstood. Useful audit evidence is often obtained from a fuller discussion with management on important issues than is usually supported by e-mail exchanges. Responding to auditor questions by e-mail might also make it easier for management to provide inaccurate or incomplete responses if they are motivated to do so.

The Audit Methodology Does Not Discourage Individual Team Members from Thinking Creatively, Applying Skepticism and Exercising Appropriate Judgment

135. Most audit firms use methodologies to assist staff in achieving an efficient and effective audit and for quality control processes. These methodologies are often in the form of software that sometimes supports decisions and generates electronic working papers that can be viewed at remote locations.
136. Such methodologies can be an effective mechanism for achieving compliance with auditing standards and for checking whether all necessary steps in the audit process have been performed. However, there is a risk that increasing too far the level of prescription in audit methodologies will have negative implications for other elements of audit quality. For example:
- If compliance with a very prescriptive methodology is over-emphasized, there is a risk that insufficient emphasis is given to experienced staff tailoring the specified audit procedures to the circumstances and considering whether further procedures need to be performed.

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- Over-emphasizing the process by which an audit is performed may detract from experienced audit partners and staff making important judgments.
 - Reducing too far the freedom of action of partners and staff may undermine the motivation of these individuals and cause them not to pursue a career in auditing.
137. The trend to use computerized methodologies also has the potential to distance both partners and staff from the company being audited. In part, this trend increases the risk that the information and audit evidence that have historically been obtained by spending time with company personnel, “walking the floor” and observing and inspecting the company’s operations may not be obtained.

The Audit Methodology Requires Effective Supervision and Review of Audit Work

138. Much of the detailed “on-site” audit work may be performed by staff who are relatively inexperienced. In such circumstances, it is vital that their work is supervised and reviewed by experienced staff.
139. Although some modern methodologies provide the opportunity for electronic, off-site review of working partners, this may not be an effective means of assessing whether staff have undertaken the audit thoroughly and demonstrated an appropriate degree of skepticism. Furthermore electronic, off-site review is unlikely to assist with the coaching or on-the-job-training that is so vital for developing the skills and competencies of less experienced staff.

The Audit Methodology Requires Appropriate Audit Documentation

140. Audit documentation performs a number of roles including:
- Assisting the engagement team to plan and perform the audit.
 - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work.
 - Enabling the engagement team to be accountable for its work.
 - Retaining a record of matters of continuing significance to future audits.
 - Enabling the conduct of intra-firm quality control reviews and inspections, and external inspections in accordance with applicable legal, regulatory or other requirements.
141. Documentation of the rationale for an audit judgment is likely to increase the rigor, and therefore the quality, of that judgment. The process of committing to writing the issues and how they have been resolved is likely to improve the rigor of the auditor’s thought process and the validity of the conclusions reached.

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There Is Effective Engagement with the Auditors of Other Components in the Group (Where Appropriate)

142. Most large entities will have divisions, subsidiaries, joint ventures or investees accounted for by the equity method (components). One or more components are frequently audited by audit teams other than the group audit team. Component auditors may be from within the group auditor's firm, from one of its network firms, or from a different firm of auditors.
143. The group auditor will often wish to use the work of the component auditors when obtaining evidence to support the group auditor's opinion on the group financial statements. It is important for the group auditor to understand component auditors and, especially in relation to significant components, engage with them.

Network Firms

144. Some audit firms operate internationally through a network of firms. Network firms often share:
- Common methodologies;
 - Common quality control policies and procedures; and
 - Common monitoring policies and procedures.
145. Whilst an international firm's audit methodology may be applicable across all the firms within the network, the importance of ensuring that the firms within the network observe consistently high standards of professional skill, integrity and conduct cannot be overstated.

There Is Effective Engagement with the Client's Internal Auditors (Where Appropriate)

146. Many large entities will have internal auditors. It is likely to be important for both efficiency and effectiveness for there to be effective engagement between the external and internal auditors. For example, the internal audit function is likely to have obtained insight into the entity's operations and business risks that will provide valuable input into the auditor's understanding of the entity and risk assessments or other aspects of the audit.

The Audit Process Is Adapted to Developments in Professional Standards and Is Responsive to Regulatory Inspection Findings

147. The audit firm's audit process should not remain static but should evolve with changes in professional standards. Importantly, continual improvements to the firm's audit methodology and tools should be made to respond to findings from internal reviews and regulatory inspections.

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5. Output Factors

148. In this Section, the main outputs from audits are described within the categories of:

- The reliability of audit reporting to users of audited financial statements;
- The usefulness of audit reporting to such users;
- The quality and usefulness of audit communications to those charged with governance;
- The quality and usefulness of audit communications to management; and
- Transparency reports.

5.1 The Reliability of Audit Reporting to Users of Audited Financial Statements

Output	Indicator
The reliability of audit reporting to users of audited financial statements	Audit reporting is likely to provide a positive contribution to audit quality where audit reports are written in a manner that conveys the auditor's opinion on the financial statements.

149. The ultimate objective of an audit is the provision of an auditor's opinion that provides users confidence as to the reliability of the audited financial statements. For the majority of users, the absence of a qualified auditor's opinion is an important signal. However, the value of that signal is influenced by the reputation of the audit firm that has conducted the audit and an assumption about the effectiveness of the audit process employed. One of the difficulties associated with the audit process is that the work performed and the findings that arise from it are largely invisible to the main users of the audit – including the shareholders of companies.
150. Audit reports have developed over the years, influenced by law and auditing standards, to a degree that they are largely standardized. An audit report can be unmodified; it can also be modified by:
- A qualification of the opinion
 - The inclusion of an adverse opinion
 - The disclaimer of an opinion.
151. An audit report also can contain an emphasis of matter paragraph to draw users' attention to a matter disclosed in the financial statements that the auditor believes is fundamental to users' understanding of the financial statements. Such a matter may concern, for example, uncertainty regarding the entity's ability to continue as a going concern.
152. The audit process often results in management making changes to the draft financial statements, in terms of both the quantitative and qualitative information contained. This

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activity is, however, not transparent to users. Faced with “clean and coherent” financial statements, users may impute that a quality audit has been performed. The converse is certainly likely to be the case. Faced with financial statements that contain arithmetical errors, inconsistencies and disclosures that are difficult to understand, in the absence of a qualified auditor’s report users may conclude that a poor quality audit has been performed.

5.2 The Usefulness of Audit Reporting to Users of Audited Financial Statements

153. Information obtained by the IAASB signals that:

- (a) The financial statement audit and the independent auditor’s opinion on an entity’s financial statements are valued. However, other than communicating the auditor’s overall conclusion, the content of the auditor’s report is not viewed as being as useful or informative as it could be.
- (b) Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor’s report. Some of those users wish to obtain this richer information directly from the entity and/or through communications about the auditor’s insight into such matters. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as the quality of its corporate reporting and the quality of the audit.
- (c) Some users also believe that the communicative value of the auditor’s report could be improved if changes were made to the structure and wording of the auditor’s report.

154. The IAASB is undertaking a separate initiative to explore how to enhance the quality, relevance and value of auditor reporting. There are many potential options for changes that might address these concerns, including some shorter-term options that fall under the IAASB’s mandate and some longer-term options that would require co-operation with organizations the mandates of which extend to legislative and other regulatory frameworks.

5.3 The Quality and Usefulness of Audit Communications to Those Charged with Governance

Output	Indicators
The quality and usefulness of audit communications to those charged with governance and management	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Communications with those charged with governance include information about: <ul style="list-style-type: none"> ○ The scope of the audit. ○ The threats to auditor objectivity.

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Output	Indicators
	<ul style="list-style-type: none"> ○ The key risks identified. ○ Judgments made in reaching the audit opinion. ○ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting. ○ Insights into the entity's financial reporting practices. ○ Recommendations for improvement to the entity's financial reporting process.

155. Those charged with governance, especially audit committees, have an important role in fostering audit quality. This can best be achieved where there is effective two-way communication.

156. Effective two-way communication assists:

- The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship;
- The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

5.4 The Quality and Usefulness of Audit Communications to Management

Output	Indicators
The quality and usefulness of audit communications to management	<p>Audit reporting is likely to provide a positive contribution to audit quality where communications with management include findings about:</p> <ul style="list-style-type: none"> • Misstatements in the financial statements. • Deficiencies in internal control. • Perspectives on industry issues and trends and opportunities for improvement.

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Output	Indicators
	<ul style="list-style-type: none">• Observations on regulatory matters.

157. While not a direct objective, an audit has the ability to make a valuable contribution to management to assist them in complying with relevant law, regulations and financial reporting standards. It can also provide useful information of weaknesses in controls and accounting systems that can lead to improved efficiency or effectiveness in management's processes.

5.5 Transparency Reports

158. A number of countries have introduced requirements for audit firms to provide information annually about their governance and quality control systems.¹⁹ Making such information publically available generally assists users of audited financial statements understand the characteristics of individual audit firms and this information may directly assist entities selecting a new audit firm. Transparency reports also provide an opportunity for audit firms to distinguish themselves by highlighting particular aspects of their arrangements and therefore to compete on aspects of audit quality.
159. Clear public information on, for example, the firm's processes and practices for quality control, for ensuring independence, and on their governance provide a clear incentive to all within the audit firm to live up to both the spirit and the letter of what the firm promises.

¹⁹ EU Member States, for example, are required by the Statutory Audit Directive to require firms that audit public interest entities to disclose annually specified information covering the legal structure of audit firms, any network they are part of, corporate governance and quality control systems, financial information and information about the basis of partner remuneration.

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6. Stakeholder Perspectives of Audit Quality

160. Some academics have observed that audit involves both a technical component and a service component. The relative importance of these two components is likely to vary between different stakeholder groups.
161. The technical component of audit quality is often considered as having been achieved when there is a high probability that an auditor will both (a) discover a misstatement in the client's financial statements, and (b) report that misstatement.²⁰ The technical component is most likely to be of importance to users, those charged with governance and audit regulators. Considering audit quality solely from this perspective would likely focus on the inputs discussed in this paper and suggest that the more resources (both in quantitative and qualitative terms) are allocated to an audit the higher its quality would be. This fails to recognize the interests of other stakeholders and the needs of the capital markets more generally.
162. The service component of audit quality is most likely to be of importance to management who will take into account the efficiency of the audit and its cost. Management is likely to have an interest in ensuring that the cost of the audit is constrained and that it is completed in a reasonable timeframe. This perspective suggests that a quality audit involves an effective audit being performed on a timely basis for a reasonable fee. There is, however, subjectivity around the words "effective," "timely," and "reasonable," which makes audit quality so difficult to evaluate and measure.
163. There is a potential conflict between the wishes of management to limit audit fees and the wishes of other stakeholders for the highest audit quality. Those charged with governance, who will usually determine the audit fees to be paid, have an important responsibility in balancing these pressures and ensuring that ultimately an effective audit is performed.
164. The fee charged is often a reflection of the skills and experience of the audit engagement team and the time that they spend. These factors are likely to directly reflect audit quality but 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. There is also a belief that the audit firm's interest in marketing non-audit services to the entity may allow it to discount audit fees. However, relevant ethical requirements and regulatory action in a number of countries have reduced the potential for this to happen.
165. While it is important to focus on the inputs to audit quality, this perspective alone is insufficient to address the question of whether audit quality has been achieved in the broader context. The IAASB has undertaken a survey of stakeholders in nine countries regarding key factors that affect their perspectives of audit quality.
166. This survey demonstrates that perceptions of audit quality vary amongst stakeholders depending on their level of direct involvement in audits and on the lens through which they

²⁰ Based on LE DeAngelo, *Auditor size and auditor quality*, Journal of Accounting and Economics, 1981

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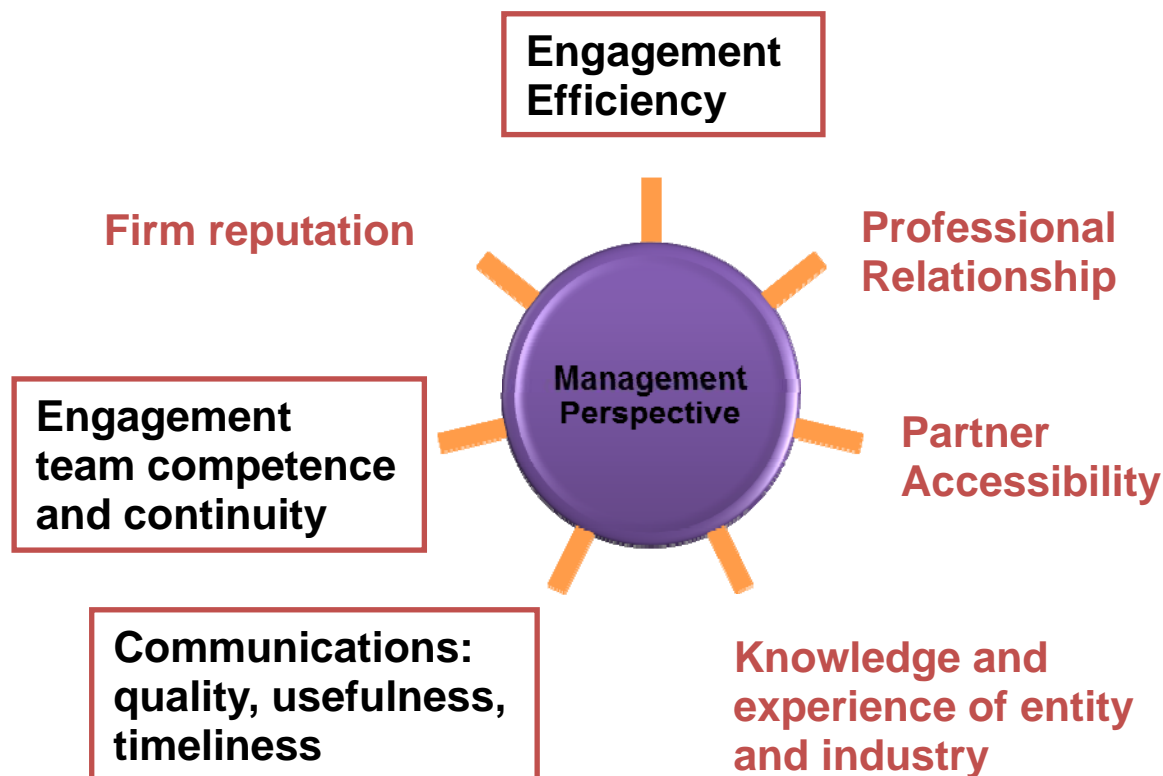
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assess audit quality. The table below lists a number of factors that the following key stakeholder groups are likely to take into account in forming a view on the likely quality of an audit:²¹

- Management (both large entities and owner-managed entities)
- Audit committees (large entities)
- Institutional investors and public sector stakeholders

6.1 Management



167. Management of both large entities and owner-managed entities is likely to view an audit as a service. An important feature of services is that the perception of their quality is usually based on *how* they are provided as much as their outcome.

²¹ The IAASB has undertaken a survey of stakeholders in 9 countries and selected representatives of the IAASB Consultative Advisory Group regarding key factors that affect their perspectives of audit quality (Audit Quality Perspectives Survey). The findings from this survey form the basis for the quality factors reflected in this paper.

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168. Based on the Audit Quality Perspectives Survey, it seems that management will pay particular attention to:

- Engagement efficiency, including, where appropriate, the coverage of subsidiaries
- The quality, timeliness and usefulness of communications from senior team members
- The competence and continuity of the engagement team

Engagement Efficiency, Including, Where Appropriate, Coverage of Subsidiaries

169. Overall engagement efficiency seen from management's perspective contributes to management's perception of audit quality. Engagement efficiency may be demonstrated by the auditor in such ways as:

- Early notification of potential audit and financial reporting issues, including those arising from changes in standards and regulation.
- Proactive and timely engagement with management on resolving issues identified during the audit.
- Effective issue resolution, drawing on expert input in specialized areas where appropriate.
- Meeting agreed timelines and reporting deadlines.
- Timely submission and clear articulation of information requests.
- Avoidance of duplicate inquiries of management on the same matter from different engagement team members.
- Effective interaction between the external auditor and the internal audit function (when one exists).

170. In the context of group audits, the firm's geographic reach and therefore its ability to provide efficient audit coverage for subsidiaries and other components of the group also contribute to management's perception of audit quality. The greater the international reach of the firm, the greater the likely impact on management's perception of the firm's strength, depth of resources, and breadth of capabilities, and therefore of the overall engagement efficiency.

Quality, Timeliness and Usefulness of Communications

171. The quality, timeliness and usefulness of communications from the engagement team, whether through informal discussions with management or a formal management letter, all add to the value of the service that management perceives it receives on the audit. Apart from communications on financial reporting issues, management may particularly value:

- Insights into, and recommendations for improvement in, particular areas of the entity's business.
- Observations on regulatory matters.

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- Global perspectives on significant industry issues or trends.

Competence and Continuity of the Engagement Team

172. The professional competence, including technical skills and experience, of engagement team members contributes to management's forming a view as to the credibility of the engagement team and, therefore, the quality of the audit work.
173. Management may develop an appreciation of the engagement team's professional competence in a number of ways, such as:
- How the engagement team has dealt with significant unusual or complex issues during the engagement.
 - Whether the engagement team has asked probing questions on significant issues.
 - Whether the engagement team has effectively applied technical expertise in resolving highly complex financial reporting issues.
 - The timely involvement of partners and experienced staff.
174. In addition, continuity in the engagement team from year to year can often influence management's perception of audit quality. Accumulated prior knowledge of the entity and its business amongst the engagement team will likely be valued by management as this contributes to the conduct of an effective and efficient audit.
175. Other factors that the survey indicated can be of importance to management are:

Factor	Description
Good working relationship with engagement partner	<p>Personal relationships impact how management perceives audit quality. In particular, the presence of chemistry and a "cultural fit" between management and the engagement partner are likely positive factors influencing management's view of audit quality.</p> <p>However, while seeking a good relationship between the auditor and management is understandable, if audit quality is to be achieved for other stakeholders, it is vital that this relationship does not result in over-familiarity or a loss of skepticism on the part of the auditor.</p>
Accessibility of engagement partner and others within the engagement team	<p>The accessibility of the engagement partner and others within the engagement team helps to build rapport and mutual understanding. It also helps to demonstrate to management that the entity's audit and its business are valued by the audit firm. Accessibility also may manifest itself through frank and open dialogue between the engagement partner and management on a regular basis. A number of respondents to the survey</p>

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Factor	Description
	commented on the importance of the engagement partner being empowered to take decisions without over-referral to technical specialists within the firm.
Knowledge of, and experience with, the entity and its industry	The extent to which the auditor can demonstrate knowledge of, and experience with, the entity and its industry can be a powerful influence over management's perception of audit quality. This aspect is particularly important in specialized industries, such as the financial services or the oil and gas sectors, where prior industry knowledge and experience are almost invariably prerequisites for an auditor to be appointed.
Audit firm reputation	Management, especially of larger entities, value public reputation of the firm and its brand recognition. A number of larger firms have a very high public profile and this is generally associated in the public's mind with high audit quality. Reputations can be damaged by poor external inspection reports, disciplinary proceedings or regulatory sanctions. Client failures can also damage a firm's reputation and, in part, this is why many audit firms have rigorous client acceptance systems.

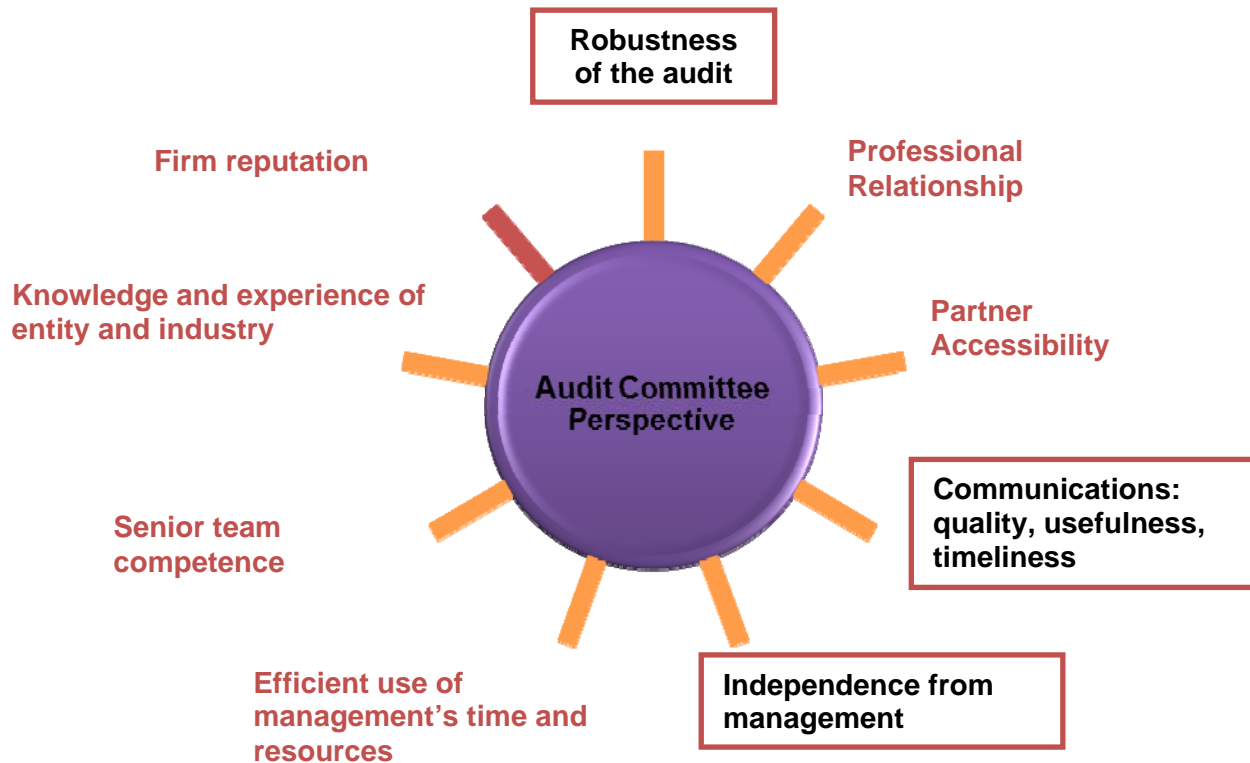
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6.2 Audit Committees



176. While some of the factors that influence audit committees' perceptions of audit quality are similar to those of management²² based on the Audit Quality Perspectives Survey, it appears that the main factors that audit committees look for when evaluating audit quality are:

- The robustness of the audit;
- Quality, timeliness and usefulness of communications; and
- Independence from management.

²² Important factors include:

- Professional relationship with engagement partner
- Accessibility of engagement partner and others within the engagement team
- Knowledge of, and experience with, the entity and its industry
- Competence of senior engagement team members
- Efficient use of management's time and resources
- Firm reputation

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The Robustness of the Audit

177. The engagement team's audit approach is a major factor in the audit committee's overall evaluation of the effectiveness of the audit, and therefore audit quality. Factors that audit committees are likely to consider include whether:

- The audit is appropriately focused on the higher risk areas;
- The engagement team is properly structured and sufficient time has been spent by partners and experienced staff;
- The group auditor has been sufficiently involved in the audit of components.

178. Equally, in forming a view on audit quality, the audit committee will likely consider whether the engagement partner has challenged management in a robust way on contentious issues, and displayed conviction in taking a principled position on those issues, including modifying the audit opinion where deemed necessary. Such evidence may suggest to the audit committee both auditor independence from management and the conduct of a robust audit.

179. A signal of a robust audit can also be conveyed by the engagement partner through demonstrating appropriate professional skepticism, such as through probing inquiries on significant matters, and exercising appropriate professional judgment on significant issues.

Quality, Timeliness and Usefulness of Communications

180. In relation to the quality, timeliness and usefulness of communications, audit committees value auditor communications that provide:

- Unbiased insights regarding the performance of management in fulfilling its responsibilities for the preparation of the financial statements.
- Insight into the entity's financial reporting practices.
- Recommendations for improvement to the entity's financial reporting process.
- Information that enable them to effectively fulfill their governance responsibilities, including, where applicable, their responsibility to evaluate the effectiveness of the audit.

Independence from Management

181. Audit committees value the objectivity of the auditors and their willingness, where necessary, to take differing views from management and perhaps the audit committee itself.

182. Audit committees also sometimes have a role in monitoring auditor independence. The IAASB's informal survey on the role of audit committees showed that in some larger economies, activities in this regard included one or more of the following:

- Pre-approval of non-audit services provided by the auditor;
- Approval of fees paid to the auditor for non-audit services; and

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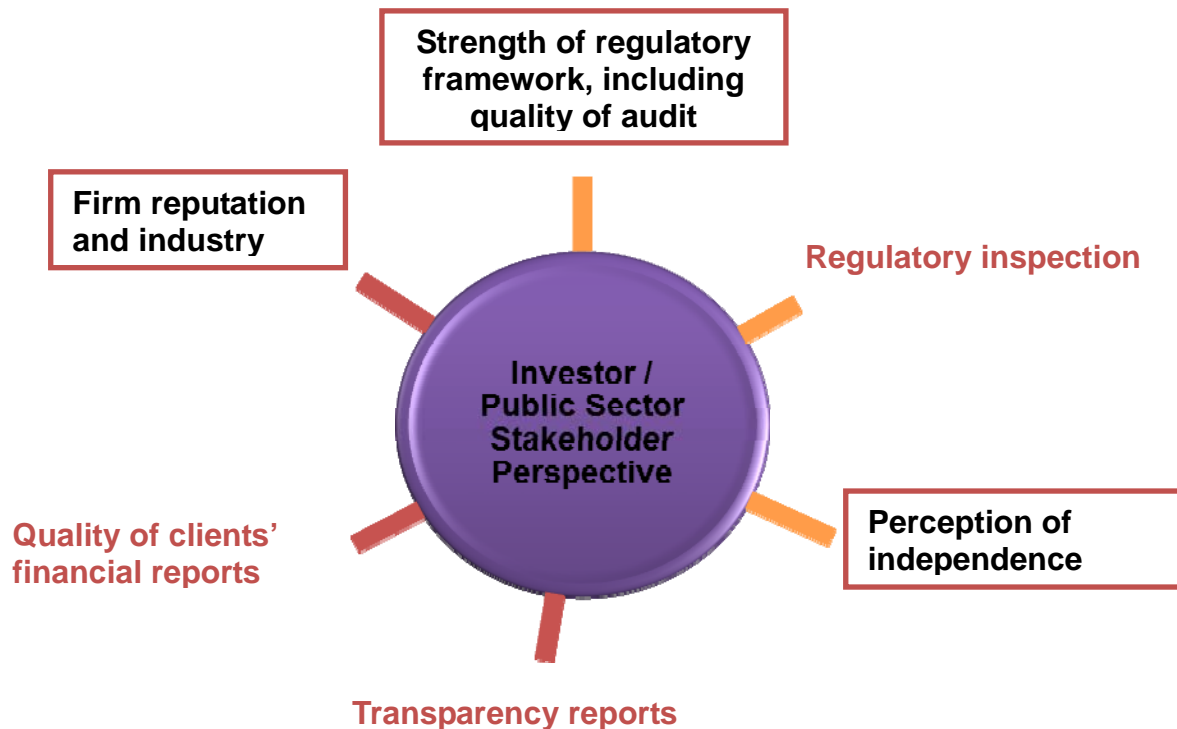
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- Review of hiring policies relating to the employment of ex-partners and staff of the audit firm.

6.3 Institutional Investors and Public Sector Stakeholders



183. Based on the Audit Quality Perspectives Survey, it seems that the main factors that are likely to influence the perceptions of audit quality of institutional investors and public sector stakeholders are:

- Firm Reputation and Industry Expertise;
- Perception of Independence; and
- The Strength of the Regulatory Framework Surrounding Audit.

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Firm Reputation and Industry Expertise

184. From institutional investors' perspective, a firm's reputation and industry expertise may be gauged in a number of ways, particularly through the firm's branding, its client list, and whether it has clients in the same industry.
185. The firm's client list can have an important impact on investors' perceptions of audit quality. A roster of high profile clients may be seen by investors as an implicit endorsement of quality on the presumption that such clients would not engage the firm if it did not offer a high-quality service.
186. Investors may also view a firm that has many audits in the same industry as indicative of audit quality. This is on the presumption that entities competing in the same industry would not engage the same firm if it did not have the industry expertise and experience to meet their audit needs. In making this judgment, however, investors may not necessarily be aware of the limited choice amongst audit firms that may exist in some industries or market segments.
187. More generally, a track record of auditing "household name" entities in a particular industry can suggest to investors that the firm has in-depth industry expertise.

Perception of Independence

188. Evidence of independence will influence investors' perceptions of audit quality. Independence may be demonstrated in a number of ways, such as:
 - A designated role for audit committees to consider auditor independence, including the provision of non-audit services.
 - Robust regulatory requirements governing auditor independence, e.g. periodic rotation of audit engagement partners.
 - Monitoring by audit regulators of regulatory requirements.
 - Firms resigning from the audit engagement if there are independence issues or withdrawing from other client relationships where appropriate.

Strength of the Regulatory Framework Surrounding Audit

189. The strength of the regulatory framework that surrounds the audit also can be a significant influence on investor perceptions of audit quality. A robust regulatory regime will recognize and support the important role of the audit in ensuring high-quality financial reporting. At the same time, it will provide institutional mechanisms for ensuring adequate oversight of the firms, including provisions for adequate sanctions for poor quality or negligent audit work.
190. A strong system of corporate governance will facilitate the conduct of effective audits through emphasizing to audit committees the important role they play in overseeing the financial reporting process, including the audit. Also, a regime that requires the use of high-quality financial reporting standards will support perceptions of audit quality through

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mandating robust benchmarks against which the auditor should validate the entity's financial reporting practices.

191. A number of investors responded to the Audit Quality Perspectives Survey by observing that a strong audit committee gave them reassurance about the likely quality of the audit undertaken. This was particularly the case when the audit committee had described the work undertaken by them on audit effectiveness in the entity's annual report.

Other Factors

Factor	Description
Quality of Clients' Periodic Financial Reports, Including Disclosures	<p>The overall quality of the entity's financial report, including disclosures, can lead to a favorable impression by investors of audit quality, especially if the entity's business involves complex transactions that give rise to difficult financial reporting issues. In this regard, compliance with the requirements of the applicable financial reporting framework and whether a fair presentation is achieved are implicit criteria in investors' evaluation of the quality of the financial reporting. These considerations, in turn, include matters such as:</p> <ul style="list-style-type: none"> • The understandability and transparency of disclosures in significant areas, for example, going concern, measurement uncertainty, and transactions involving difficult substance-over-form issues. • The quality of the entity's accounting policies and practices.
Regulatory inspection reports	Findings from published regulatory inspection reports influence investors' perceptions of audit quality as do disciplinary findings.
Transparency reports	A number of investors responded to the Audit Quality Perspectives Survey by observing that transparency reports can influence their perceptions of the quality of the audit firm.

Public Sector Stakeholders

192. Many of the factors affecting perceptions of audit quality for audit committees are likely to influence in similar ways perceptions of audit quality for primary public sector users. However, the latter's expectations may differ in the sense that these often go beyond the financial aspects.

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193. In addition to the factors applicable to audit committees as described above, the following aspects of reporting and communication by Public Sector Audit Institutions can contribute to primary public sector users' views on audit quality:

- Insight into the operations and financial reporting practices unique to public sector entities;
- Constructive and timely recommendations in areas of performance (including value for money) and compliance with relevant mandates;
- Fair, unbiased and politically neutral reporting;
- Well-balanced and educational reports in the appropriate contexts.

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7. Considerations Relating to Small Audits and Public Sector Audits

7.1 Considerations Specific to Small Audits and SMPs

194. Audit quality is vital to audits of all sizes. The different elements of this Framework apply to audits of all entities and all audit firms regardless of size. Having said that, factors of audit quality can be subtly different for small audits and SMPs:

Interactions

- In many smaller entities, there is little distinction between management and those charged with governance. An owner-manager will usually fulfill both roles. There is also often a long established relationship and the auditor is often viewed as a valued business and tax advisor to the entity. This results in frequent direct communications and the auditor being well informed about business developments.
- Micro- and small-entity management lacking in-house financial reporting expertise will often call on an auditor's financial reporting expertise in preparation and presentation of annual financial statements.
- Auditors of micro- and small-entities often establish long-term relationships with their clients. The length of tenure is seen by users, clients and professionals as adding significantly to audit quality as the auditors have a wealth of knowledge of both the client's financial reporting process and its industry.
- The nature and length of the relationship with management and the auditor's direct involvement in the preparation of the financial statements can assist audit quality. However, unless the auditor is careful, these same factors can result in the auditor adopting an over-trusting approach and jeopardizing objectivity.

Contextual Factors

- The applicable financial reporting framework applied by micro- and small-entities is often less complex than that mandated for larger entities, including listed entities. Use of a less complex financial reporting framework can help avoid a disproportionate amount of the time of senior members of the audit team being spent on accounting complexities.
- Reporting deadlines can be less onerous for audits of micro- and small-entities than for listed entities, thus allowing the auditor to benefit from evidence obtained from events and transactions after the balance sheet date.
- Micro- and small entity management (usually) do not release earnings estimates prior to completion of the audit, thereby reducing pressure both on management to resist audit adjustments and on auditors to avoid issuing a modified audit report.
- The business undertaken by micro- and small-entities is often less complicated, with few sources of income and activities. Accounting systems are usually simple and utilize relatively uncomplicated technology. This reduces the need for the auditors to

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have specialized knowledge, although doing business through the internet can cause complexities.

Input Factors

- Sole practitioners have direct control over the firm's culture, and in SMPs engagement partners can have a very direct influence over it. Input factors such as governance arrangements, promotion and reward systems, consultation, and monitoring activities are directly dependent on the quality of engagement partners in these firms. This direct reliance on the characteristics of engagement partners (or the sole practitioner) can be both a strength and a weakness of the small firm environment.
- Audits of micro- and small entities by very small firms and sole practitioners are often conducted on site by senior professional staff who are able to apply directly their accumulated experience and knowledge of the entity and thereby contribute directly to audit quality.
- As the audits are relatively simple, audit methodologies need not overly complex. The small number of staff in an SMP also allows it to develop relatively straightforward quality control policies and procedures, although this can present challenges in relation to using independent staff in quality monitoring processes.

Output Factors

- The relationship between the engagement partner and those charged with governance and management is often very immediate and direct. This allows the engagement partner and other members of the audit team, if any, to communicate on a direct and timely basis with management and those charged with governance prior to, during, and at the conclusion of the audit.
- The existence of a long established relationship and a close involvement in the entity's business developments gives the auditor an enhanced opportunity to provide meaningful business advice to their clients.

7.2 Considerations Specific to Public Sector Audit Institutions

195. Audit quality is of crucial importance in the public sector. The interactions and input, output and contextual factors of this Framework are largely relevant to public sector audit institutions, such as Supreme Audit Institutions (SAIs). However, due to their societal role and constitutional mandates, there may be a somewhat specific emphasis on certain factors:

Interactions

- Public sector auditors may often have direct contact with primary users of financial statements and auditors' reports. It is not unusual for auditors to make presentations of their reports and findings to the legislature or ministries (concerning government agencies or government-owned companies). This may enhance the auditors'

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knowledge of expectations of primary users of financial statements and auditors' reports.

- The public sector audits often draw attention from media and individual citizens.

Contextual Factors

- Public sector bodies are usually not-for-profit organizations and, provided they operate in line with set budget limits, there is usually relatively little focus from stakeholders on the financial outcome of the entity. There may be more focus on matters such as:
 - The entity's general performance and achievement of the objectives set for it by the legislature or the government;
 - Compliance with laws and regulations; and
 - Environmental issues.

In many countries, such information is included in the annual financial reports or is issued in connection with the annual financial reports. In such circumstances, the auditor will either have a mandate to report on this information or be associated with it.

- Public sector auditors usually are prohibited from withdrawing from an engagement.
- A challenge for public sector auditors in developing countries can be the absence of a well-established financial reporting framework.

Input Factors

- Most public sector entities work in a less complex financial environment compared to large companies in the private sector. Consequently there are lower demands for advanced knowledge of matters such as financial instruments and taxation. On the other hand, public sector auditors have to be well-informed about laws and regulations, performance indicators, etc.
- Due to set mandates, most public sector auditors are often prohibited from taking on additional work assigned by the audited entity. The insight an auditor can gain from non-audit service engagements must be obtained by other means.
- In some countries, public sector audit institutions have to keep within fixed limits for how much they may spend on staff; this can limit their ability to recruit and retain sufficient numbers of high quality staff to consistently achieve audit quality.

Output Factors

- Public sector auditors often carry out their work in an environment which gives citizens access to official documents. This freedom of information often results in the

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public sector auditor disclosing more detailed information, for example, on an entity's business risks and internal control.

- Besides the auditor's statement, public sector auditors issue additional publicly accessible reports disclosing detailed findings concerning business risks, internal control, etc. Usually a range of recommendations are listed in these reports. Actions taken upon the recommendations are recorded and seen as an expression of the "impact" from the audits.
- Public sector audit organizations may draw general conclusions from all audits carried out pointing at general weaknesses in governance, accounting, reporting, etc. This may create cause for an audit organization to make recommendations for improvements in general laws and regulations concerning government entities.

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Appendix

List of Acronyms

CPD	Continuing Professional Development
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IESBA Code	Code of Ethics for Professional Accountants issued by the IESBA
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
INTOSAI	International Organization of Supreme Audit Institutions
IPD	Initial Professional Development
ISA	International Standard on Auditing
ISQC	International Standard on Quality Control
SMP	Small- and Medium-Sized Practices