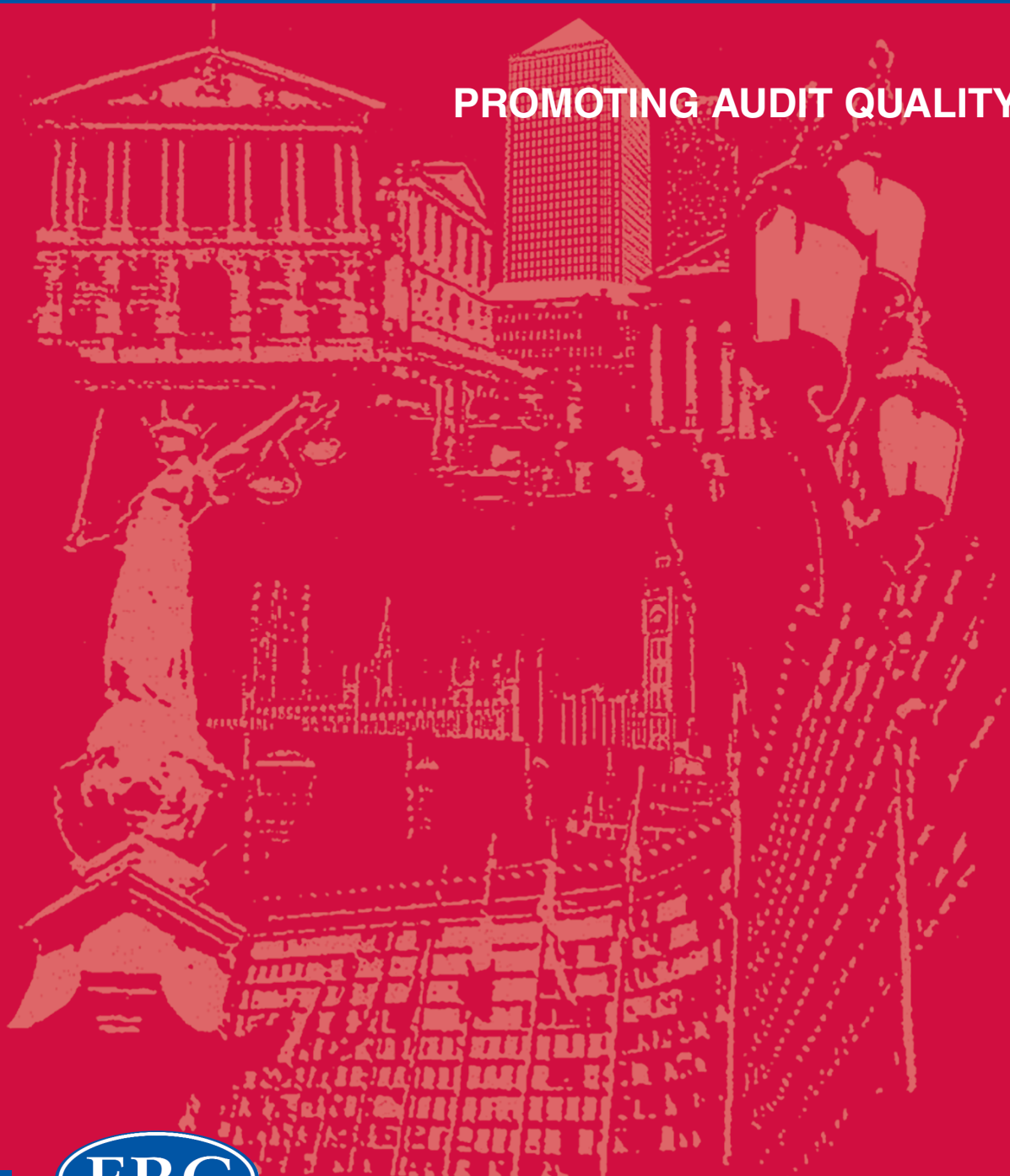


2006

November

# *Discussion Paper*

## PROMOTING AUDIT QUALITY



**Discussion Paper**

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## Discussion Paper

# PROMOTING AUDIT QUALITY

<i>Contents</i>	<i>Page</i>
Introduction	5
1 The current environment	9
2 Audit quality	17
3 The culture within an audit firm	23
4 The skills and personal qualities of audit partners and staff	27
5 The effectiveness of the audit process	33
6 The reliability and usefulness of audit reporting.	41
7 Factors outside the control of auditors affecting audit quality	45
<b>Appendices</b>	
1 Recent changes in the regulation of corporate reporting in the UK that are likely to impact confidence in financial reporting and audit quality	49
2 The provisions of the Companies Act 2006 that affect audit quality	57
3 Researching audit quality	61
4 Audit resources within major firms at 31 December 2005	67



## INTRODUCTION

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This is the first of a number of Discussion Papers to be published by the Financial Reporting Council ('the FRC') discussing the way it addresses its objectives, and inviting stakeholders and commentators to comment on whether:

- It has identified the key issues that should be addressed if a particular objective is to be achieved; and
- There are additional steps that should be taken to address those issues.

The FRC's purpose in undertaking this process is to ensure that it is aware of the views of the constituencies that it serves, and that its policies and actions command support. To the extent that the responses reveal a consensus for change or action that is outside its powers, it will raise those matters with those responsible.

### Promoting audit quality

This Discussion Paper addresses the FRC's objective of promoting and maintaining confidence in the audit process and the resulting audit report as a key component of the corporate reporting and governance regime and the effective operation of capital markets.

In order for that confidence to be justified, the FRC believes that users of financial reports must be able to rely on an audit report giving a robust and objective opinion that the financial statements concerned show:

- A true and fair view;
- Have been properly prepared in accordance with the applicable accounting framework; and
- Have been prepared in accordance with the relevant legal requirements.

The FRC is aware that some commentators have questioned whether the existing regime is capable of meeting the needs of users and other stakeholders in the current business and investment environment. However, given the extensive and wide-ranging changes that have been introduced in recent years, the FRC believes that any fundamental review of the financial reporting regime should take place only after such changes have been fully assimilated by all concerned. Accordingly, in the light of the responses that the FRC receives to this paper, the FRC will consider whether, and if so when, there would be benefit in publishing a Discussion Paper that focuses on the financial reporting regime, including audit, and its ability to meet the needs and

expectations of all stakeholders, unconstrained by the existing legislative and regulatory framework.

This Discussion Paper seeks opinions as to whether, within the existing legal and regulatory framework, all appropriate steps are being taken to maintain and enhance the quality of audits and, if not, seeks views as to what more could or should be done.

In order to facilitate that discussion, this Paper identifies those drivers that the FRC believes are central to achieving a high quality audit and then considers whether there are 'threats' which weaken the effective operation of those drivers and, if so, whether those threats need to be addressed.

Through this Discussion Paper, the FRC seeks the views of stakeholders and other parties interested in the audit process as to whether the FRC:

- Has identified all the relevant drivers;
- Has identified the threats to those drivers and whether there are other threats that should be considered; and
- Should be taking any additional action to improve the likelihood of audits being of a consistently high quality.

Those views will be analysed and a feedback document will be published. Thereafter the FRC envisages holding meetings at which the suggestions that emerge can be discussed. The FRC will consult on any proposals that it intends to take forward.

The responses to this Discussion Paper will be of particular importance to the Professional Oversight Board ('the POB'), including the Audit Inspection Unit ('the AIU') which monitors the quality of the audits of listed and other major public interest entities, and to the Auditing Practices Board ('the APB') which sets auditing and ethical standards in the UK.

Whilst the FRC believes that this initiative will contribute to an understanding of audit quality in its broadest sense, the FRC has focussed its initial work, and this Discussion Paper, on identifying the drivers, and the threats to thereto, of audit quality in relation to the audits of UK listed companies and other public interest entities.

This Discussion Paper has been prepared in the context of the financial reporting framework in the UK and the Republic of Ireland. However, because of the increasingly international context in which standard setting takes place, the FRC is keen to receive the views of all those interested in promoting high quality audits wherever they may be located.

The FRC welcomes the views of those stakeholders and other parties interested in the audit process.

Although the Discussion Paper raises specific questions, commentators should not feel that they are constrained by those questions, or required to answer all of them. However, it will assist collation of views, if the questions are used to structure responses on this topic.

Comments, to reach the FRC by 31 March 2007, should be addressed to:

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All responses will be regarded as being on the public record unless confidentiality is expressly requested.



## THE CURRENT ENVIRONMENT

### *The overall position*

- The quality of **financial reporting and the effectiveness of the audit process have been the subject of unprecedented analysis, review and reform** over recent years.
- While **financial reporting in the UK operates effectively and audit is fundamentally sound**, there can be no place for complacency. This is an appropriate opportunity to consider whether there are **ways of promoting audit quality**.

### *Developments since Enron*

- **Reviews by the UK Government and European Parliament** have led to revisions to the Companies Act and a new 8<sup>th</sup> Directive as well as reforms of:
  - Financial reporting, including requiring consolidated financial statements for publicly traded companies in conformity with IFRSs.
  - Corporate governance, including updating the Combined Code and Guidance on Internal Control.
  - Regulation of audit, including establishment of the POB, AIU and AIDB.
- **APB issued Ethical Standards for auditors and a new suite of auditing standards.**

### *Issues that may affect confidence in the audit process*

- Despite the developments made, **some commentators still have concerns** about audit quality as a result of:
  - The changing business environment, with financial reporting becoming more complex and increasingly requiring more estimates and valuations.
  - The possibility that the audit will not detect 'management' fraud.
  - The relationship between executive management and the auditors.
  - The lack of transparency of the work of auditors and the judgements made by them.
  - The effect of an increasingly prescriptive approach to audit.

# 1 THE CURRENT ENVIRONMENT

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## The overall position

- 1.1 Following the high profile collapses of Enron and WorldCom and the demise of Andersen, the quality of financial reporting and the effectiveness of the audit process have been the subject of unprecedented analysis, review and reform over recent years.
- 1.2 These events confirmed the important role that financial reporting makes to the effective operation of the capital markets and reviews undertaken in the UK during the past 6 years have concluded that financial reporting in the UK operates effectively and that the audit is fundamentally sound and appropriate to achieve its objective – namely a reliable and objective audit opinion.
- 1.3 The Co-ordinating Group for Accounting and Auditing Issues ('the CGAA'), established by the Government to consider whether, and if so how, the UK should respond to the lessons to be learned from the Enron and WorldCom collapses, reported:

*“We are conscious of the work that had taken place in [the UK] before the recent events in the US. A number of corporate failures in this country in the late 1980s and early 1990s led, through various reports and reviews, such as the Cadbury report, to the establishment of a sophisticated and effective system of oversight in this country, to the extent that the UK can claim, with some justification, to be in the forefront of best practice. We do not subscribe to the more extreme views that have been canvassed; business and the professions have much to be proud of, and the great majority carry out their work with honesty, professionalism and skill.”<sup>1 2</sup>*

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1 Final Report of the Co-ordinating Group on Audit and Accounting Issues – 29th January 2003

2 Similarly, when delivering its first report following inspection of the work of the four largest UK audit firms in the period to 31<sup>st</sup> March 2005, the Audit Inspection Unit reported ‘Our inspections identified no systemic weaknesses in the overall policies, procedures and systems of quality control operated by the firms and indicate that, when properly applied, those procedures and systems should provide reasonable assurance that appropriate audit opinions are issued by the firms. However, we have identified certain areas in which we consider that improvements to these policies, procedures and systems, and/or the application thereof, should be made, either to achieve compliance with relevant standards or to enhance audit quality.’ - AIU 2004/5 Audit Quality Inspections, Public Report June 2005.

- 1.4 However, there can be no place for complacency. Reliable financial reporting and high quality audit cannot prevent financial failure; but they can help by identifying and signalling the existence of actual or potential problems to stakeholders. This is, therefore, an appropriate opportunity to consider whether there are additional ways, within the existing regime, of promoting audit quality.<sup>3</sup>

## Developments since Enron

- 1.5 As acknowledged by the CGAA, the above conclusion was made possible because of the extensive consideration that was given in the UK to corporate governance, financial reporting and auditing in the period since 1990. An appreciation of the steps that have been taken to reinforce the corporate reporting regime in the UK (including the steps that have already been taken to underpin audit quality) is essential to an informed consideration of the matters raised in this Discussion Paper.
- 1.6 Until the early 1990s, regulation of the corporate reporting regime in the UK largely comprised (i) company law and (ii) self-regulation by the accountancy bodies. The key changes introduced in response to the corporate reporting scandals of the late 1980's were:
- The creation of the Financial Reporting Council ('the FRC') (with oversight of the Accounting Standards Board<sup>4</sup> ('the ASB') and the Financial Reporting Review Panel<sup>5</sup> ('the FRRP'));
  - The establishment of various committees on corporate governance, beginning with the Cadbury Committee; and
  - Changes to the constitution of the Auditing Practices Board ('the APB') (to introduce more non-practitioners and to provide it with operational independence from the accountancy institutes and the Consultative Committee of Accountancy Bodies).
- 1.7 In 2002, after public confidence in US accounting, auditing and corporate governance practices was severely shaken by events relating to companies such as Enron, WorldCom and Tyco<sup>6</sup>, the UK Government undertook reviews of audit and accounting issues and the regulatory regime for the accountancy profession. In January 2003, reforms were announced that were aimed at raising standards of corporate governance of listed companies, strengthening the audit profession and providing a more effective system of regulation of the profession.
- 1.8 In 2006, the European Parliament approved a new European 8<sup>th</sup> Directive on Statutory Audit to strengthen the regulation of audit within Member States.
- 1.9 The key elements of the reforms introduced by the UK and the EU include:
- Financial reporting*
- Companies with securities that are admitted to trading on a regulated market of any Member State are required to prepare consolidated financial

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3 Any proposals that the FRC concludes should be considered further will be the subject of detailed consultation, including a consideration of the cost benefit implications of the proposals.

4 The ASB is responsible for setting accounting standards in the UK.

5 The FRRP is responsible for investigating concerns that companies within its scope have failed to comply with accounting standards and other reporting responsibilities.

6 The US Congress responded by passing the Sarbanes-Oxley Act with substantial changes to the responsibilities of company management and auditors.

statements in conformity with International Financial Reporting Standards ('IFRSs') as adopted for use in the European Union. (EU)

- The FRRP's responsibilities have been extended to include directors' reports and interim statements, and the proactive monitoring of compliance with accounting standards. (UK)
- Auditors are required to review and report on an increased amount of the information contained in a company's annual report. (UK)

#### *Corporate governance*

- The FRC updated the Combined Code to reflect the review of the role and effectiveness of non-executive directors by Sir Derek Higgs and Guidance on Audit Committees developed by a group led by Sir Robert Smith. (UK)
- The FRC reviewed and updated the Turnbull Guidance on Internal Control. (UK)

#### *The regulation of audit*

- To strengthen independence and improve effective communication between various parts of the regulatory framework, the FRC assumed the functions of the Accountancy Foundation (which included the APB, the Review Board and the Ethical Standards Board)<sup>7</sup>. (UK)
- The Professional Oversight Board ('the POB') was established to assume delegated responsibilities from the Secretary of State for Trade and Industry for the regulation of audit. (UK)
- The Audit Inspection Unit ('the AIU') was created to undertake the independent monitoring of audit quality of listed companies and other major public interest entities. (UK)
- The new 8<sup>th</sup> Directive (2006/43/EC) on statutory audits of annual accounts and consolidated accounts set requirements for the regulation of audit within Member States. (EU)
- The Accountancy Investigation and Discipline Board ('the AIDB') was established to carry independent investigations into, and the discipline of accountants involved in matters of a public interest nature. (UK)
- The larger audit firms agreed to disclose publicly information regarding their governance and quality control mechanisms. (UK)
- Having been given responsibility for setting standards for the independence, objectivity and integrity for auditors, the APB issued new ethical standards for auditors. (UK)
- The APB issued a suite of auditing standards, known as International Standards on Auditing (UK & Ireland). These are based on the International Standards on Auditing ('ISAs') issued by the International Auditing and Assurance Standards Board ('the IAASB') and supplemented where appropriate by certain requirements from the superseded auditing standards and to reflect UK and Irish laws and regulations. (UK)

The changes that have the most direct impact on audit quality are discussed in more detail in Appendix 1.

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<sup>7</sup> The combination of the Financial Reporting Council and the Accountancy Foundation took formal effect on 1 April 2004.

1.10 By any measure this represents a significant amount of change over a short period of time. The changes involved need to be assimilated by the preparers of financial statements, investors and audit firms – all of whom must either apply or become familiar with the new requirements.

### Issues that may affect confidence in the audit process

1.11 Despite the initiatives described above, some commentators have continued to express concerns about audit quality. The main concerns that have been expressed are summarised below.

#### *The changing business environment*

1.12 Although the primary purpose of an audit has not changed since it was first established in company law, the business environment has evolved significantly in the last quarter of the twentieth century. In particular:

- Having grown in size, companies' activities are increasingly diverse and international in dimension;
- The way business is transacted has become significantly more complex. The use of financial instruments has become commonplace;
- The number of transactions involved has increased exponentially. Processing of transactions is now automated (and virtually instantaneous). Increasingly, there is less underlying physical documentation;
- The carrying amount of an increasing number of assets and liabilities carried at fair value, may be difficult to measure;
- Investors, regulators and other stakeholders have sought accelerated reporting; and
- Increasingly, there is a relationship between the performance of a company and the remuneration of its management, which in turn can magnify the significance of minor adjustments to the financial statements.

As a result, there is a perception that it has become more difficult for companies to reflect the state of their business in financial statements in a way that can be easily comprehended by non-accountants. There are increasing differences of view as to what is 'accurate' in the context of the evolution of accounting frameworks to include more estimates and valuations and the impact that this has on the 'reasonable assurance' provided by auditors on the truth and fairness of the financial statements.

1.13 In response, the audit process has evolved. For example:

- The high volume of transactions has reduced the cost effectiveness of obtaining audit evidence by testing the authenticity of individual transactions. Auditing has become more 'risk-based' and increased reliance is placed on the auditor's assessment of the client's control environment, supported by such techniques as 'analytical procedures';
- As accounting standards have addressed the complexity of modern business and have sought to achieve consistency in financial reporting, the role of the auditor has developed to cover:

- The client's compliance with more comprehensive and complex accounting standards;<sup>8</sup> and
- More extensive disclosure obligations within annual reports; and
- The auditor's judgement has become more important in relation to those assets and liabilities (including estimates) that are not capable of objective valuation but which are required to be included in financial statements under new fair value accounting standards.

These changes raise a number of issues – such as whether sufficient 'traditional' substantive testing is being performed, whether the increased emphasis given to checking compliance with accounting standards is diverting the auditors' attention from verifying the existence of assets and the completeness of liabilities and whether the audit team collectively has sufficient experience to make the judgements that are increasingly important.

### **Fraud**

- 1.14 Confidence in the audit process can be undermined when high-profile instances of undetected fraud occur, with the result that the relevant financial statements contain material misstatements.
- 1.15 The APB examined this issue in 1998 when it published a Consultation Paper, 'Fraud and Audit: Choices for Society'. That paper and the issues raised by it remain as relevant today as when it was issued. In particular, it highlighted the fact that the audit process cannot be relied upon to uncover fraud involving collusion between senior management and third parties. Although, as described in paragraph 16 of Appendix 1, various initiatives have been pursued following publication of that Consultation Paper, the risk of 'management' fraud being undetected remains a real and continuing threat to confidence in the audit process.

### ***The relationship between executive management and auditors***

- 1.16 A relationship based on trust and openness between the executive management of a company and its auditor contributes to an effective audit. However, that relationship has also been a perennial cause of concern because it is of such importance to the auditor – audit fees are a major source of fee income; audit clients are a significant, albeit no longer the major, source of non-audit engagements; and a firm's reputation is founded on its performance as an auditor.
- 1.17 Over the past 5 years, various initiatives have addressed this concern. In particular, audit committees have assumed greater responsibility for overseeing the audit process, for considering the effectiveness of the audit undertaken, and for monitoring the independence of auditors from management. Similarly, through the introduction of a new suite of Ethical Standards, the APB has addressed threats arising, for example, from familiarity (by requiring lead audit partners to rotate every 5 years) and from the provision of non-audit services (by prescribing the services that firms can provide to audit clients).
- 1.18 Whether there are further ways in which the concerns that arise from the relationship between the executive management of a company and its auditor can be addressed is considered in section 7 below.

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8 Auditors need to determine whether management has accounted for an item in accordance with the appropriate standard – a decision that may be of considerable significance if, for example, it would impact revenue recognition.

### ***Increased transparency***

1.19 As users and commentators have understood the way the audit is presently conducted, they have become increasingly aware of the importance of understanding the nature of the work undertaken by auditors and the basis for the judgements made by them. Allied with an increasing climate of distrust between the public and business, between investors and management, and between investors and auditors, this awareness has led commentators to call for greater transparency in the audit and financial reporting process<sup>9</sup>.

### ***The effect of law and regulation***

1.20 In addition to seeking a greater transparency so that they are aware of the role of the auditor in the key judgements reflected in financial reports, some commentators have expressed concerns at:

- The increasingly prescriptive approach taken in both accounting and auditing standards as a result of the drive for international harmonisation;
- Whether auditors are fully discharging their responsibilities in relation to the legislation relating to a company's accounting records<sup>10</sup>; and
- A perceived reduction in the level of assurance being provided as a result of changes to the form of the audit report.

A summary of the provisions of the Companies Act 2006 that affect audit quality is set out in Appendix 2.

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9 Some of the suggestions put forward by institutional investors for consideration include giving shareholders access to reports by auditors to audit committees, entitling investors to obtain information from auditors, and providing for shareholders to receive answers to questions addressed to the auditors of a company at its Annual General Meeting. All of these proposals reflect a lack of confidence in the agency relationship upon which the current structure is based whereby the audit is commissioned and overseen by the directors and audit committee of a company.

10 Sections 221 and 237, Companies Act 1985.



## AUDIT QUALITY

### *Determining audit quality*

- There is **no single agreed definition** of audit quality that can be used as a 'standard' against which actual performance can be assessed.
- An auditor's opinion as to whether the financial statements are '**true and fair**' is **subjective**. Different views may be held as to the extent and nature of audit evidence required to support the opinion.
- **Limited transparency** makes an assessment of audit quality difficult by those who rely on it.
  - The audit report does not provide users with information to assess the underlying quality of the audit.
  - Users play a limited role in appointing and instructing the auditor.

### *The approach taken by the FRC*

- **To help assess audit quality** in this paper the FRC:
  - Identifies drivers of audit quality.
  - Considers threats to those drivers.
- The FRC believes there are **four main drivers**:
  - The culture within the audit firm.
  - The skills and personal qualities of the audit partners and staff.
  - The quality of the audit process.
  - The reliability and usefulness of audit reporting.

## 2 AUDIT QUALITY

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- 2.1 As indicated in the Introduction, audit quality is a concept that falls squarely within the remit of the FRC, including the POB (including the AIU) and the APB. So it is important that there should be clarity as to how those bodies view 'audit quality' and the factors that they regard as determinants or 'drivers' of audit quality. This section describes the approach that the FRC takes to this subject.

### **Determining audit quality**

- 2.2 An audit involves those responsible for preparing financial information (the directors of a company), engaging a firm of accountants (the auditor) to report in a way prescribed by legislation (a true and fair view opinion) to the users (the shareholders of the company).

#### ***(a) An audit opinion is subjective***

- 2.3 The essence of an audit report - the statement that the financial statements in question show a true and fair view - is a subjective opinion. It is not a definitive assertion that those financial statements are accurate.<sup>11</sup>

- 2.4 An audit is therefore designed to provide 'reasonable assurance' as to the accuracy of the financial statements. For the purpose of an audit 'reasonable assurance' is defined to be a high but not absolute level of assurance. However, what is 'reasonable' is a matter of judgement in each particular circumstance. Different views may be held as to the extent and nature of audit evidence that is needed to support the required opinion.

#### ***(b) The nature of the market for audit services***

- 2.5 In most circumstances, the performance of a product, or the outcome of a service, provides an effective and visible measure of the quality of that product or service. In other circumstances, purchasers and users can assess the quality of the product or service based on their knowledge of the work undertaken and the reputation of those responsible for it.
- 2.6 Since an audit is a statutory requirement, it is not open to listed companies and shareholders to choose another means of achieving the objective and therefore

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<sup>11</sup> It would be neither feasible nor cost or time effective to require an audit to provide absolute assurance as to the accuracy of the financial statements.

those providing an audit service are not open to competition from competing products.

- 2.7 The position is further exacerbated by the fact that a small number of firms conduct the majority of audits of larger companies. Whilst the FRC recognises that the structure of the audit market and its impact on choice and competition may also have an influence on audit quality, it is not discussed in this Paper because the structure of the audit market is the subject of a separate discussion process taking place under the auspices of the FRC.<sup>12</sup>
- 2.8 This combination of a service that lacks transparency, the lack of competition from competing products and the small number of providers could allow a situation to develop where a poor quality audit is performed but the audit firm is not penalised financially. It is therefore incumbent on the Regulator (the FRC) to assess the quality of audits being performed and to try to ensure high standards.

***(c) The ability of users to assess the underlying quality of an audit.***

- 2.9 There is limited transparency in the case of an individual audit. The way in which an auditor has approached the audit, the extent of the audit evidence obtained, and the key judgements that have been made are not disclosed or made available to those who rely on audited financial statements.
- 2.10 The form of an audit report is specified by law and auditing standards, with the consequence that it has become standardised. Save in the rare circumstances where the report is modified, either by a qualification or by an emphasis of matter paragraph, the audit report simply informs a reader that, in the opinion of the auditor, the financial statements in question show a true and fair view, in accordance with the relevant financial reporting framework, and have been prepared in accordance with the applicable law. Virtually no information is provided about the way in which the auditor has approached the audit, the extent of the audit evidence obtained, and the key judgements that have been made; and therefore shareholders have no ability or opportunity to question or challenge the service provided by the auditor.
- 2.11 As a result, users cannot rely on a detailed knowledge of the audit process that has in fact been undertaken. They are reassured by other factors – such as the fact that the auditor is professionally qualified, the reputation of the audit firm and the regulatory regime that is applicable to the preparation of the financial statements and the conduct of the audit.
- 2.12 It is important to appreciate that the lack of transparency that is inherent to the audit process may also be a disadvantage to the companies and audit firms involved. Companies have no means of communicating the importance that they attach to the quality of the audit of their financial statements. Audit firms have no means of demonstrating the effectiveness of the work that they carry out – obligations of confidentiality prevent audit firms from publishing information regarding frauds detected, errors corrected and systems of internal control strengthened as a result of their work.

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<sup>12</sup> A Discussion Paper, “Choice in the UK Audit Market” was issued in May 2006 and was followed by stakeholder meetings. The FRC has now established a Market Participants Group (‘MPG’) to provide advice to the FRC and, in particular, the MPG will identify and assess possible actions which market participants could take to mitigate the risks arising from the characteristics of the market for the audit for major public interest entities in the UK.

### **(d) Users play only a limited role in relation to the appointment of the audit firm and the terms of engagement**

- 2.13 The terms on which the audit is undertaken are normally discussed between management and the audit firm and confirmed under the supervision of the audit committee (and, ultimately, the board of directors). Although the non-executive directors who comprise the audit committee have regard to the interests of shareholders when considering which firm to appoint and on what terms, and shareholders are able to approve or reject the appointment of the auditors recommended by the board of directors at the Annual General Meeting, concern has been expressed that this does not give the shareholders any real ability to influence the choice of auditor or the focus of the audit.

### **Attempts to define ‘audit quality’**

- 2.14 Against this background, a number of organisations have tried to define the essence of a high quality audit, so that there could be a ‘standard’ against which actual performance of individual audits could be assessed.

*“At its heart [audit quality] is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgements. Ultimately, auditors provide a quality service to shareholders if they provide audit reports that are independent, reliable and supported by adequate audit evidence.”<sup>13</sup>*

*“Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements...A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board properly to discharge their responsibilities.”<sup>14</sup>*

- 2.15 Both descriptions are at a high level. But they identify certain features that are thought necessary if an audit is to be of a high quality - the judgements made by the auditor must be objective and supported by ‘adequate audit evidence’ (ICAEW) or ‘sufficient appropriate audit evidence’ (AIU). Neither provides an independently defined or objectively verifiable measure of the sufficiency of evidence that is required before an audit opinion may be properly given. This is unsurprising given the variation in the entities involved (size, industry, corporate governance arrangements etc.) and that the evaluation of audit judgements is inherently difficult.
- 2.16 Similarly, a body of academic research has sought to investigate audit quality issues. Appendix 3 contains a summary of the main research approaches that have been pursued. Significantly, whilst such research reveals ways in which audit quality in general can be assessed, it has not resulted in a definition of a high quality audit that can be used as a ‘standard’ against which actual performance can be assessed. Appendix 3 indicates a number of areas where further research might be beneficial (provided that adequate information can be obtained about individual audits from the firms themselves).

### **The approach taken by the FRC**

- 2.17 The FRC believes that the most appropriate approach is to define those key factors, or drivers, that determine whether a quality audit is undertaken and

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13 ICAEW Audit and Assurance Faculty publication “Audit Quality” (2002)

14 AIU - 2004/5 Audit Quality Inspections, Public Report June 2005

assess the way in which audit firms and individual audit teams perform against them. This involves:

- Identifying those factors, or drivers, that determine whether an audit is of high quality;
- Considering whether there are threats to those drivers; and
- Assessing the extent to which the FRC (through one or more of its operating bodies) should take action to reinforce the effectiveness of those drivers.

2.18 The FRC believes that the four main drivers of audit quality are:

- The culture within an audit firm;
- The skills and personal qualities of audit partners and staff;
- The effectiveness of the audit process (being a combination of ethical, auditing and quality control standards together with the firms' audit methodology); and
- The reliability and usefulness of audit reporting.

2.19 The drivers referred to in paragraph 2.18 are discussed in Sections 3 to 6 below. Section 7 then considers factors outside the control of auditors that can affect whether an audit is of high quality.



## THE CULTURE WITHIN AN AUDIT FIRM

### *The importance of the culture within an audit firm*

- Audit quality can be driven by audit firms **creating an environment where achieving high quality is valued, invested in and rewarded.**
- **Indicators** of audit firm cultures that enhance audit quality are:
  - Leadership of firms emphasising the importance of auditors discharging their professional responsibilities.
  - Respect for the principles underlying auditing and ethical standards.
  - Partner and staff development systems that promote personal characteristics essential to quality auditing.
  - Not letting financial considerations drive decisions with a negative effect on audit quality.
  - Promotion of consultation on difficult issues and providing sufficient resources to deal with matters as they arise.
  - Development of an information infrastructure to support the audit function.

### *Possible threats to an audit firm's culture*

- **Threats to quality oriented cultures** include:
  - Audit leadership having insufficient input to the firm's management decisions.
  - Over-emphasis on winning and retaining audits.
  - Over-emphasis on non-audit services.
  - Excessive cost cutting in times of economic downturn.
  - Insufficient importance placed on technical training.

## 3 THE CULTURE WITHIN AN AUDIT FIRM

### The importance of the culture within an audit firm

- 3.1 Auditors must have regard to the public interest nature of an audit as well as reviewing audit evidence sceptically and exercising judgement objectively and robustly. The environment in which the audit team works can materially affect the mindset of the audit team and the way it discharges its responsibilities.
- 3.2 The culture within a firm is a key driver of audit quality because it has the ability to create an environment where achieving high quality in every aspect of the audit process is valued, invested in, and rewarded. It is an area that has been subject to considerable focus and discussion within the profession and, over the past 6 years, the APB has introduced standards that are directed at reinforcing the key components of an effective culture.<sup>15</sup> It has also been a primary focus of the monitoring work of the AIU.
- 3.3 Some of the principal indicators of whether a firm has an appropriate culture from the perspective of enhancing audit quality are:
- Whether the firm’s leadership promotes effectively the importance of the firm properly discharging its professional responsibility as an auditor.  
For example, as audit clients are an important source of a firm’s total income, but audit may not be the majority income stream, 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) taking precedence.
  - Whether in complying with ethical and professional conduct standards, the firm has regard to the fundamental principles of those standards and acts in a way that respects those principles.  
No ethical standards can cater for every situation – particularly as business relationships become increasingly complex. Consequently, the approach that a firm takes to situations that might compromise that firm’s objectivity

<sup>15</sup> SAS 240, “Quality Control for Audit Work,” followed by ISQC (UK and Ireland) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements,” and ISA (UK and Ireland) 220, “Quality Control for Audits of Historical Financial Information”.

or independence in ways that are not specifically contemplated in ethical or professional conduct standards constitute important indicators of whether the culture of a firm is appropriate.

- Whether the firm's training, counselling, appraisal, promotion and remuneration structures promote the personal characteristics – such as integrity, objectivity, rigour, scepticism, perseverance and robustness - that are essential to quality auditing.

This involves, for example, ensuring that the behaviour of audit partners and staff is not influenced by encouraging them to believe that they will be indirectly rewarded for success in selling non-audit services to their audit clients or penalised for jeopardising a client relationship by taking a robust position on audit issues. Similarly important will be whether a firm takes appropriate steps to investigate and address those situations that it becomes aware of where something has gone wrong – for example, because there has been inappropriate behaviour or poor quality auditing.

- Whether the firm avoids decisions dictated by short term financial considerations where those decisions would have a negative effect on audit quality.

The audit fee negotiated with an audit client, the financial target that a firm sets for the margin to be achieved on audit work, and the approach a firm takes to any irrecoverable costs arising from work that is unexpectedly required in the course of an audit should reflect the importance of conducting a full audit in the public interest. Similarly, the importance that a firm attaches to the maintenance of training programmes and the retention of senior staff may be indicative of its willingness to invest in activities that might adversely affect profit in the short term.

- Whether the firm attaches importance to the effective provision of technical support, to risk management and to compliance with ethical standards.

That appropriate importance is attached to such matters will be indicated by whether there is a culture of consultation amongst partners and whether those involved have sufficient resource to deal properly with issues as they arise and their decisions have appropriate standing within the firm.

- Whether appropriate emphasis is given to the development of an information infrastructure to support the audit function.

Audit quality can be enhanced if an information infrastructure is developed that enables the firm to develop databases to support audit judgements (for example by assembling business and industry related information), to track independence issues and ensure that they are properly addressed, and to plan and effectively manage the rotation of partners and managers on audit engagements.

### Possible threats to an audit firm's culture

- 3.4 The FRC believes, based on the experience of the AIU's inspections of audit firms that carry out audits of listed companies and other major public interest entities, that the leaderships of those firms attach considerable importance to quality oriented cultures and do invest in promoting audit quality<sup>16</sup>.

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<sup>16</sup> AIU, '2004/5 Audit Quality Inspections, Public Report' June 2005; and AIU, '2005/6 Audit Quality Inspections, Public Report' July 2006

- 3.5 However, economic pressures change, and in order to protect quality oriented cultures, audit firms will need to guard against, in particular, the following:
- The leadership of the audit function having insufficient input into management decisions because of the competing interests of other parts of the practice.
  - Over-emphasis on winning audit appointments and on the retention of audit clients at the expense of the quality of audit judgements.
  - Over-emphasis on non-audit services combined with under-investment in audit, with the consequential migration of valuable talent to other practice areas and to industry.
  - 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 in the medium term.
  - Internal training that is focused on improving client service at the expense of necessary training in technical competence and understanding the public interest aspect of auditing.
- 3.6 Although the AIU, through its inspection work, has an insight into the cultures of some firms, those cultures are not apparent to users and others with an interest in the effectiveness of the audit process. To address this, an agreement was reached between the Department of Trade and Industry and many of the larger audit firms under which they agreed to publish information about their internal governance and quality control processes. The largest firms now do this in their Annual Reports. However, there have been concerns that this information is not identified separately and in many cases it is couched in terms that are too general for the original purpose of promoting confidence in the internal governance and quality control of the firms<sup>17</sup>.
- 3.7 In August 2006 the POB published a Discussion Paper on the information that the auditors of public interest entities should be required by law to publish. That report recommended that “transparency reports” should include information on the processes and procedures by which the firm ensures that it undertakes audit work of high quality, on the firm’s structure, governance and network arrangements, and on the way in which the firm remunerates partners. That consultation will form the basis for the development of regulations to give effect to the requirements on transparency reporting.
- Q1 Are there other important indicators of an audit firm’s culture that are not referred to above?**
- Q2 Are there pressures that could compromise the culture of audit firms that have not been identified above?**
- Q3 Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?**

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17 See Appendix 1, paragraphs 33 to 36.

## THE SKILLS AND PERSONAL QUALITIES OF AUDIT PARTNERS AND STAFF

### *The importance of the skills and personal qualities of audit personnel*

- **Key drivers** of audit quality include:
  - The **skills** base of partners and staff.
    - Audit teams typically reflect a 'pyramid structure' with much of the detailed 'on-site' audit work performed by inexperienced staff.
  - The **training** given to audit personnel.
    - Training needs to be appropriately co-ordinated with audit work.
    - Training at all levels needs to address a broad range of issues.
    - Managers and partners need to provide mentoring and 'on the job' training.
    - Post-qualification training needs to focus appropriately on audit related issues.
  - The approach to **appraisal** of partners and staff.
    - Audit quality can be enhanced if appropriate emphasis is given to factors that promote audit quality.

### *Possible threats to the skills of an audit team*

- **Threats** include:
  - Failure to develop the necessary personal characteristics through effective mentoring.
  - Failure to retain staff with the necessary experience and expertise.
  - Allocating more capable staff on the basis of client prestige rather than audit risk.
  - Insufficient or ineffective training.

## 4 THE SKILLS AND PERSONAL QUALITIES OF AUDIT PARTNERS AND STAFF

### The importance of the skills and personal qualities of audit personnel

- 4.1 Audit is a discipline that relies on competent individuals exercising such qualities as integrity, objectivity, rigour, scepticism, perseverance and robustness to enable them to make reliable judgements. For example, on issues relating to assessing the risk of material misstatement due to fraud or error, the adequacy of audit evidence and the evaluation of accounting estimates and valuations required by accounting standards.
- 4.2 For an audit to be of high quality it is essential that audit partners and staff have the necessary expertise. The means by which the accounting profession and the audit firms develop and maintain such expertise are, therefore, key drivers of audit quality. Those drivers include:
- The skills base of the partners and staff;
  - The training provided by the audit firms and the education and training associated with obtaining a professional qualification; and
  - The approach taken to the appraisal of partners and staff.

#### *The skills base of the partners and staff*

- 4.3 The skills of audit partners and staff lie at the heart of an audit firm's ability to undertake a high quality audit. These include technical skills, business knowledge and experience, combined with innate judgement skills.
- 4.4 The skills of an auditor develop over time and the most effective individuals are likely to be those with extensive professional experience.
- 4.5 As shown in Appendix 4, the structure of a large accountancy firm is 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 may be performed by staff that are relatively inexperienced; indeed many may still be in training contracts. Because of this, it is important that managers and partners, with the requisite experience and skill, are available with time to supervise their teams, deal with significant technical and judgemental issues and communicate effectively with senior client management.

### *The training provided by the audit firms*

- 4.6 Although a degree in accountancy or a related subject is not a pre-requisite, many auditors are graduates and have excellent academic qualifications. The profession endeavours to ensure that auditors have the necessary technical skills through admission exams and practical training. However, those professional exams are designed also for qualification as an 'accountant' and there is a perception that the exams may have become progressively less focussed on audit. For example, one of the professional bodies offering an audit qualification no longer has a pure auditing paper in its final examination. Consequently, additional training in auditing has increasingly to be provided by the firms themselves.
- 4.7 Against this background, the training in auditing that is provided by the audit firms may be said to have acquired increased importance. Firms generally provide training in the technical aspects of audit and in the requirements of the audit methodology of the firm. They also provide essential practical experience by including trainees in audit teams undertaking audit work. And as auditors are increasingly expected to address broader issues in the public interest (such as the issues raised by the Combined Code), the training provided by firms needs to extend beyond teaching staff how to apply the firms' methodologies related to accounting and auditing.
- 4.8 The training provided by the firms merges learning the technical aspects of auditing with gaining practical experience. In principle, this is undoubtedly the correct approach because classroom training is only part, and perhaps only a small part, of the process by which auditors develop skills and experience. Learning from experience is a key element.
- 4.9 However, the business needs of the firm (and, in particular the demands for resource to meet client needs) may mean that that training is not as effective as might be expected. For example, training of the technical aspects of auditing may be focussed on the application of the firm's methodology, with the consequence that the specific underlying fundamental principles and ethics of auditing are not instilled in those carrying out audits. Alternatively, the value to be gained from practical experience may be reduced if that experience is obtained before the trainee has received the relevant theoretical training or if, because audit teams comprise a large number of junior staff, the opportunity for experienced auditors to provide effective mentoring is or may be limited.
- 4.10 Professional accountancy institutes have established requirements relating to continued professional development (CPD)<sup>18</sup> and the post qualification development programmes developed by the firms have the potential to be an important contributor to an auditor's competence. Generally, however, such programmes address a wide range of areas relevant to the firm's business as a whole and are not necessarily concerned with the technical skills needed to support auditing.
- 4.11 It follows that to achieve consistently high quality audits:
- Staff training needs to be appropriately co-ordinated with the audit work being undertaken;
  - Staff training at all levels needs to address auditing, as well as the increasingly broad range of related issues that auditors have to address;

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<sup>18</sup> Until 31 December 2005 auditors were required to complete a minimum number of hours of CPD each year. Under new ICAEW requirements, all accountants have to undertake a process of self diagnosis and then carry out a development activity which is sufficient to enable them to keep up to date and to maintain competence.

- Managers and partners need to have sufficient time and motivation to provide mentoring/'on the job' training; and
- The development of post-qualification training for audit partners and staff needs to be appropriately focussed on audit related issues.

#### ***Approach taken to the appraisal of partners and staff***

- 4.12 A firm's appraisal process can materially affect the attitude of staff to a career in auditing and the attention that they pay to achieving a high quality audit. However, for the reasons discussed in Section 2, a high quality audit is a difficult outcome to measure.
- 4.13 Measures that are used in appraisals include:
- Technical knowledge – where the focus tends to be on whether there has been a failure or other indication of a lack of technical expertise (including compliance with ethical requirements);
  - Efficiency - because completing an audit within budget and on time are easy measures to use to assess performance and efficiency is an important metric for a firm; and
  - In the case of partners and managers - relationship management.
- 4.14 The FRC believes that appraisals of partners and staff could be used to enhance audit quality if:
- Audit quality is emphasised in the setting of objectives and in appraisals;
  - Importance and reward is attached to the role of mentoring less experienced members of staff; and
  - Appraisal systems are developed for partners that emphasise those factors that promote the exercise of good audit judgement, including consultation on difficult issues.

#### **Possible threats to the skills of an audit team**

- 4.15 The identification of misstatements in the financial statements of a company (where they exist) is more likely where competent audit partners and staff have key personal characteristics such as integrity, objectivity, rigour, and scepticism. The qualities of perseverance and robustness are also important in ensuring that the necessary changes are made to the financial statements in the face of persuasive and, possibly, intimidating client management. Those characteristics can be inculcated and enhanced through effective mentoring by experienced partners and staff. The ability to develop and retain sufficient staff with audit experience to perform this mentoring role is therefore an essential factor that influences whether audit firms are building a pipeline of resource to undertake audits effectively.
- 4.16 However, the numbers of people who are capable of mentoring is limited. And such people may have other demands on their time, including 'special' or non-audit work or involvement in the internal management of the firm which they might regard as more career-enhancing.
- 4.17 It is generally recognised that accountancy firms make enormous efforts to recruit and retain high quality graduates. However, many who enter the profession see an accountancy qualification as a route to other opportunities and have no intention of remaining in audit. As a result, many leave the firms at,

or soon after, qualification as accountants<sup>19</sup>. There is therefore a danger that firms may retain insufficient staff to be able to provide audit teams with the experience and expertise needed. It would be advantageous if audit firms were able to improve retention levels, including by promoting the value of audit experience with staff and externally.

- 4.18 This resource problem is exacerbated if the largest, more prestigious, clients of an audit firm are allocated the most capable audit personnel because, as a result, those scarce resources will not necessarily be available to other less well-known clients where the risk that the financial statements are misstated may be greater.
- 4.19 The problem of allocating sufficient resources to those companies with the greatest need applies more generally. A significant component of the larger firms' quality control systems is the process for accepting or continuing to act for a client. As a result, firms may decline to accept appointment as auditor to those companies that are identified as very high risk.
- 4.20 While client selection may be justifiable in the context of an individual audit firm, there is a danger, from the public interest perspective, that this may lead to high risk audits being undertaken by audit teams without the requisite skills and experience. This, in turn, increases the risk of audit failure.
- 4.21 Experience, competencies 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. In circumstances where attrition rates significantly reduce the number of experienced staff available, it may be appropriate to undertake a fundamental review of the qualification and training requirements for auditors (both pre and post qualification).

**Q4 Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?**

**Q5 Has this paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?**

**Q6 Should there be a fundamental review of the qualification and training requirements for auditors?**

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<sup>19</sup> Attrition rates are high – reported at 18% across all staff and 26% among newly qualified staff in 2004 – *Accountancy Age* published 30 June 2005.



## THE EFFECTIVENESS OF THE AUDIT PROCESS

### *The importance of an effective audit process*

- An audit process is **likely to be effective** for a quality audit if:
  - The **structure, experience and knowledge** of the audit team is appropriate for the engagement and resources are sufficient to enable a considered response to issues that may arise.
  - **High quality technical support is available** when the audit team encounters a situation it is not familiar with.
  - The **audit methodology** is well structured and:
    - Provides a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.
    - Provides for compliance with auditing standards without inhibiting exercise of judgement.
    - Requires appropriate audit documentation.
    - Ensures there is effective review of audit work.
  - The **objectives of ethical standards are achieved**, providing confidence in the integrity, objectivity and independence of the auditor.
  - Audit **quality control procedures are effective**, understood, applied, and monitored within firms and across international networks.

### *Possible threats to an effective audit process*

- **Increased use of computerised audit methodologies** may distance auditors from the company being audited, reduce flexibility and result in time spent coping with the technology at the expense of evidence gathering.
- **Over-prescriptive auditing standards, regulation and audit methodologies** can have adverse impacts such as:
  - Insufficient emphasis on tailoring audit procedures to specific circumstances.
  - Inhibiting the exercise of judgement.
  - A focus on producing documentation at the expense of performing audit procedures properly.
- **'Client capture'** where the relationship with the client is so close that objectivity is impaired.

## 5 THE EFFECTIVENESS OF THE AUDIT PROCESS

### The importance of an effective audit process

- 5.1 The effectiveness of the process by which an audit is undertaken can play a major part in ensuring that the audit team undertakes a quality audit. An audit process is likely to be effective if:
- The structure of the audit team and the level of professional experience and industry expertise is appropriate for the particular engagement;
  - High quality technical support is available;
  - The audit methodology used is well structured;
  - The objectives underlying ethical standards for auditors are achieved; and
  - Firm-wide quality control procedures are effective and applied.

### *The structure of the audit team*

- 5.2 It is well recognised that the audits of most large companies, especially multi-national companies, have tight reporting deadlines and are becoming increasingly complex. There is an ever-increasing need for experienced auditors to be available to address the complexity of the activities of those companies and to make the audit judgements that are involved.
- 5.3 An audit firm, therefore, needs to manage the allocation of its resources in such a way 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).
- 5.4 This involves structuring an audit team so that it has:
- Sufficient resource to enable:
    - partners to be adequately involved in establishing the overall audit strategy, assess and develop responses to audit issues as they are identified, and evaluate 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 respond in a considered way to those issues that may arise in the course of the audit, having regard to the reporting timetable involved.
- Individuals with appropriate knowledge of the industry in which the client operates and its applicable financial reporting framework. The challenge of having sufficient experienced personnel undertaking the audit is exacerbated in those industries where industry specific knowledge is vital – e.g. for the audits of banks, insurance companies, investment businesses, utility companies and oil companies. This is also an area where the development and use of databases (of the type described in paragraph 3.3 above) can be of particular benefit; and
- Partners and staff with the skills and experience to handle the considerations arising from the characteristics of a particular company or its management.

### ***Access to appropriate technical support***

- 5.5 No audit team will have the expertise to address each and every situation that may arise in the course of an audit. When an audit team encounters a situation with which it is not familiar, there are likely to be benefits in discussing that situation with other persons whose experience may be relevant. A firm's technical function is likely to be a valuable source of guidance in such circumstances. An effective process will, therefore, promote consultation with technical staff where appropriate and ensure that there is sufficient experienced technical staff available to give timely responses.

### ***The audit methodology***

- 5.6 Audit methodologies are one of the means by which firms ensure that audits are undertaken in a consistent and comprehensive manner and that an audit is carried out in accordance with auditing standards. Increasingly in recent years these methodologies have been embedded in computerised systems to help ensure that they are applied in practice throughout the organisation and to provide a mechanism for the review of work undertaken from a remote location.
- 5.7 If an audit methodology is to achieve a consistently high quality audit, it should:
- Provide a framework and procedures to assist the engagement team in carrying out an effective and efficient audit to obtain sufficient appropriate audit evidence as a basis for concluding that the financial statements are free from material misstatement;
  - Provide for compliance with the requirements of applicable law and auditing standards, without being so prescriptive that it inhibits the exercise of judgement or the exercise of scepticism, perseverance and robustness;
  - Require the work undertaken and the audit judgements made to be properly documented. Appropriate audit documentation is needed both to perform a high quality audit and to demonstrate that an audit has been conducted in accordance with applicable requirements. It is also recognised that the documentation of the rationale for an audit judgement is likely to increase the rigour, and therefore the quality, of that judgement;
  - Ensure that there is an effective means by which partners and managers can review (in the presence of the staff concerned) audit work undertaken at client locations.

### ***Achieving the objectives of ethical standards***

- 5.8 The credibility of the audit process depends upon users of financial statements having confidence in the integrity, objectivity and independence of auditors and the work that they perform.
- 5.9 The Ethical Standards issued by the APB combined with the professional conduct standards of the accounting institutes are designed to ensure that users of financial statements have that confidence. It is therefore essential that audit teams comply with the standards and achieve the objectives on which those Ethical Standards and professional conduct standards are based.

### ***Firm-wide quality control procedures***

- 5.10 Firm-wide quality control procedures contribute to the effectiveness of an audit process. ISQC (UK and Ireland) 1 establishes quality control standards for audit firms in the UK<sup>20</sup> and requires firms to have policies and procedures to address such matters as:
- Effective and timely consultation with technical staff;
  - Quality control reviews undertaken by independent partners; and
  - Monitoring the firm's system of quality controls, including carrying out periodic inspection of a selection of completed engagements.
- 5.11 Firm-wide quality control processes can help to produce a consistently high quality audit if:
- They include clearly defined firm-wide procedures that are understood and applied by all partners and staff. While ISQC (UK and Ireland) 1 sets out requirements as to where firms need policies and procedures regarding aspects of quality control, it is not prescriptive as to what those policies and procedures should be;
  - They check that advice obtained in the course of discussions about audit issues is followed through and implemented;
  - They encourage rigorous evaluations of those audits selected for internal monitoring; and
  - They require that deficiencies revealed by monitoring processes are rigorously followed up. This is particularly important in relation to network firms because significant reliance on the quality of a network firm's work may be based on the premise that they use the same methodologies and systems of quality control when undertaking group audits.
- 5.12 As companies have become increasingly international, if not global, in their activities, audit firms have increased their international coverage by building networks of firms that practice under the same name. When the group audit of an international company is undertaken, it is normal for these network firms to undertake the audits of subsidiaries in their respective jurisdictions.
- 5.13 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 consistent high standards of professional skill, integrity and conduct cannot be overstated. Firms therefore need to give priority to having effective quality control systems across the whole network.

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<sup>20</sup> ISQC (UK and Ireland) 1 was based on SAS 240 (Revised) which had been in place in the UK since September 2000.

## Possible threats to an effective audit process

- 5.14 An inherent limitation of an audit is the fact that the audit process cannot provide absolute assurance that the financial statements are free from material misstatement. In part this is because aspects of both auditing and accounting involve subjective judgement. There are also limits to the ability of auditors to identify fraud, especially where committed by senior management.
- 5.15 It is neither possible nor practical to develop an audit process that can deliver absolute assurance as that would involve reviewing, probably contemporaneously, every transaction and related management decision. In the case of fraud, the present consensus tolerates the possibility that fraud may not be identified for the reasons discussed in the APB's Consultation Paper – 'Fraud and Audit: Choices for Society'.
- 5.16 In practice the key factors that determine whether auditors exercise judgement successfully in these areas are that auditors have the technical skills, experience and personal qualities discussed in Section 4.

### *Increased use of computerised audit methodologies*

- 5.17 The ever increasing role of computerisation and information technology in the methodologies of audit firms 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 has historically been obtained by spending time with company personnel, 'walking the floor' and observing and inspecting the company's operations may not be obtained. Indeed, there is anecdotal evidence that the proportion of audit time spent by staff sitting in the audit room completing electronic schedules is increasing at the expense of time spent reviewing client records, discussing accounting issues with client staff and otherwise obtaining audit evidence.
- 5.18 The challenges posed by increased use of computerised audit methodologies also include:
- Excessive use of computerised programmes that reduce flexibility and exacerbate the trend towards auditing being seen as a 'box-ticking' exercise;
  - New staff spending their time learning how to use the technology (because the methodologies require extensive training), rather than how to audit; and
  - Partners and managers reviewing audit work from remote locations with the consequence that, while this approach may be 'efficient' (in a narrow sense), it significantly reduces the opportunity for experienced staff to provide mentoring and 'on the job training' and may limit the active involvement of the partner in decision making.

### *Over-prescriptive auditing standards and regulation*

- 5.19 The preparation of auditing standards has traditionally involved a 'principles based' approach, leaving flexibility for the auditor to apply those standards in the way best suited to the circumstances of any particular audit. Recently, there has been pressure from regulators internationally for standards which can more easily be enforced and some believe that this is leading to greater emphasis on the procedural aspects of an audit<sup>21</sup>.
- 5.20 There is a risk that this trend, which some believe is also occurring in the development of accounting standards, may lead auditors to assess the

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21 While there is likely to be some increase in the number of requirements with which auditors will be required to comply, the APB is hopeful that the international standards that result from the IAASB's Clarity Project (see Appendix 1, paragraph 20) will not be unduly prescriptive.

appropriateness of a particular auditing approach or accounting treatment solely by reference to the provisions of the applicable standard – and they will not stand back and ask the fundamental question ‘Is this the appropriate approach?’ This risk is exacerbated by the fact that it will always be easier to defend an approach that is consistent with the applicable standard to regulators and others who may review the auditor’s approach with the benefit of hindsight.

5.21 There may also be a risk that increasing the number, and level of prescription, of the requirements in auditing standards will have negative implications for other elements of audit quality. For example:

- If the requirements of auditing standards are over-emphasised, the impression may be given (to both auditors and interested third parties) that those standards are all-encompassing and that there can be a single approach to an audit. This can create a consequential risk that insufficient emphasis is given to experienced staff tailoring the specified audit procedures to the circumstances and considering whether further procedures (not mandated by the auditing standards) need to be performed.
- Over-emphasising the process by which an audit is performed may give a misleading impression of an audit and may detract from experienced audit personnel making important judgements. Key auditing decisions can be highly judgemental.
- Excessive emphasis on documenting the work undertaken may result in audit staff giving priority to building an audit file to demonstrate the work that has been carried out in compliance with auditing standards, rather than performing audit procedures properly.

5.22 Developments such as these may also de-motivate partners and staff and adversely impact retention levels within the firms. This, in turn, may lead to a situation where audit firms are unable to resource engagement teams with sufficient partners and staff with the appropriate experience (including for the reasons set out in paragraph 4.17).

5.23 The FRC and its operating bodies, the APB and the POB, are alive to the threat that auditing standards may become over-prescriptive. When participating in international meetings of audit regulators or standard-setters, they emphasise the need to guard against audit regulation becoming overly prescriptive, and the risks that could result if it does.<sup>22</sup>

5.24 Firms need, however, to recognise that if they espouse principles in place of rules, they must accept that not every situation can be provided for expressly

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22 In particular, in discussions regarding the revisions to the current ISAs at meetings of the IAASB and its sub-committees, the APB and its representatives have emphasised the importance of observing the conceptual test established at the outset of the Clarity Project (see paragraph 20 of Appendix 1), namely that to be a mandatory requirement an audit step must meet the following three criteria:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of any other Standard.

Further, as the EC develops the criteria that it will apply when endorsing auditing standards for use throughout the EU, as required by the new 8<sup>th</sup> Directive, the FRC, the POB, and the APB (at the various different meetings and committees that they attend) are urging the EC to guard against over-prescription for the reasons set out in this section.

## **Client capture**

- 5.25 The background to the APB's Ethical Standards on independence, objectivity and integrity is described in Appendix 1, paragraphs 22 to 28. One of the challenges the APB faced in developing these standards was to ensure that they were sufficiently robust to deal with what may be described as 'client capture'. Client capture exists 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 scepticism that is so fundamental to an effective audit. Client capture is also likely to arise if the partner believes that his remuneration, and indeed his ongoing career with the audit firm, is dependent on maintaining 'happy client management'.
- 5.26 The APB addressed this threat by requiring lead audit partner rotation (every 5 years for listed companies)<sup>23</sup>, by requiring firms to appoint an ethics partner<sup>24</sup> and by establishing 'independent partner' review requirements<sup>25</sup>.
- 5.27 The APB's standards are principles based and it is important that they are applied in both substance and form. It will be important to determine the extent to which audit firms and individual audit partners respond to the need to avoid 'client capture' before considering further change to the regulatory regime.
- Q7 Are there other factors that determine whether an audit process is effective?**
- Q8 Are there threats to the effectiveness of the audit process that have not been identified above?**
- Q9 Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?**

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23 ES3

24 ES1

25 ISQC (UK and Ireland) 1 and ISA (UK and Ireland) 220



## THE RELIABILITY AND USEFULNESS OF AUDIT REPORTING

### *The importance of an audit opinion that commands confidence*

- The form of **the auditor's report is highly codified and standardised**.
  - Key elements are specified by law and auditing standards.
  - A clean auditor's report operates as a signal rather than a source of new information.
  - Confidence in the auditor's report is inextricably linked to confidence in the presumed quality of the audit process.
- Good communication with audit committees is likely to make a **key contribution to a high quality outcome** to the audit. Benefits include:
  - Encouraging a dialogue about the scope of the audit.
  - Providing a forum to discuss the key risks identified and judgements made in reaching the audit opinion.
  - Discussing qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.

### *Threats to confidence in audit reporting*

- The FRC is conscious that **some users and commentators have concerns** about:
  - Whether the scope of the meaning of "true and fair view" was restricted following the introduction of IFRS. This is being addressed by the Companies Act 2006.
  - Whether auditors are properly fulfilling their legal responsibilities to consider the adequacy of a company's accounting records.
  - Whether auditor's reports should be more informative about key audit issues.

## 6. THE RELIABILITY AND USEFULNESS OF AUDIT REPORTING

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### The importance of an audit opinion that commands confidence

- 6.1 The ultimate objective of the audit process is the provision of an audit opinion in which users of financial statements have confidence.

#### *Form of the audit report*

- 6.2 As discussed in Section 2, one of the difficulties associated with the audit process is that the quality of the work performed is largely invisible to the main users of the audit, the shareholders. Furthermore, because the key elements of the auditor's report are specified by law and auditing standards, the report has become highly codified and standardised. Unless it is modified (either by a qualification or by an emphasis of matter paragraph) it contains little information that gives users an insight into the underlying quality of the financial information of the audited company.
- 6.3 However, for the majority of users, the mere fact that the auditor has given an unqualified audit opinion to a particular set of financial statements is of more importance than any supplementary information. As a result, a clean audit report operates as a signal, rather than a source of new or unexpected information.
- 6.4 This emphasises the fact that confidence in the reliability of an audit report is inextricably linked to confidence in the presumed quality of the audit process, and therefore the effectiveness of the drivers of audit quality discussed in this Discussion Paper.

#### *Good communication with audit committees*

- 6.5 The audit has the ability to make a valuable contribution to the future management and operation of the entity concerned. In that respect the nature and quality of communications between audit committee and auditor is a major factor.
- 6.6 The FRC believes that an audit committee is an important stimulus to audit quality. Where there is an effective audit committee, two-way communication between the auditor and the audit committee is likely to make a key contribution to a high quality outcome to the audit.

- 6.7 The benefits of effective, two-way communication between auditors and audit committees are that:
- It encourages a dialogue about the scope of the audit and the areas and issues to be the subject of greater scrutiny;
  - It provides a forum at which the audit committee can be satisfied that the auditor has identified and addressed the key risks, and at which the significant judgements that are made in reaching an audit opinion can be discussed;
  - Sharing information helps both the auditor and the audit committee to fulfil their respective responsibilities. The sort of information exchanged may include matters relating to the auditor's independence and objectivity, information about the planning of the audit, and the findings from the audit, including the auditor's views on the qualitative aspects of the entity's accounting and reporting (including valuations and estimates); and
  - Potential ways of improving financial reporting (and related matters) can be discussed.
- 6.8 The audit committee therefore has the opportunity to form its own opinion on the judgements being made and to communicate them to the auditor, who in turn will take them into account in reaching the audit opinion. This process is intended to go some way to allaying the concerns of shareholders that management may be able to persuade auditors to make inappropriate judgements.

### Threats to confidence in audit reporting

- 6.9 The FRC is conscious that some users and commentators have concerns about the form of the audit report and whether auditors are properly discharging their responsibilities in relation to it.
- 6.10 One concern arises from the change to the wording of the opinion required by law to be given by auditors following the introduction of IFRSs. The traditional opinion - that the accounts show *'a true and fair view'* - has been replaced with *'true and fair view, in accordance with the relevant financial reporting framework'*. There is concern that the inclusion of the additional words restricts the scope of the meaning of 'true and fair view' and will encourage auditors to adopt a more compliance orientated approach. The Companies Act 2006 addresses the concern as to the form of the audit opinion. The amendment to the existing legislation requires directors to approve accounts only if they show a true and fair view and auditors to have regard to this responsibility when giving their opinion on the accounts.
- 6.11 Another concern relates to auditors' duties in relation to the adequacy of a company's accounting records and whether those duties are fully understood and properly discharged by auditors. The Companies Act 2006 will result in a continuation of the obligations of both directors and auditors in this regard.
- 6.12 The APB intends to issue guidance for auditors on the issues referred to in the preceding paragraphs (accompanied by legal advice where appropriate) and, as appropriate, to reflect that guidance in its ISAs (UK and Ireland).
- 6.13 In addition, the FRC is aware that there is debate within the Audit Quality Forum as to whether audit reports should be more informative about the key audit issues and how they were resolved. Some institutional investors think that there may be merit in requiring disclosure in the audit report of the basis of the

auditors' conclusions similar to that required by French legislation (the justification des appréciations). These ideas, and the way in which they might be implemented, require consultation involving all affected constituencies and may require changes in the existing law.

**Q10 Are there other factors that determine whether audit opinions command confidence?**

**Q11 Are there other reasons why users may not have confidence in the audit opinion?**

**Q12 Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?**

## FACTORS OUTSIDE THE CONTROL OF AUDITORS AFFECTING AUDIT QUALITY

### *The approach taken by management*

- **Good corporate governance** plays a major role in ensuring companies attach appropriate importance to corporate and financial reporting and to the audit process.
- Nevertheless, there **will always be a risk** that management may be motivated in some circumstances to obstruct the audit process.

### *The contribution made by audit committees*

- Although the auditor is responsible for the planning and scope of the audit, **the audit committee can be of considerable significance** in areas such as:
  - Considering the scope of the audit and major risk areas.
  - Being satisfied as to the appropriateness of the audit plan and audit resources.

### *The role of shareholders and commentators*

- **Support of auditors**, where appropriate, by shareholders increases the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.

### *The role of litigation as a driver of audit quality*

- The liability regime in the UK is being reformed in a way that is designed to ensure that **exposure to litigation remains a stimulus to audit quality**.

### *The approach of regulators*

- **Regulators need high quality staff**, able to assess whether audit firms have undertaken high quality audits in compliance with **the principles** of professional standards. For this to work, audit firms must also adhere to the principles.

### *The pressures caused by the accelerating reporting regime*

- **Tight reporting deadlines** limit the opportunity for detailed work by auditors after the reporting period and results in increased reliance on work performed before the end of the reporting period.

## 7 FACTORS OUTSIDE THE CONTROL OF AUDITORS AFFECTING AUDIT QUALITY

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- 7.1 It is important to appreciate that the audit process does not take place in a vacuum. There are various external influences that can impact the ability of auditors to fully and effectively discharge their responsibilities.

### The approach taken by management

- 7.2 The emphasis that has been placed on corporate governance over the past 15 years<sup>26</sup> has played a major role in ensuring that companies attach appropriate importance to corporate and financial reporting and to the audit process. Nevertheless, there will always remain a risk that the managers of some companies will obstruct auditors in the proper performance of their role and seek to enhance the performance of the company and manage the profits of the company. Their motivation may be to boost the company's share price, either to qualify for performance related bonuses or simply to disguise poor strategic decisions.
- 7.3 This risk and the ways in which it may manifest itself were examined in two Consultation Papers issued by the APB – 'Fraud and Audit: Choices for Society' and 'Aggressive Earnings Management'. The responses to those papers confirmed that it is not possible to rely on the audit process alone as a guard against this risk. It is appropriate, therefore, that the Government has introduced changes to company law that are intended to provide a more effective disincentive to fraudulent activity<sup>27</sup>.

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<sup>26</sup> See Appendix 1, paragraphs 10 to 13.

<sup>27</sup> For example, section 234ZA of the Companies Act 1985 requires the directors' report to include a statement to the effect that, so far as the directors are aware, there is no relevant information of which the company's auditors are unaware and that the directors have taken all the steps they ought to have taken as directors in order to make themselves aware of relevant audit information and to establish that the company's auditors are aware of that information. If a false statement is given, every director who knew the statement to be false, or was reckless as to whether it was false, and failed to take appropriate steps to prevent the directors' report from being approved is guilty of an offence and liable to imprisonment and/or a fine.

## The contribution made by audit committees

- 7.4 The planning of an audit is a vital part of the audit process and is invariably the subject of discussion between the auditor and management. In the case of listed companies, the audit plan should also be discussed with the audit committee<sup>28</sup>.
- 7.5 Although the auditor is responsible for the planning and scope of an audit, the approach taken by the company, particularly by its audit committee, can be of considerable significance in, for example, the following areas:
- Considering the scope of the audit, including ensuring that effective testing will take place in major risk areas;
  - Satisfying itself that the audit plan, including any areas for particular review, the amount and seniority of the resource to be deployed, and the adequacy of the time to complete the audit are appropriate having regard to its own knowledge of the company and its business;
  - Emphasising to management and users the importance attached by the company to the integrity of its financial statements; and
  - Ensuring that statements by the company (such as preliminary and trading statements) are made only when all concerned are satisfied that the information to be given is consistent with the financial statements or their underlying knowledge.

This process is reinforced by the fact that, following the completion of the audit, audit committees carry out a review of audit effectiveness.

- 7.6 Against this background, a question arises as to whether the FRC should take further steps (for example, by developing 'best practice' guidance for audit committees in relation to the evaluation of audit effectiveness) to reinforce the contribution made by audit committees. Similarly, there are indications that readers of audited financial statements would welcome publication of a brief summary of the work undertaken by the audit committee to evaluate audit effectiveness.

## The role of shareholders and commentators

- 7.7 In circumstances where the auditor's primary responsibility is to report to shareholders, it is important that those shareholders respond in a considered and constructive way when auditors take a public position in relation to the way in which a company has prepared its financial statements or in relation to the conduct of the directors and management of a company – for example by qualifying the audit report, or resigning or not seeking reappointment and by issuing a statement setting out matters that the auditor regards as relevant to shareholders.
- 7.8 If shareholders take appropriate action in support of auditors in such circumstances, there will be an increased likelihood that directors and management more generally will comply with their obligations.

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<sup>28</sup> See the Combined Code and the FRC's publication 'Guidance on Audit Committees'.

## The role of litigation as a driver of audit quality

- 7.9 For many years, the exposure that auditors face from professional negligence claims has been thought to be a stimulus to quality of the audit work undertaken by audit firms. However, over the past 15 years, litigation has increased to a level that is beyond the capacity of the firms to bear or obtain insurance cover. This is due to the ever increasing size of the companies and transactions involved and to the changing nature of the law.
- 7.10 The liability regime affecting auditors in the UK is being reformed in a way that is designed to ensure that the audit firms' exposure to litigation remains a stimulant of audit quality. However, these changes will also heighten the importance of ensuring that the disciplinary functions of the FRC and of the individual professional institutes is effective and that there are available to those bodies ranges of punishments that are appropriate for both individual auditors and audit firms.
- 7.11 The AIDB, which is tasked with investigating and taking disciplinary action in public interest cases involving accountants or accounting firms, is a new body and some experience of its operation needs to be gained so that a proper assessment can be made of its powers and the range of remedies available to it.

## The approach of regulators

- 7.12 Over the past 5 years, increasing importance has been placed on the concept of regulatory inspection as a means of stimulating and reinforcing audit quality<sup>29</sup>. That reliance will be justified if regulators have sufficient personnel of the necessary quality to carry out the inspections concerned.
- 7.13 In particular, to provide a real stimulus to consistent high quality auditing, it will be important that such personnel understand the principles reflected in applicable auditing standards and methodologies and have the ability and experience to assess whether firms have complied with the principles when reviewing the key judgements made by an auditor when reaching an opinion on a company's financial statements.
- 7.14 Similarly, the firms that are subject to review have an important contribution to make. In particular, it will be counter-productive if, when regulators make points based on principle, firms take a defensive approach based on the argument that they have complied with the requirements of the applicable auditing standards. If they do take such an approach, there is a risk that regulators will be driven to focus on compliance with standards alone.

## The pressures caused by the accelerating reporting regime

- 7.15 As companies seek to publish their results as quickly as possible after the relevant reporting period, the opportunity for detailed work by auditors after the period end becomes increasingly limited. The impact of accelerated reporting is exacerbated by the fact that auditors usually need to complete most of their audit work by the date of the preliminary announcement. Analysts and other commentators tend to comment on, and the markets tend to react to, preliminary announcements.

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29 See paragraphs 29 – 32 of Appendix 1.

Also, in June 2006 the EC adopted the new 8<sup>th</sup> Directive (2006/43/EC) on statutory audits which requires Member States to ensure that all statutory auditors and audit firms are subject to a system of quality assurance and to public oversight.

7.16 This has the effect of requiring auditors to place increased reliance on work done before the end of the relevant reporting period to validate the company's control environment and the accounting systems used so that reliance can be placed on management data for the company's financial results for the period concerned.

**Q13 Are there other external factors that have the potential to adversely affect audit quality?**

**Q14 Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?**

**Q15 Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?**

**Q16 Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?**

**Q17 Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?**

## RECENT CHANGES IN THE REGULATION OF CORPORATE REPORTING IN THE UK THAT ARE LIKELY TO IMPACT CONFIDENCE IN FINANCIAL REPORTING AND AUDIT QUALITY.

### Financial reporting

#### *The introduction of IFRSs*

1. In order to improve the quality and consistency of financial reporting in the EU, IFRSs were introduced for the financial statements of listed companies for periods beginning on or after 1 January 2005.
2. In the short term, the changes caused by the first time adoption of IFRSs have placed very significant burdens on management and auditors alike. Both have had to learn a new financial reporting framework and address complicated judgemental situations and disclosure requirements. There is a possibility that, in the short term, the challenges presented by the introduction of IFRSs may have diverted time and attention from the conduct of the traditional and key elements of the audit process – namely the gathering and verification of audit evidence.
3. Some recent standards have required the use of fair value measurement, and therefore increased use of judgement (both by management and auditors) in the preparation and audit of financial statements.
4. This is likely to have a longer term and more significant impact on audit quality because the degree of measurement uncertainty implicit in fair value valuations increases the risk that misstatements in financial statements will occur, whether innocently or as a result of deliberate manipulation by management.
5. It is inevitable that auditors will be expected to detect such misstatements. The ability of the profession to do so will depend on the experience of the members of the audit team involved in making audit judgements, the level of involvement of the audit engagement partner, and the information and techniques they rely upon.

#### *The information contained in a company's Annual Report*

6. Annual reports contain a considerable amount of material in addition to the audited financial statements – for example, the Annual Report of a listed company contains, at the minimum, a Chairman's Report, a Directors' Report, and historical financial information.
7. Recently, there has been extensive consideration of the merits of requiring annual reports to include more information about the business issues affecting listed companies. Earlier this year, the Government pulled back from a statutory requirement that quoted companies should include an Operating and Financial Review in their annual report. However, quoted companies must comply with the obligation on all companies to include an enhanced business review in their Directors' Report, as required by the EU Accounts Modernisation Directive.

8. These developments have led to increases in the role of auditors, who are now required to:
  - Audit parts of the Directors' Remuneration Report;
  - Review the company's statement of compliance with the Combined Code<sup>30</sup>, and
  - Report on the consistency of the Directors' Report with the financial statements<sup>31</sup>.
9. These additional responsibilities recognise that, based on information obtained in the course of the audit, auditors can make a wider contribution to confidence in corporate reporting.

## Corporate governance

### *Audit Committees*

10. The FRC believes that effective audit committees have a particularly important role to play in promoting audit quality.
11. The Combined Code, when revised in 2003, included the principle that boards of directors should establish transparent arrangements for maintaining an appropriate relationship with the company's auditors<sup>32</sup>. The relevant Code provisions include:
  - Making recommendations in relation to the appointment and remuneration of the external auditors and approving the terms of engagement;
  - Reviewing external auditors' independence and objectivity;
  - Assessing the effectiveness of the audit process; and
  - Developing a policy on the engagement of the external auditor to supply non-audit services.
12. These aspects of the Code were reinforced in the FRC's publication, "Guidance on Audit Committees"<sup>33</sup> which contained recommendations on such matters as effective communication between the auditor and the audit committee and the steps to be taken when assessing the effectiveness of the audit process<sup>34</sup>.
13. Some annual reports contain reports from audit committees that describe how they have evaluated audit effectiveness<sup>35</sup>. However, as yet, no comprehensive review has been undertaken to establish the extent to which audit committees

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30 Since 1993, the Listing Rules have specified those aspects of the Combined Code that auditors are required to review. Currently auditors' reports state whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 Combined Code specified for their review by the Listing Rules of the Financial Services Authority, and they report if it does not. Auditors are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedure.

31 New legislation effective from 1 April 2006.

32 Principle C.3

33 This guidance was developed by a Committee of the FRC chaired by Sir Robert Smith.

34 The Guidance recommends that audit committees should:

- Review whether the auditor has met the agreed audit plan;
- Consider the robustness and perceptiveness of the auditors in handling the key accounting and auditing judgements;
- Obtain feedback about the conduct of the audit from key people involved (e.g. the finance director and the head of internal audit); and
- Review and monitor the content of the external auditor's management letter in order to assess whether it is based on a good understanding of the company's business.

35 Independent Audit's publication 'Board reporting in 2006' notes that, Associated British Foods, Aviva, Gallaher, Hanson and Rexam provided descriptions of the work they had undertaken to evaluate audit effectiveness.

have been actively involved in considering audit quality and the impact this has on audit firms' performance. The evidence available suggests that audit committees consider audit effectiveness in different ways and the process for this is more likely to be formalised for larger listed companies than smaller listed companies.

## The audit

14. Over the past 10 years, extensive steps have been taken to ensure that auditing standards address all the key areas and have been updated to address the conduct of audits in the modern business environment. Similar steps have been taken to strengthen the ethical and professional conduct standards applicable to auditors. In addition, Consultation Papers have been used to promote discussion about key sensitive issues that impact audit quality. These have resulted in changes to auditing standards and to legislation. These initiatives are described below.

### *Consultation Papers*

15. In 1998, the APB published a Consultation Paper entitled "Fraud and Audit: Choices for Society" which sought to inform and stimulate a debate on the actions that might be taken to establish the right balance between increasing the likelihood of auditors detecting management fraud in listed companies and the costs and consequences that would flow from such changes.
16. Following this consultation:
  - The Government has introduced changes to company law that are intended to provide a more effective disincentive to fraudulent activity by company directors<sup>36</sup>.
  - The Combined Code has been amended to include a requirement that, at least annually, the directors should conduct a review of the effectiveness of the group's system of internal controls and risk management and should report to shareholders that they have done so<sup>37</sup>.
  - The APB issued a standard that mirrored the requirements of the Combined Code relating to relations between auditors and audit committees<sup>38</sup>.
17. However, there was little support for a radical change to auditing standards (to achieve a more forensically orientated audit) to increase the likelihood that frauds would be detected (which would necessarily increase the cost and intrusiveness of an audit).

### *Auditing Standards*

18. In December 2004, after extensive consultation, the APB replaced the auditing standards that had been developed for use in the UK and Ireland with a comprehensive suite of auditing standards based on the ISAs issued by the

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36 For example, section 234ZA of the Companies Act 1985 requires the directors' report to include a statement to the effect that, so far as the directors are aware, there is no relevant information of which the company's auditors are unaware and that the directors have taken all the steps they ought to have taken as directors in order to make themselves aware of relevant audit information and to establish that the company's auditors are aware of that information. If a false statement is given, every director who knew the statement to be false, or was reckless as to whether it was false, and failed to take appropriate steps to prevent the directors' report from being approved is guilty of an offence and liable to imprisonment and/or a fine.

37 Guidance to support this requirement was published by the Turnbull Committee in 1999 and has recently been updated by the FRC.

38 SAS 610 'Communication of audit matters to those charged with governance' (since replaced by ISA (UK and Ireland) 260.)

IAASB. These were entitled 'International Standards on Auditing (UK and Ireland)' because, where necessary to maintain existing requirements and clarity, the standards issued by the IAASB were supplemented by standards and guidance from the auditing standards previously issued by the APB.

19. Other than in relation to the new standards covering audit risk and fraud, which were based on newly developed ISAs, the introduction of ISAs (UK and Ireland) did not involve a significant change from the APB's previous auditing standards.
20. These standards are likely to be replaced in about 2008/2009 because, following the recent adoption of the new 8<sup>th</sup> Directive, the EC is empowered to mandate the use of one set of auditing standards throughout the EU. Preliminary indications are that the standards most likely to be mandated are those issued by the IAASB. Partially in order to make its standards suitable for adoption by the EC, the IAASB is in the process of revising the structure and improving the clarity of its standards (the so-called 'Clarity Project'). Those structural changes are designed to:
  - Clarify the obligations imposed on professional accountants by the requirements contained in the standards;
  - Eliminate any possible ambiguity about the requirements a professional accountant needs to fulfil arising from the use of the present tense in the guidance contained in the current standards; and
  - Improve the overall readability and understandability of the standards through structural and drafting improvements.
21. While there is likely to be some increase in the number of requirements with which auditors will be required to comply, the APB is working to achieve international standards resulting from the Clarity Project that are not unduly prescriptive in nature.

### **Ethical Standards**

22. Over recent years, there has been extensive discussion about ways in which auditor independence could be enhanced. Concepts that have been discussed include:
  - Mandatory audit firm rotation;
  - Periodic compulsory re-tendering for audits; and
  - Prohibition of non-audit services.
23. These options were reconsidered and rejected<sup>39</sup> by the APB when developing the Ethical Standards on auditors' integrity, objectivity and independence that it issued in December 2004.
24. The Ethical Standards issued by the APB represented a comprehensive revision of the ethical guidance previously issued by the accountancy bodies. They reflected the EC Recommendation on auditor independence as well as the conclusions of the Government's post-Enron review of accounting and audit

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39 In relation to mandatory rotation and compulsory re-tendering, the APB was not persuaded that such an approach, or the considerable additional costs that would be incurred, was warranted on the evidence available. Furthermore, it took the view that before further consideration is given to the need to require rotation of audit firms, an assessment should be made of the effectiveness of the significant changes that had been introduced by the Combined Code and the Smith Report with the objective of enhancing the independent nature of the auditor's relationship with the company and its management. The APB believes that the threats arising from extended relationships between an audit engagement partner and the audit client can effectively be addressed by rotation of the audit engagement partner and requires rotation of the audit engagement partner on listed clients after 5 years.

issues (including the requirement that audit engagement partners on listed companies rotate every 5 years).

25. In developing the Ethical Standards the APB sought to find the right balance between:
  - Developing standards that underpin the integrity of audit;
  - Not unreasonably inhibiting the business activities of companies; and
  - Not jeopardising the ability of audit firms to perform high quality audits.
26. The Ethical Standards address issues such as financial and business relationships, auditor rotation and, importantly, non-audit services. They provide a robust framework of principles for the evaluation of threats, the implementation of safeguards and transparency with those charged with governance of the entity being audited. Clear prohibitions are established only where the APB believes that safeguards would not be effective.
27. Key areas where the APB has advanced the strength and clarity of ethical requirements for auditors include:
  - Requiring the appointment of an ethics partner to oversee the development and communication of ethics policies within an audit firm and to provide a point for consultation by individual audit partners;
  - Clarification of economic dependency, where the APB believes that audit firms should be prohibited from undertaking an audit if the total fees received from the client regularly represent more than 10% of the firm's income; and
  - Tightening the circumstances in which tax and corporate finance services can be provided by auditors to audit clients where a contingent fee is charged and there is reasonable doubt as to the appropriateness of a related accounting treatment.
28. The requirements in the Ethical Standards apply to audits of all sizes and are supplemented by a small number of requirements that apply specifically to the audits of listed companies. Certain exemptions and alternative provisions were permitted for the audit of very small entities.<sup>40</sup>

## The regulation of audit

### *Independent monitoring of audit quality of listed companies and public interest entities*

29. The Government review undertaken in 2002 recommended that the monitoring of the quality of audits of listed and other major public interest entities should be undertaken by a new independent inspection unit reporting to a professional oversight board within an integrated independent regulator<sup>41</sup>. The review also stated that that the independent inspection unit should take monitoring into new

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40 ES-PASE 'Provisions available for Small Entities' issued in December 2004. 'Small Entities' are defined as those entities that are not subject to a statutory or regulatory obligation to have their financial statements audited.

41 The review recommended that under the new arrangements the professional accountancy bodies continue to register firms to conduct audit work, with their regulatory activities being overseen by the POBA (now known as the POB). The audit registration committees of the accountancy bodies receive formal reports from the AIU on their monitoring work, with the POB overseeing the action taken by them in response to the AIU recommendations. The Companies (Audit, Investigations and Community Enterprises) Act 2004 implemented the statutory changes necessary to give effect to these regulatory arrangements.

areas by focusing on the judgements taken by audit partners rather than just considering processes and systems.

30. In accordance with those recommendations the AIU and the POB were established as part of the FRC and became fully operative, with appropriate statutory backing, in 2004.
31. The AIU's monitoring approach is designed to provide a more challenging regime for the major firms than existed under the previous arrangements. The AIU has implemented an approach to the monitoring of audits by the major firms based on the following characteristics:
  - Wide-ranging reviews of firm-wide procedures, including an assessment of how the culture within firms impacts audit quality;
  - Focussing on major audits for review – such selection is largely risk-based;
  - In-depth reviews of major audits, focusing on the quality of the group audit, including critical assessment of the key audit judgements made and a detailed review of compliance with UK Auditing Standards; and
  - Review of the quality of reporting to the relevant entity's audit committee.
32. Since commencing operation in June 2004, the AIU has undertaken out two rounds of annual inspections and published two public reports. Its first public report covered its work at the four largest UK audit firms ('the Big Four') in the period to 31 March 2005. The AIU's second annual report was based on its work on the second year inspections at the Big Four and first year inspections at five 'Other Significant' firms.

### Transparency reporting

33. Transparency reporting by major audit firms has a role to play in increasing confidence in the skills and processes of audit firms. First, it can help investors and the potential buyers of audit services to understand the relative strengths of a particular audit firm (there are similarities with the workings of the Combined Code, in that relatively weak or inadequate disclosures by a firm can be seen as adding a risk factor to the use of that firm). Secondly, clear public information regarding, for example, the firm's processes and practices for quality control, for ensuring independence, for partner remuneration, and on its governance and network arrangements, provide an incentive to all within the audit firm to live up to both the spirit and the letter of what the firm promises.
34. Until a few years ago most audit firms published very limited information about themselves. Two factors changed this, at least for the largest firms:
  - Following the Limited Liability Partnerships Act 2000, most of the largest firms have adopted or are adopting the LLP form, which requires accounts and reports much as for a limited liability company; and
  - The CGAA concluded that there was a legitimate public interest in the public availability of information on those firms which audit public interest entities<sup>42</sup>.
35. In response, 13 of the 20 largest audit firms gave a voluntary undertaking to meet the proposals from the Government for transparency reporting. Most major audit firms now incorporate "transparency" information as part of their Annual Report and Accounts prepared as an LLP. However, they tend not to

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42 Final Report of the Coordinating Group on Audit and Accounting Issues, 29 January 2003.

identify specific information separately as a “transparency report”. In many cases the information is couched in terms that are too general to enable readers to distinguish one audit firm from another.

36. The requirement that audit firms should disclose such information is now reflected in the new 8<sup>th</sup> Company Law Directive (2006/43/EC).



## THE PROVISIONS OF THE COMPANIES ACT 2006 THAT AFFECT AUDIT QUALITY

1. The Companies Act 2006 contains a number of amendments to the current law that have the potential to affect audit quality. A number of these are referred to in this Discussion Paper and this Appendix provides a more detailed description of the proposed reforms.

### Changes in UK law to support the introduction of IFRSs

2. During 2005 a concern was raised by some investors that changes to company law to support the introduction of IFRSs seemed to inadvertently weaken audit quality. These concerns arose from changes to the Companies Act 1985 which included a new requirement for the auditor's report to identify the financial reporting framework applied in the preparation of the financial statements. Some asserted that the strength of the requirement for auditors to conclude on whether the financial statements presented a 'true and fair' view was being diluted by changing the reference to 'true and fair view, in accordance with the relevant financial reporting framework'. In the UK the relevant financial reporting framework would be either 'IFRSs as adopted by the European Union' or 'United Kingdom Generally Accepted Accounting Practice'.
3. To alleviate such a concern, the DTI had issued the following guidance:
 

*'The requirement that an audit opinion states whether the annual or consolidated accounts give a true and fair view in accordance with the relevant financial reporting framework clarifies the context in which the audit opinion was given, it does not represent a restriction of the scope of that opinion.'*
4. There was also a concern that where IFRSs were being adopted, the responsibilities of company directors were being changed because IFRSs require management to prepare financial statements that 'present fairly' the financial position, performance and cash flows of the company, rather than the traditional 'true and fair view'<sup>43</sup>.
5. In August 2005, the FRC published its analysis of the implications of recent changes in the accounting framework on the 'true and fair' concept. The FRC analysis concluded that, although there would be changes to the format and content of both company accounts and audit reports:
  - The concept of the 'true and fair view' remains a cornerstone of financial reporting and auditing in the UK;
  - There would be no substantive change in the objectives of an audit and the nature of auditors' responsibilities; and
  - The need for professional judgement remains central to the work of preparers of accounts and auditors in the UK.
6. Notwithstanding this, the Government has accepted that more should be done to ensure that the new legislation does not dilute the pre-existing responsibilities of either directors or auditors. The Companies Act 2006 requires that:

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<sup>43</sup> This concern existed despite the new Section 262(2A) of the Companies Act 1985 stating that the terms "present fairly" and "true and fair view" should be read as having the same meaning.

- The directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit and loss of the company. If annual accounts are approved that do not comply with the requirements of the Act, every director who knew they did not comply, or was reckless as to whether they complied, and failed to take reasonable steps to secure compliance or prevent the accounts being approved commits an offence and is liable to a fine;
- The auditors of a company must have regard to the directors' duty described above; and
- The auditors' report should separate out the three elements that are now required, namely whether the financial statements:
  - give a true and fair view of the assets, liabilities, financial position, and profit and loss of the company;
  - have been prepared in accordance with the relevant financial reporting framework (and where applicable Article 4 of the IAS Regulation); and
  - have been properly prepared in accordance with the requirements of the Act.

### Accounting records

7. Under section 221, Companies Act 1985, companies are required to maintain accounting records that are capable of enabling accounts to be prepared for the company and to enable the directors to determine the company's financial position from time to time. Auditors are required (section 237) to carry out such investigations as will enable them to form an opinion as to whether a company maintains 'proper' accounting records, and to report if they are of the opinion that the company does not do so.
8. Some commentators argue that auditors have not properly understood the ambit of these requirements and their importance to shareholders. They believe that auditors construe the legislation too narrowly, relating the test only to financial reporting considerations without regard to wider business considerations.
9. The Companies Act 2006 contains sections that restate these legislative provisions in slightly different language. Companies will be required to maintain 'adequate' accounting records and auditors will be required to report the fact if they are of the opinion that such adequate accounting records are not maintained.
10. The APB intends to review those standards and guidance that relate to this requirement to ensure that the auditor's responsibilities are clearly addressed.

### Other changes to UK company law.

11. The Companies Act 2006 includes a number of changes that may impact audit quality. Changes that are worthy of note are as follows:
  - The ability of audit firms to limit their liability. Under the Companies Act 2006 a liability limitation agreement between a public company and its auditor may be authorised by the company passing a resolution in general meeting approving the agreement or the principal terms of it. The liability limitation agreement is not effective to limit the auditor's liability to less than such amount as is fair and reasonable in all the circumstances of the case.

- Establishing a criminal offence where a misleading audit report is issued. Under the Companies Act 2006 an auditor commits an offence if he knowingly or recklessly causes an auditor's report on a company's accounts to include any matter that is misleading, false or deceptive in a material particular<sup>44</sup>.
- Increasing the transparency of the audit process by:
  - requiring the name of individual partners signing audit reports to be identified;
  - increasing the quality of information available regarding auditor resignations; and
  - requiring companies to publish on their website matters relating to the audit that members propose to raise at the next accounts meeting of the company.

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44 A person guilty of such an offence will be liable to a fine on conviction or indictment.



## RESEARCHING AUDIT QUALITY

### Introduction

1. This appendix contains a brief overview of some research approaches that have been used to investigate audit quality issues. The discussion concentrates on a small number of areas that are key to the audit quality debate - for example, whether quality considerations can be inferred from visible market choices and whether there is a link between regulation and quality. Although reference is made to some general findings, this appendix does not set out to review or summarise all existing research nor to demonstrate what is good or bad quality research. Rather the emphasis is placed on how research can inform thinking about the nature of audit quality; this could contribute to consideration of potential additional future research.
2. The most common definition of audit quality applied in academic research is:
 

*“the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach”* <sup>45</sup>.

This definition focuses on whether an appropriate opinion is given on the financial statements involved and is concerned with the risk that an auditor will give an unqualified audit opinion when this is not warranted. It incorporates the two primary dimensions of technical competence (discovery of any misstatement) and independence (willingness to report such misstatements once discovered) of the auditor. Under this approach, higher quality auditing involves a higher probability of detection and reporting of unadjusted misstatements.
3. The technical competence and independence of the auditor *in fact* can be referred to as the “monitoring strength” of the audit<sup>46</sup>, but the reference in the definition to “market-assessed...probability” draws attention to the importance of the market’s perception of the technical competence and independence of the auditor - auditor reputation. While over time the monitoring strength of an audit firm should be reflected in its reputation, the two attributes may not be consistent in the case of any individual audit. Thus it is possible that a firm with a reputation for high quality auditing may not deliver an audit with a high level of monitoring strength on a specific engagement. Indeed, this is the problem that is often reflected in the major cases of alleged audit failure when high reputation firms are associated with an individual set of deficient financial statements.
4. Because of the difficulty of observing and measuring directly the monitoring strength aspect of audit quality in practice, research studies have often focussed on auditor reputation as a surrogate indicator. This has normally been based on comparison between the top tier (Big 4-8) and other firms, and assumes that larger firms have valid reputations for higher quality audits.
5. The discussion below is organised around a number of linkages that have motivated research on audit quality. However, two caveats should be noted:

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45 DeAngelo, L., (1981) “Auditor size and auditor quality”, *Journal of Accounting and Economics*, December, pp.183-199.

46 Watkins et al (2004) *op cit*.

- First, much of the research in this area has been conducted in North America and its applicability in the environment of the UK cannot be assumed.
- Secondly, the focus is on whether an appropriate opinion was given on the financial statements as the indicator of suitable quality auditing which may be considered a measure of minimum quality only. Other dimensions that could be considered such as the role of the audit in enhancing the governance of an enterprise or its control systems are not considered below.

## Investigating audit quality

### *The link with market demand for audit quality*

6. Several studies have investigated the extent to which the market for audit services acts as a driver for audit quality, and specifically in what circumstances the market demands higher quality auditing. The most common research approach has been to investigate whether particular types of client or circumstance<sup>47</sup> are associated with the demand for auditors with a reputation for higher quality. If a higher quality audit will improve the credibility of the financial information being disclosed, then companies may be willing to pay for a brand name auditor to signal higher quality information.
7. While some studies have indeed identified a differentiated demand for higher quality auditors, overall results are mixed. A significant difficulty with this kind of research is that it demonstrates demand for auditors with quality reputations (normally measured by comparing the top tier firms with other firms) but does not measure the actual monitoring strength applied. Due to the unobservability problem, it remains an assumption that firms with higher quality reputations deliver higher quality audits<sup>48</sup>.

### *The link between actions by audit firms and differences in audit quality*

8. The corollary to looking at the demand for audit quality is to investigate the extent to which the actions of audit firms themselves act as drivers for the supply of audit quality into the market.
9. The largest volume of research in this area is based on investigation into audit fees which are used as a surrogate for audit effort. For example, one way in which auditors can protect themselves against higher risks is to engage in a higher volume of audit work and to increase fees accordingly in order to maintain high quality. Conversely there has also been concern that in the case of low fees, possibly as a result of 'low-balling' in order to acquire a new audit client, the quality of audit will suffer.
10. While overall there is some evidence that audit firms with higher quality reputations (top tier firms) may undertake more work and charge higher fees in certain circumstances, these findings have not proved to be very stable between different environments, different data sets and different time periods

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47 For example where there may be higher risks associated with reported financial numbers or where there is a high level of potential conflict in the agency relationship between management and investors.

48 Examples of studies looking at the demand for differential audit quality are: Francis, J.R. and E.R. Wilson (1984) "Auditor changes: A joint test of theories relating to agency costs and auditor differentiation", *The Accounting Review*, Vol. 63, October, pp.663-682; Clarkson, P.M. and D.A. Simunic (1994) "The association between audit quality, retained ownership and firm specific risk in U.S. vs Canadian IPO markets", *Journal of Accounting and Economics*, Vol.17, pp.207-228.

and it remains uncertain whether any higher fees reflect higher underlying audit quality or the market power of the major suppliers of audit services<sup>49</sup>.

11. The extent to which the methodology and evidence processes followed by the audit firm influence the quality of audit supplied is an area where very little systematic research exists. High quality auditing should be associated with high quality methods, processes and quality control procedures, and high quality auditors are likely to invest in the development of methods that reduce the risk of conducting low quality audits. There has been only limited research into the link between what methods auditors actually use and audit quality. For example, one survey study has reported evidence that, faced with difficult technical choices, auditors will favour a compliance approach rather than apply higher standards of reporting<sup>50</sup>.
12. An additional mechanism by which audit firms may be able to identify their quality status is through establishing industry specialisation. An auditor with more specialist industry expertise is likely to be perceived to deliver higher quality audits, and the evidence does tend to support the relevance of expertise as a quality signal.

#### ***The link with factors that can threaten audit quality***

13. A related area of investigation into the behaviour of individual auditors within firms has been the extent to which deliberate “quality threatening behaviours” (such as reducing audit work to meet budget pressure) are found in practice. While evidence that such behaviour does take place has been reported from members of audit teams, this has been survey based and so captures beliefs, often regarding the behaviour of others, rather than evidence from actual audit engagements. Consequently, making any link to the consequences of such behaviour for the level of audit quality ultimately achieved in practice and the quality of financial information reported is much more difficult to establish<sup>51</sup>.
14. The incidence of behaviour that could jeopardise audit quality and the related actions taken by audit firms to prevent such behaviour and incentivise high quality auditing in part reflect the culture, values and leadership of the firm. These factors as potential drivers of quality, and their impact on practice and behaviour of individual audit engagements have not been subject to systematic evaluation or research and remain important matters for consideration in the current environment.
15. An additional source of evidence about what factors undermine audit quality can be obtained from investigation of the circumstances that have occurred in real cases of alleged audit failure<sup>52</sup>. Within the UK, the reports that result from Department of Trade Investigations have been one source of information about problems in such cases. In contrast to the research approaches mentioned above, the principal difficulty with this type of evidence is the specifics of the

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49 Palmrose, Z. (1986) “Audit fees and auditor size”, *Journal of Accounting Research*, Vol.24:1, pp.97-110 is one example of a study showing a link between reputation and audit fees.

50 Martens, S.C. and J.E. McEnroe (1992) “Substance over form in auditing and the auditor’s position of public trust”, *Critical Perspectives on Accounting*, Vol.3, pp.389-401.

51 For an example of a recent study in this area, see Pierce, B and B Sweeny (2006) “Perceived Adverse Consequences of Quality Threatening Behaviour in Audit Firms”, *International Journal of Auditing*, Vol.10:1, March.

52 For examples of discussion of some cases in recent years see: Gwilliam, D. R. (2003). *Audit Methodology, Risk Management and Non-Audit services: What can we Learn from the Recent Past and what Lies Ahead?*, Briefing 05:03, London: Centre for Business Performance, Institute of Chartered Accountants in England and Wales; Morrison, M. A. (2004) “Rush to judgement: the lynching of Arthur Andersen & Co.”, *Critical Perspectives on Accounting*, Vol. 15 No. 3, pp. 335-375.

context in which problems may have arisen are not necessarily applicable to other organisations.

16. A developing body of research has examined whether the market relationship between an audit firm and a client company can create threats to audit quality. Specifically, this work has investigated whether the joint provision of audit and non-audit services is associated with observable differences in auditor behaviour which could indicate that quality is undermined, such as the auditor's willingness to issue a modified audit report and the extent of discretionary choices evident in the financial statement numbers that have been accepted by the auditor. While potentially this is an important line of research for policy decisions about the constraints that should be placed on auditor-company relationships, there is as yet little evidence based on the position in the UK.<sup>53</sup>

#### ***The link between auditor liability and audit quality***

17. With respect to auditor liability, two sets of arguments have been advanced. First, it can be reasoned that in the presence of higher liability associated with litigation, high quality auditors will be less willing to accept more risky clients because of the greater threat to reputation in the event of a problem. If this occurs then those risky clients will be audited by auditors with less reputation at stake and this may mean that a lower quality of audit service is delivered to the market. Conversely, it can also be argued that the threat of litigation provides a powerful incentive for auditors to ensure that those audit engagements that they do undertake are executed to appropriate quality. For example some evidence has been reported that following a relaxation in the liability regime in the United States to proportional liability, higher reputation firms accepted a greater level of accounting choices that had the effect of increasing clients' reported income<sup>54</sup>.

#### ***The link between regulation and audit quality***

18. A further source of potential drivers for audit quality is the legal and regulatory environment within which the audit is conducted. This includes the regulatory regime that applies for deficient auditing, as well as the impact of standards that apply to auditors and systems of inspection. While standards and codes make an important contribution, these tend to codify minimum standards and it is more difficult to articulate how standards can promote or motivate high quality above the standardised minimum. There can be debate, therefore, as to whether regulation promotes high quality, through raising standards, or limits quality by encouraging a compliance only mentality.
19. The link between standards, related schemes for inspection and monitoring of compliance and audit quality is an area that has not yet been subject to evidence based examination to any significant extent. There are considerable issues regarding the extent to which standards codify existing good practice or lead the development of practice, the problem that standards primarily establish only minimum levels of quality and the fact that they are likely to have differential impact on different types of supplier. Thus the impact of standards is likely to be greatest on smaller firms rather than the large firms with international reputations. The same may be true for systems of inspection, but there is also the related concern that the need to provide a documented record for

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53 For US evidence, see Larker, D.F. and S.A. Richardson, "Fees paid to Auditors, Accruals, Choices and Corporate Governance", *Journal of Accounting Research*, 42:3, June 2004, 625-658 and Kinney, W.R., Z.V. Palmrose and S. Scholtz, "Auditor Independence, Non-Audit Services and Restatements: Was the US Government Right?", *Journal of Accounting Research*, 42:3, June 2004, 561-588.

54 Lee, H.Y. and V. Mande (2003) "The effect of the private securities litigation reform act of 1995 on accounting discretion of the client management of big 6 and non-big 6 auditors", *Auditing: A Journal of Practice and Theory*, Vol.22:1, pp.93-108.

inspection that is consistent with the requirements of standards can result in a compliance approach to the audit rather than an approach driven by objectives of high quality reporting.

20. A difficulty limiting the potential impact of regulation as a driver for audit quality more generally is the tendency for regulatory measures to be introduced to deal with identified past problems, rather than anticipated future risks.

#### ***The link between audit quality and other aspects of corporate governance***

21. A major emerging area which requires more understanding concerns the interaction between auditing and other elements of the governance system intended to contribute to high quality financial reporting, most notably the role of the audit committee. As the responsibilities of audit committees with respect to matters such as the appointment of the auditor have grown, it is relevant to consider what attributes audit committee members equate with high quality auditing. There is the potential for a virtuous circle in which different parts of the governance structure reinforce one another. A more independent audit committee can be expected to recommend a higher quality audit, the results of which should lead to better information for use in the market.

#### ***The link between audit quality and the quality of financial information***

22. The product of the quality of the audit can be related to the quality of the financial information contained in the eventual financial statements. The monitoring strength of the audit is relevant to the quality of financial information produced, but the reputation of the auditor is also important in that this affects the credibility of the information. Thus higher quality auditing should result both in financial information that is a more appropriate reflection of the economic activities of the company and more credible information.
23. The links between signals of differential audit quality (normally the size and standing of the audit firm) and a number of financial reporting variables have been investigated. These include the likelihood that a modified audit opinion will be attached to the financial statements (for example for financially distressed companies), the subsequent identification of problems with the numbers disclosed, through actions by bodies such as the Financial Reporting Review Panel, and the apparent presence in the financial statements of reporting choices that could be associated with earnings management.
24. Generally it has been found that the manner in which the market reacts to financial statement information is influenced by the reputation of the auditor (again tested through the comparison of top-tier audit firms with other firms)<sup>55</sup>. This suggests that the reputation dimensions of audit quality do influence users' confidence in the financial statements.

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55 Krishnan, G. (2003) "Audit quality and the pricing of discretionary accruals", *Auditing: A Journal of Practice and Theory*, Vol.22:1, pp.109-126.



### AUDIT RESOURCES WITHIN MAJOR FIRMS AT 31 DECEMBER 2005

		%
Partners with more than 10 years experience as partner	386	
Partners with less than 10 years experience as partner	500	
Total partners	886	5.8
Directors	450	2.9
Managers	3,507	22.8
Assistant Managers/other qualified staff with greater than 3 years experience	3,651	23.7
Students with less than 3 years but greater than 2 years experience	1,563	10.1
Students with less than 2 years but greater than 1 year's experience	2,618	17.0
Students with less than 1 year's experience	2,732	17.7
<b>Total</b>	<b>15,407</b>	<b>100</b>

#### Notes

1. The staff numbers summarised above were provided by the four largest firms and three of the next tier of seven other significant audit firms. If the numbers involved in audit in the three other significant audit firms are extended to the other four firms in this tier the total number of auditors would be increased by about 2000.
2. 'Experience' categories were provided by the FRC and do not necessarily correspond to the way individual firms categorise partners and staff for internal purposes.
3. The numbers provided include only 'mainstream' audit and therefore exclude staff who are not wholly involved in the audit function such as tax and information technology specialists.
4. One firm has not split the number of audit partners between more than / less than 10 years experience. For the purpose of this analysis these partners have been allocated 44% : 56% based on the split within the other firms.



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