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The drivers of audit quality

Paper prepared for the Audit Committee Chair Forum

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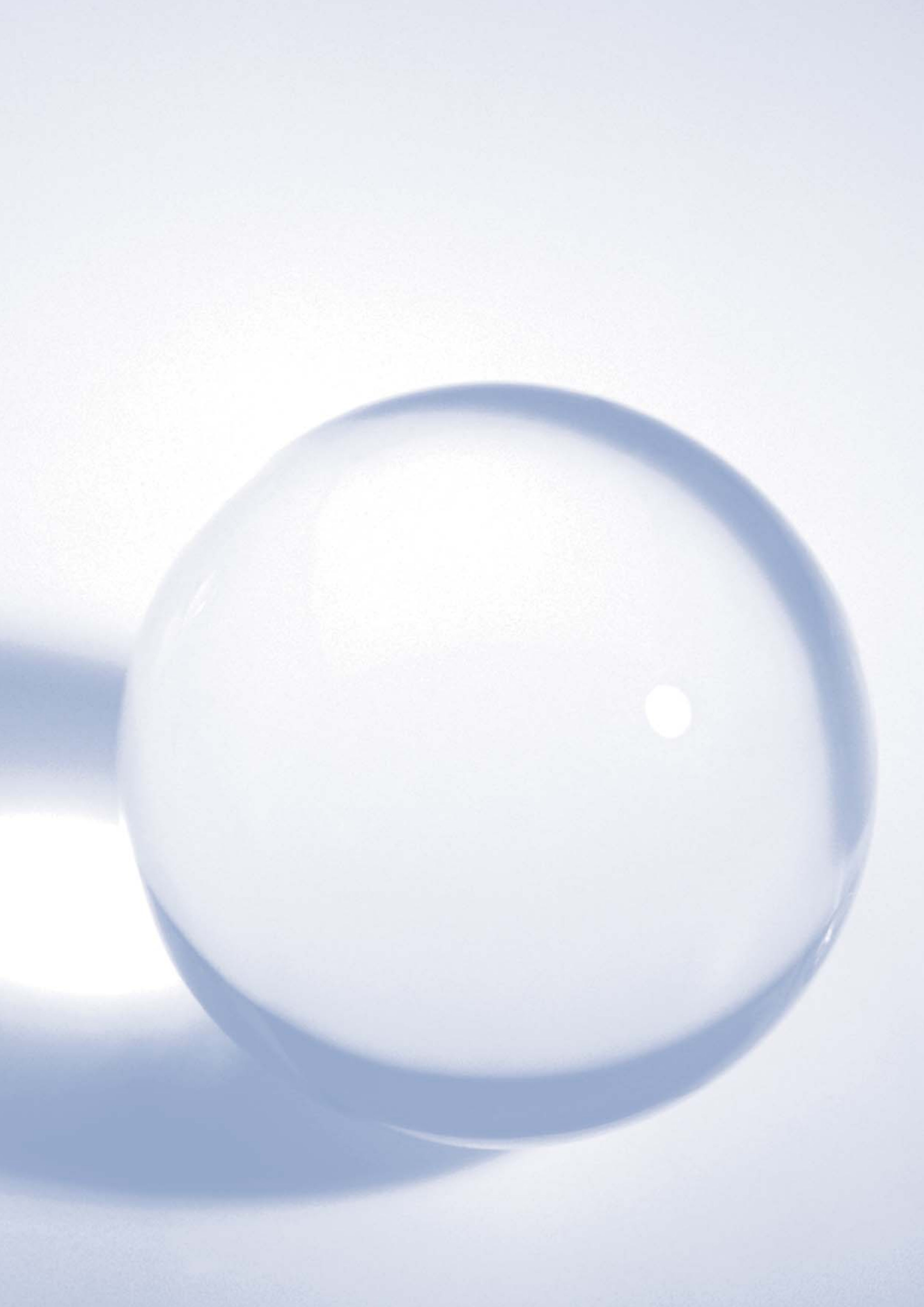
Executive summary

- The Financial Reporting Council is charged, through the Audit Inspection Unit, with monitoring audit quality. However, ‘audit quality’ is intangible, with no agreed definition.
- Although the ACCF meeting came to no unequivocal resolution, it was agreed that an overiding aspect of audit quality was the quality of the individuals conducting the audit, at all levels of the audit team. It related to their understanding of the business, their objectivity and scepticism, and their ethical stance and the culture of the audit firm.
- Assessing audit quality is just as difficult as defining it. Members of the audit committee, as independent non-executives at a remove from the business, are less able to do this than are the company’s executives. Thus the audit committee needs to rely in part on management in its evaluation of the auditors.



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Introduction

This paper reflects the discussions of a meeting of the Audit Committee Chair Forum (ACCF) held on 20th July 2006 regarding the drivers of audit quality. The meeting was addressed by representatives of the Financial Reporting Council (FRC) and its Audit Inspection Unit (AIU). The purpose of the meeting was to solicit members' views on the drivers of audit quality, to inform an FRC project and paper in this area.

The discussion related in part to a slide presented by the FRC entitled 'Drivers of Audit Quality'. This is included as Appendix 1 to this report. The questions posed by the FRC (not all of which were fully addressed during the wide-ranging discussion) were as follows:

- How do your audit committees evaluate audit effectiveness?
- Which of the drivers do you consider to be the most important?
- What do you consider are the greatest threats to audit quality?

The Financial Reporting Council

The Financial Reporting Council (FRC) is the UK's independent regulator for corporate reporting and governance[1]. Its aim is to promote confidence in corporate reporting and governance. Its six objectives are:

- high quality corporate reporting
- high quality auditing
- high quality actuarial practice
- high standards of corporate governance
- the integrity, competence and transparency of the accountancy and actuarial professions
- effectiveness as a unified independent regulator.

In relation to auditing and financial reporting, the functions exercised by the FRC include setting, monitoring and enforcing accounting and auditing standards, and statutory oversight and regulation of auditors. Of relevance to this paper, it is the oversight body for the following:

- Accounting Standards Board (ASB)
- Auditing Practices Board (APB)
- Professional Oversight Board (POB)
- Financial Reporting Review Panel (FRRP)

The roles of the Auditing Practices Board and the Professional Oversight Board are particularly relevant to this discussion. The Audit Inspection Unit (AIU), which, inter alia, monitors the quality of audits for listed companies, is a part of the POB. Terms of reference for these Boards are set out at Appendices 2 and 3.

It was in connection with these activities that the FRC was seeking input from members of the ACCF regarding audit quality.

[1] Narrative in this section is taken largely from http://www.frc.org.uk/about/

The FRC presentation

> *"Regulators are looking for something against which to judge performance."*

> *"Mere compliance with the standards does not, and cannot ensure that a high quality audit will be performed."*

The FRC presentation included a background on the development of auditing bodies and auditing standards in the UK. Continued changes in regulations (e.g. the Company Law Reform Bill, the EU 8th Directive, the Combined Code and the introduction of International Financial Reporting Standards (IFRS) to name but a few) mean that companies are being pulled in many directions, and that different stakeholders have different meanings of 'audit quality'. Given that it is the role of the AIU to monitor and promote improvements in audit quality, determining a suitable definition is critical.

The FRC also believes that although auditing standards and inspection are an important part of the framework by which audit quality is achieved, they are insufficient by themselves to ensure audit quality.

A slide was presented (Appendix 1) that set out the FRC's view of the drivers of audit quality. This diagram formed the basis for much of the discussion that followed.

The aim of the audit

> *"There's no legal doubt on what the audit is for. There is Public doubt on what the audit is for. And investors' views differ from management's."*

In order to evaluate audit effectiveness and audit quality, it is necessary to understand the aim of the audit. Interestingly, not all of the ACCF members were in agreement as to the aim of the audit, with a discussion taking place about the stewardship function of financial statements and whether audit had a role outside that. However, audit is a legal requirement.

It was further agreed that there is an expectations gap, in that the sophisticated investor understands audit limitations, but the man in the street probably has a higher expectation of what the auditor does. One reason that there is trouble defining audit quality is that stakeholders of different types have different priorities and expectations of the audit.

> *"The construct is that the auditor is engaged by the people who are paying [i.e. the management]; answerable to the non-executives; reporting to the shareholders. It's difficult to explain how you've done a good audit!"*

A further issue raised regarding audit effectiveness and quality was the fact that, with the introduction of IFRS, financial statements have become over-long and over-complicated. As one participant stated, *"Only the cognoscenti can conceivably get any value from them."* It was suggested that stakeholders can be distracted from the fundamentals of the business by these statements.

What is audit effectiveness?

> *"Assessment of audit effectiveness is a box you tick on the way to reappointment [of the auditors]."*

The FRC questions addressed both audit effectiveness and audit quality. Considerable discussion took place around these topics. It was decided that they were not the same, but that there was a considerable overlap between them. Because of the interest in the subject, audit effectiveness was put on the agenda for a future ACCF meeting.

What is audit quality?

> *"You start with the presumption that the auditor is doing a good job, and appraise to see if there's any sign that it isn't."*

> *"The fact that Enron collapsed and Andersens went bust [sic] did more to improve the quality of audit than anything else."*

As stated earlier, because part of the FRC remit is to monitor audit quality, it is fundamental that they have a clear appreciation of how the term is understood. Accordingly, they are undertaking a project to understand the drivers of, and the potential threats to, audit quality.

The term is used – and misused – in many different ways. To an audit partner, audit quality might be about what his/her audit team is doing; to an institutional investor it could relate to the quality of financial reporting in general, which is much broader. An illustration was used of a paper on 'true and fair' that had been circulated by one of the major investment houses: although this purported to be a discussion on audit quality, it was in fact much broader than that one subject.

The discussion on audit quality was extensive, but two key themes to emerge were the tone and culture of the audit firm, and the practices followed during the audit.

Tone at the top

Auditing is a process rather than a product. The audit reports – management and statutory – are the tangible output, but they do not really show how the audit was done. One fundamental driver of audit quality, agreed by all taking part in the discussion, was the need for the people at the top of audit firm to set an appropriate tone and culture, to ensure that the work was carried out conscientiously, ethically, and in line with all appropriate standards and guidelines. Employing and training quality people is a pre-requisite, as is setting an appropriate reward structure.

As an example of an inappropriate culture, Andersens in the USA was mentioned, with its drive towards doubling non-audit revenues from audit clients, and the problems that arose from that[2].

In its investigations into audit quality the AIU focuses particularly on the nature of communications throughout a firm, and how much attention is paid to the views of technical partners, etc. They believe that the firm culture and the tone at the top are fundamental to audit quality.

Auditing practices and practicalities

> *"The bigger the firm, the better and more sophisticated the people tend to be."*

The nature of the audit market in the UK is that 99% of FTSE 100 audits and 97% of FTSE 250 audits are carried out by the Big Four audit firms[3]. Many commentators, and some of the participants at the meeting, believe that this is an insufficient number of suppliers. The audit committee chairs noted that to some extent this concentration on the Big Four is a branding issue, but it also reflects the international capability of these firms, and the fact that it is advantageous to have one audit firm covering all territories, to avoid the "opportunity for mischief". They did note that such international coverage is a capability of the firms, rather than an indicator of quality.

Nonetheless, the general view at the meeting was that the quality of staff and partners, in general, would be higher at the Big Four firms than at others, because more talented people would gravitate to those firms. This is perceived as being an indicator of quality[4].

A question was raised as to how feasible it was, even with a Big Four auditor, to have quality audit staff working for each client. This is a resourcing issue. Most listed companies have financial reporting periods ending on 31st December and 31st March; this means that there is a peak time for audit staff, when there will be no spare capacity, and this must be balanced with slack periods at other times. This being the case, how practical is it to expect top quality people on all of the audits in this busy period?

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2 For detail, see: Arthur Andersen's Fall From Grace Is a Sad Tale of Greed and Miscues, by Brown and Dugan, Wall Street Journal, 7th July 2002.

3 Source: AIU 2005/6 Audit Quality Inspections Public Report, dated July 2006. Downloadable from http://www.frc.org.uk/

4 This does mean that the recruiting practices of the Big Four firms become critical in the evaluation of quality.

Assessing audit quality

"The big word is 'assurance'. You're trying to seek assurance that what's presented is a set of data that has integrity."

The audit committee has to satisfy itself that the numbers and accounts taken as a whole are reasonable, and are the outcome of a process that has integrity.

The view of the meeting was that one major reason that audits could lack quality would be because the auditors failed to understand the business and its industry. Without such knowledge it is impossible to appreciate the business risks, and to plan and conduct an effective audit.

However, understanding the business and industry, whilst necessary, is not sufficient as an indicator of audit quality. It was agreed that the auditor needs to maintain an objective approach to the work, and not be 'captured' by the client. Furthermore, they must have the necessary scepticism to challenge the explanations they are given by management.

One indicator of audit quality lies in reviewing the auditors' planning process; another lies in the questions they ask during the audit.

Related to this, it was suggested that a specific way to consider audit quality might be to examine the time budget for the audit, in particular the time allowed for senior managers and partners, and to evaluate how the actual outcomes related to that budget. However, the committee chairs took the view that such information was not available to them; it was more a detailed management issue.

An important consideration, put forward by many at the ACCF meeting, related to behavioural matters. Auditing, particularly in the light of IFRS, is about making judgement calls, and the audit committee needs to understand what judgements have been made. Some of this comes from appraising the entirety of what is said – and, perhaps, what is not said – by management and the auditors about the financial statements and the auditing process. Having asked the questions of the auditors, the committee must assess the ease and clarity of their answers.

"Given the standards we are operating with, how thoroughly and rigorously have they been applied? What judgements have been made? How transparent have these judgements been? That's the area I have the most doubt over."

Can the audit committee truly judge audit quality?

> *"People often don't realise just how impossible the role of the NED is … it does come down to making judgements about what you're hearing people saying. That's terribly unscientific."*

Corporate governance regulations demand that the members of the audit committee are independent non-executive directors (NED). Whilst there are very good reasons for this, it does, by definition, mean that the audit committee is one stage removed from the business. Their very independence means that they do not have the knowledge and background that inform judgement, and they will not be au fait with the detail of the business. A view consistently expressed in the meeting was that this makes it difficult for the committee to judge directly the quality of the audit.

For example, the view was that it would be difficult for the audit committee chair or members to assess, without advice and input from the company's management, the drivers in the middle column of the diagram in Appendix 1[5].

As a result of this, the committee is very much influenced by management's view of the quality of the audit. It is management to whom the detailed audit questions are addressed, and who can assess whether the questioners have understood the business. The level of audit questioning is an indicator of audit quality, at both the senior and junior levels of the audit hierarchy. Again, the committee chairs pointed out that they and the audit committees never get to see the more junior audit staff, although these individuals are the people who do much of the detailed work, and who can affect audit quality. Thus management is far more capable of assessing audit quality than is the audit committee: *"Management tells you if the auditors don't understand it!"*

Of course, using management as a guide to the quality of the audit does, as the ACCF meeting acknowledged, have an element of circular logic: in order to establish confidence in information provided by management, the audit committee relies on the work of the auditors; and to understand the work of the auditors, it relies on management.

> *"We are always asking for managers' input. That is not healthy if the primary purpose of the audit is to provide a check on management."*

5 It was also generally felt that merely meeting the requirements on this slide would not in itself guarantee audit quality

The audit committee members do see the senior audit staff, who make presentations and answer questions about the audit. However, a very pertinent question was raised as to how this relates to audit quality:

> *"Does the audit committee assess the quality of the report to the committee instead of the work done to support that report?"*

> *"Are they making judgements about the quality of papers put in front of them and the quality of the answers across the table?"*

By the above quotes, the chairs meant that they are assessing the quality of the audit at one remove, and the quality of papers they see might not actually reflect the quality of audit work done.

One further issue was raised about how the audit committee can assess the quality of the audit, and that related to whether or not there were 'surprises' in the numbers, and changes thereto. Although the ideal was considered to be 'no surprises' it was agreed that one or two were not necessarily a bad thing. However, it was pointed out that the significance of this to audit quality depends on whether it was the auditors who had unearthed the issues – which would imply a quality audit – or whether the management had themselves found the problems.

How does the published audit report indicate quality?

> *"Is the audit report a good output in terms of reporting and demonstrating audit quality?"*

> *"We judge audit quality against a product which has lost a great deal of contact with its original objective and its original value to society."*

The published audit uses a standardised form of wording, which refers to directors' and auditors' legal responsibilities, states generically what an audit is, and confirms that the financial statements comply with relevant standards and laws. The argument put by the FRC representatives was that this output, being indistinguishable between different firms and different audits, is a poor indicator of audit quality.

A further suggestion by the FRC was that because the published output of the auditors is standard, there is no incentive for them to 'raise the bar'.

> *"Audit firms are like high jumpers: they have to get over the bar. But there's no merit in clearing the bar by three foot instead of one inch … there's no external driver for something that is higher quality."*

Various points were raised in response to this view. In particular, the chairs agreed that one did not judge the quality of the audit by the external audit report but by, inter alia, the audit management letters. These are for internal consumption, and do give a much more detailed picture of what the auditors have been doing, and what they have found. The published audit report is just one output of the audit process.

Regulatory issues around audit quality

Two main themes emerged in the discussion on regulatory issues concerning audit quality: the work of the AIU, and the EU's 8th Directive.

AIU reports

As stated earlier, the AIU monitors the quality of audits and audit firms. It focuses on the largest audits and, in its 2005/6 report, the nine largest audit firms. Its published report discusses what was done, and its overall findings and recommendations, but makes no mention of findings as regards individual companies and audit firms. Reports to individual audit firms remain private.

There was discussion at the meeting to the effect that one way to inform audit committees would be for the AIU to publish its detailed conclusions, as this would be an indicator of audit quality. It was appreciated that it might not be appropriate for such information to be available to the general public, but it could help audit committee chairs carry out their own jobs. However, the AIU representative stated that this could be damaging to firms, as his department's reports currently include matters of opinion, rather than solely matters of fact, and firms do not have a right to reply. Generally there was no consensus, at the meeting that the publication of individual reports would improve audit quality. Publishing individual results would inevitably lead to changes in the way that the AIU operates.

8th directive

The EU 8th Directive covers statutory audit. The FRC reported that there is an important issue on the horizon, as to how auditing standards are going to be regulated in Europe. The FRC is devoting a lot of time to trying to ensure that the UK's principles-based approach takes precedence over a more rules-based box-ticking approach.

The chairs at the meeting agreed that it was important that the principles-based approach was adopted, and that the UK was not sucked into adopting a more prescriptive approach. Furthermore, they noted that compliance with the US's Sarbanes-Oxley Act was a consumer of resources and time, and a further thrust from the EU in this direction would be most unhelpful. Additionally, one commented on the problems for the auditor of an increasingly regimented and litigious environment, and the fact that, anecdotally, many good people are leaving the profession or choosing not to join it:

> *"We can double the regulation, but if we don't have the top quality people, we'll get the auditors we deserve."*

Conclusions

The ACCF discussion was lively and wide-ranging, but came to no firm conclusions.

Audit quality is difficult to define, and difficult to assess. A mixture of understanding, objectivity and scepticism is needed, together with relevant technical knowledge. These must be situated within an audit firm that has an open culture and emphasises the ethical responsibilities of the auditor throughout all of its processes.

Audits must be of the appropriate quality, and a company's board has to be able to assess that quality, to determine whether it is getting a 'good' audit. The view of the meeting was that it is difficult for non-executives, at a remove from day-to-day interaction with the audit team, to make such an assessment. Accordingly, the audit committee is reliant on management to inform its view of audit quality, which presents a circular argument, as one of the roles of the auditor is to comment on that self-same management.

Questions to ask yourself

- How does my audit committee define audit quality?
- How do we determine whether a quality audit has been conducted?

And, of course, the three questions posed by the FRC:

- How do your audit committees evaluate audit effectiveness?
- Which of the drivers of audit quality do you consider to be the most important?
- What do you consider are the greatest threats to audit quality?

APPENDIX 1 – Drivers of audit quality

Inputs

Culture
- Corporate governance of firms
- Leadership
- Business Performance
- Engagement decision-making
- Ethics
- Risk Management

Human resources
- Skills base
- Appropriate training
- Performance evaluation

Engagement performance

Adequate Partner Involvement

Quantity & Quality of Audit staff

Rigorous process that encourages sound judgement

Good communication
- Internally
- With Management
- With Audit committee

Quality control procedures
- Consultation
- Independent review
- Monitoring

Outputs

Informative and reliable audit report

Job satisfaction for audit staff

Well-informed management and audit committee

APPENDIX 2 – Terms of reference of the Auditing Practices Board (APB)

Source: http://www.frc.org.uk/apb/about/aims.cfm

Aims & Objectives

Aims

The Auditing Practices Board contributes to the achievement of the Financial Reporting Council's fundamental aim of supporting investor, market and public confidence in the financial and governance stewardship of listed and other entities by pursuing its own aims of setting high quality standards and guidance:

- for the performance of external audit and other activities undertaken by accountants that result in reports or other output that is published, required by law or otherwise relied upon in the operation of the financial markets ('assurance services'); and
- in relation to the independence, objectivity and integrity of external auditors and the providers of assurance services.

Objectives

The Board intends to achieve its aims by

- Establishing Auditing Standards which set out the basic principles and essential procedures with which external auditors in the United Kingdom and the Republic of Ireland are required to comply;
- Issuing guidance on the application of Auditing Standards in particular circumstances and industries and timely guidance on new and emerging issues;
- Establishing Standards and related guidance for accountants providing assurance services;
- Establishing Ethical Standards in relation to the independence, objectivity and integrity of external auditors and those providing assurance services;
- Taking an appropriate role in the development of statutes, regulations and accounting standards which affect the conduct of auditing and assurance services, both domestically and internationally
- Contributing to efforts to advance public understanding of the roles and responsibilities of external auditors and the providers of assurance services including the sponsorship of research.

APPENDIX 3 – Terms of reference of the Professional Oversight Board (POB) and the Audit Inspection Unit (AIU)

Professional Oversight Board

http://www.frc.org.uk/poba/

The Professional Oversight Board contributes to the achievement of the Financial Reporting Council's own fundamental aim of supporting investor, market and public confidence in the financial and governance stewardship of listed and other entities by providing:

- independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies
- monitoring of the quality of the auditing function in relation to economically significant entities
- independent oversight of the regulation of the accountancy profession by the professional accountancy bodies
- independent oversight of the regulation of the actuarial profession by the professional actuarial bodies and promoting high quality actuarial work.

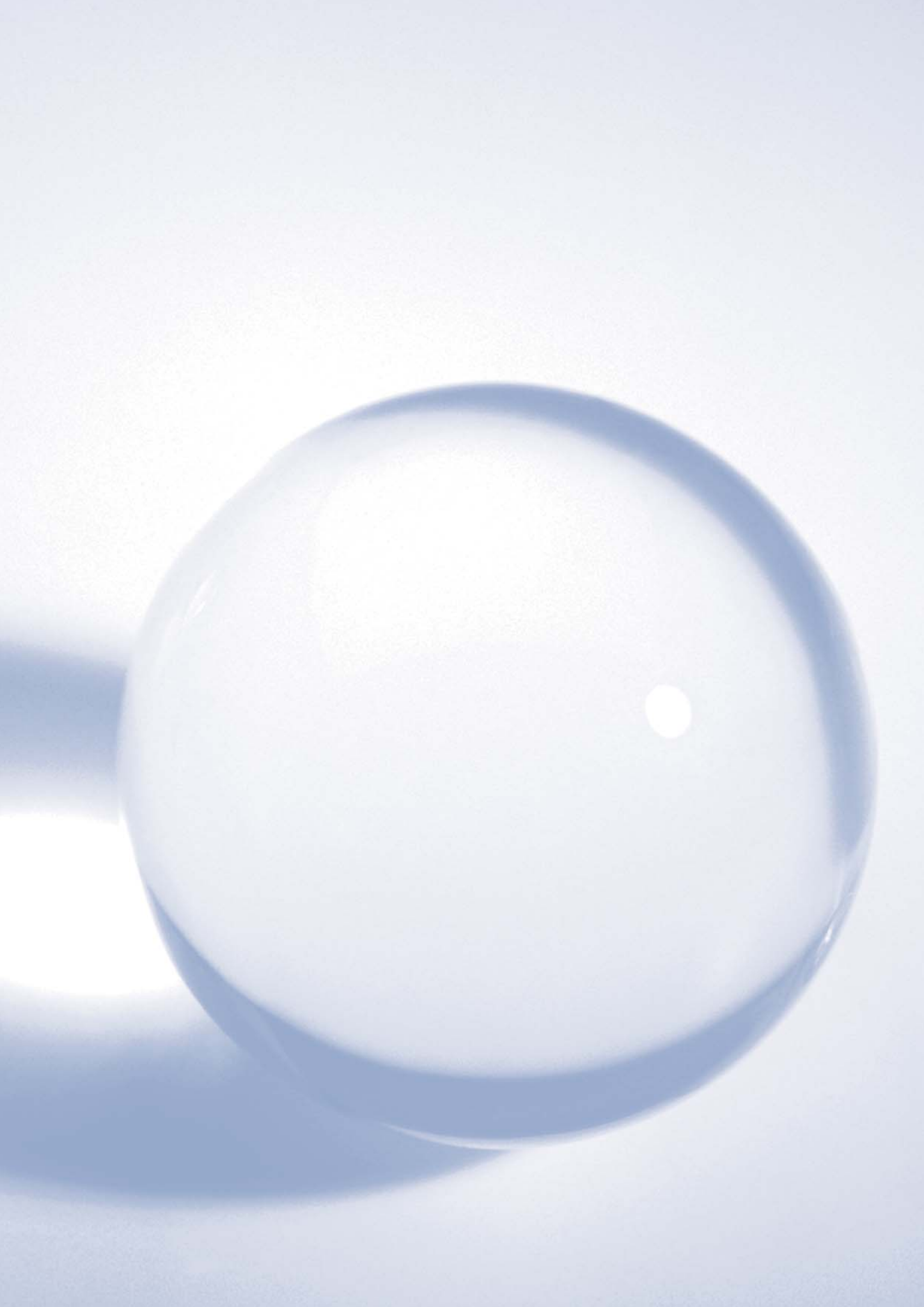
Audit Inspection Unit

http://www.frc.org.uk/poba/press/pub1137.html

The AIU is responsible for the monitoring of the audits of all listed entities and other entities in whose financial condition there is considered to be a major public interest. By monitoring and promoting improvements in audit quality, it contributes to the FRC's overall aim of promoting confidence in UK corporate reporting and governance. The AIU's monitoring approach is intended to be challenging for the firms focusing on audit partners' judgments as well as audit processes.

The first annual report, published in June 2005, covered audit inspections of the Big Four firms and their audits of companies in the FTSE 100 and 250 indices. The second annual report from the AIU covers reviews of audits within their full remit and is based on their work on the second year inspections at the Big Four and first year inspections at five Other Significant firms. …

The AIU's reports are not intended to be balanced scorecards or rating tools. The focus of its work is on those areas where it considers that improvements should be made, either to achieve compliance with relevant standards or to enhance audit quality. This emphasis may result in comments that appear critical or include little mention



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