

## **Audit Quality in Australia – A Brief Overview of Recent Regulatory and Professional Developments**

*The APPC welcomes the opportunity to assist the FRC on the subject of audit quality in Australia*

The Corporations Legislation Amendment (Audit Enhancement) Act 2012 streamlined the auditor independence work of the Australian Securities and Investments Commission (ASIC) and the FRC by removing the existing auditor independence function from the FRC and, in its place, giving the FRC a role of providing the Minister and the professional accounting bodies strategic policy advice and reports in relation to the quality of audits conducted by Australian auditors.

The Australian Auditing and Accounting Public Policy Committee (APPC) shares the FRC's interest in the quality of audits conducted by Australian auditors. This paper is intended to assist the FRC to discharge its revised role in relation to audit quality in Australia, including with respect to the following matters:

- How should audit quality be defined?
- Steps that can be taken to address the “audit expectation gap”; and
- Financial reporting initiatives, including whether there is a role for more forward-looking elements on company prospects and risks.

At the same time, we wish to identify some of the developments that have occurred in recent times that affect these matters, to assist the FRC in its reporting obligations.

### **1. Defining audit quality**

*It is important that audit stakeholders have a broad view of what constitutes audit quality*

ASIC is the key regulator under the Corporations Act and has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act and regulation of registered company auditors (RCAs), including the enforcement of auditor independence and audit quality requirements. One way in which it carries out its oversight obligations of auditors is via audit firm inspections; it also conducts surveillances and projects which cover all RCAs.

ASIC's audit inspection program aims to promote high quality external audits of financial reports of listed and other public interest entities in Australia so that users can have greater confidence in financial reports. ASIC issues audit firms with a confidential inspection report to which the firm responds as to how it will deal with the issues ASIC has identified. ASIC also publishes a public report which sets out key themes and issues it has

identified in its audit inspection program. These public reports are prepared on an aggregated basis across firms and are intended to inform stakeholders of systemic themes and issues with the objective of contributing to better audit quality by influencing all stakeholders in the financial reporting chain.

ASIC's most recent public report for the 18 months to 30 June 2012 covered inspections of 20 Australian audit firms and found that in 18% of the 602 audit areas reviewed the auditor did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated.

Whilst the audit profession shares ASIC's concern with this finding and is working with ASIC to remedy specific areas of concern identified (see below), we also consider that the finding is not necessarily reflective of all matters that influence audit quality, as reflected in current international debate on the issue of audit quality (see below). We believe that it is important that the public and audit stakeholders in particular have a broader view of what constitutes audit quality and believe that the FRC has a key role to play in promoting such understanding.

*Different stakeholders will value elements of the audit process differently*

It is important to understand that an audit is an ongoing process of interaction between the auditor and the audited entity. Further, different audit stakeholders will value certain elements of the audit process differently. As such there are challenges in evaluating the quality of an audit service given that, as a knowledge service, many parts are not directly observable or measurable.

Central to an understanding of what constitutes a quality audit service is an appreciation of the primary objective that auditing serves. This is captured well as follows:

“The ultimate objective of the audit must be quality reporting by the audited entity. The auditor's role is to challenge, probe and encourage management in order that the reporting which the entity produces delivers a fair and reasonable presentation of the entity's performance over the year and its state at the end of the year. The audit report and the audit opinion are a mechanism to enable this to be delivered; they are of great importance in doing so and are the only element of the audit currently visible to the investors which pay for the audit, but they do not represent an end in themselves.”<sup>1</sup>

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<sup>1</sup> Hermes Investment Managers (UK), 2013

*The profession in Australia is monitoring and contributing to international debate on the definition of audit quality*

In spite of the challenges involved in defining audit quality, over the years there have been numerous attempts to do so, including by ASIC and the FRC. A selection of such definitions is included in the Appendix.

The profession in Australia is monitoring and contributing to several current international initiatives that are examining issues relating to audit quality and its definition.

These include the International Auditing and Assurance Standards Board (IAASB)'s consultation paper "A Framework for Audit Quality" which describes the major factors involved in ensuring high quality audits are consistently performed by practitioners. The proposed framework identifies key elements contributing to audit quality:

- Inputs – the audit firm's culture (values, ethics and attitudes), the time, knowledge and skill brought to the audit and the effectiveness of the audit's processes and quality control procedures
- Outputs – recognising that some stakeholders (such as regulators) have the ability to influence outputs while for others (such as investors) outputs (in the form of the auditor's report) are relatively standardised
- Interactions – the nature and quality of the various interactions between involved stakeholders e.g. auditors, management, those charged with governance and regulators during the audit process
- Context – the legislative and regulatory environment within which the audit operates. The impact of the financial reporting framework and corporate governance on financial reporting quality also give context to the audit.

Similarly, the Public Company Accounting Oversight Board (PCAOB) in the United States has produced a discussion paper on Audit Quality Indicators.

The discussion paper defines audit quality as:

"Meeting investors' needs for independent and reliable audits and robust audit committee communications on:

1. Financial statements, including related disclosures;
2. Assurance about internal control; and
3. Going concern warnings.

Significantly, the proposed definition focuses on deliverables and results, rather than process or inputs.

The Center for Audit Quality (CAQ) in the US is also working to develop perspectives regarding components of an audit quality definition. In its 13 May 2013 response to the PCAOB discussion paper on Audit Quality Indicators, the CAQ notes the challenge involved in defining audit quality but supports the effort to do so as a means of providing a better understanding of what audit quality means. The CAQ proposes that two overarching concepts should be considered when considering the definition of quality:

1. Process-driven (system or input-based) quality, which is the degree of compliance of a process or its outcome with a predetermined set of criteria.
2. Outcome-based (output based) quality, which is the level of perceived value reported by the person who benefits from a process or its outcome.

The CAQ considers that these two notions of quality are reflective of the existence of multiple stakeholders, each with potential different viewpoints regarding quality. Accordingly, the CAQ considers that an effective definition of audit quality should recognise the importance of both the quality of outcomes, as well as the quality of supporting processes to deliver those outcomes.

*The APPC agrees that both input and output factors are important in defining audit quality*

Similar to the CAQ, the APPC takes the position that audit quality is about reaching the right audit opinion and about how that opinion is reached. Input and output factors are both important.

The audit profession in Australia will continue to monitor debate on these issues. The APPC considers that there may be opportunities for the profession and the FRC to work co-operatively to consider issues relating to outcome-based quality, including exploring the views of the director and investor communities on this issue.

Many drivers of audit quality are within the direct control of audit firms, their engagement partners and their teams. However, a number are external drivers, outside the direct control of the auditor, such as the general legal and standards setting environment; the educational environment; the financial reporting framework and standards of corporate governance.

It is therefore important that the profession work with regulators, legislators, standard setters and educators to determine how audit quality drivers outside its direct control can be managed and influenced to have a positive effect on audit quality.

This should include working with the FRC to investigate initiatives that could influence external drivers of audit quality, at the same time as the audit profession continues to enhance the internal drivers within its control. This concept of collaboration is explored further in section 2 below.

## 2. Bridging the audit expectation gap

*Bridging the audit expectations gap is a shared responsibility*

The audit expectation gap broadly refers to the difference between what the public and other financial statement users perceive auditors' responsibilities to be and what an auditor's actual responsibilities entail. Auditors' responsibilities in relation to the detection of fraud and in relation to the going concern concept are two areas commonly associated with the existence of an expectations gap.

Whilst there has been much research undertaken over the years on the audit expectations gap, there is still widespread misunderstanding of the respective roles and responsibilities of auditors and those charged with governance of a company. Unfortunately this most often occurs in the event of company failure, when inevitably it is presumed that auditor failure must also have occurred.

There is a need to do further research work on this subject, in particular in relation to the role to be played by those charged with governance that are in a position to influence the quality and integrity of financial reporting, as well as on how to raise awareness within the investor community.

Bridging the expectations gap requires acknowledgment that the task is a shared responsibility on the part of auditors, those charged with governance, regulators, standard setters, legislators and investors.

## 3. Financial reporting initiatives

*The APPC supports further discussions with stakeholders on whether company reports should include more forward looking statements, whilst noting the international initiatives underway*

One matter that warrants further consideration is whether there is a role for a more forward-looking element in company reports, for example regarding broad company prospects and risks. Whilst such an initiative should ideally follow international precedent and be led by those responsible for preparing entities' financial statements, there could be significant time delays in any reporting initiatives at the international level. Also, as noted above, even though companies fail for a variety of reasons, too often when a company fails there is a presumption that audit failure is also involved.

*The IAASB is consulting on proposals to enhance auditor reporting globally*

In relation to matters more directly relating to the role of auditors, in July 2013 the IAASB released an exposure draft seeking views from stakeholders in relation to the IAASB's proposals to enhance auditor reporting globally. The proposals respond to calls from investors, analysts, and other users of audited financial statements in the wake of the global financial crisis for the auditor to provide more relevant information in the auditor's report. This exposure draft includes proposed new ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, and a number of proposed revised ISAs, including revisions to ISA 700, *Forming an Opinion and Reporting on Financial Statements*.

In late 2012 the IAASB issued an exposure draft seeking views from stakeholders in relation to proposed International Standard on Auditing (ISA) 720 (Revised), *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*. The proposals extend the scope of the extant standard and the auditor's responsibilities and include suggested auditor reporting responsibilities. The IAASB continues to pursue auditor reporting on other information and intends to finalise related elements of proposed ISA 700 (Revised) when the revision of ISA 720 is completed.

The profession in Australia is contributing to consultation on all these matters.

#### **4. Other developments impacting audit in Australia**

*Recent regulatory and self-regulatory initiatives should further enhance the already high standard of audit quality in Australia*

A number of changes were made to ASIC's audit regulation powers in 2012 via the Corporations Legislation Amendment (Audit Enhancement) Act 2012. The Act implements a number of recommendations made by Treasury following its consultation report entitled *Audit Quality in Australia – A Strategic Review*. Treasury's report concluded that Australia's audit regulation framework is robust and stable, that the framework is in line with international best practice and that no fundamental changes to the framework are required.

Key changes to ASIC's audit regulation powers introduced by the Act in 2012 are as follows:

- Introduction of annual transparency reports: the Act introduced a requirement for the publication of an annual transparency report by firms conducting audits of ten or more Australian entities of the following categories – listed companies, listed registered schemes, authorised deposit-taking institutions and insurance companies.
- Auditor independence functions: the Act streamlines the auditor independence work of ASIC and the FRC by removing the existing auditor independence function from the FRC. The FRC's revised functions include giving the Minister and the professional accounting bodies strategic policy advice and reports in relation to the systems and processes used by Australian auditors to comply with

relevant legislative and professional requirements, and professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by such auditors.

- Audit deficiency notifications and reports: ASIC has been given the power, subject to conditions, to issue an audit deficiency report in relation to specified failures by audit firms that ASIC has identified during the exercise of its statutory audit functions and reasonably believes indicates a significant weakness in either the Australian auditor's quality control system or the conduct of the audit and may be detrimental to the overall quality of the audit.

In December 2012, ASIC wrote to the CEOs of the six largest audit firms – PricewaterhouseCoopers, KPMG, Ernst & Young, Deloitte Touche Tohmatsu, Grant Thornton and BDO – asking them to develop action plans to improve audit quality.

ASIC asked the firms to focus on improving the consistency of the execution of audits and to address the three broad areas requiring improvement identified in ASIC's public audit firm inspection report:

- The sufficiency and appropriateness of audit evidence obtained by the auditor
- The level of professional scepticism exercised by auditors, and
- The extent of reliance that can be placed on the work of other auditors and experts.

ASIC (by press release dated 13 June) welcomed the response by the six largest audit firms in Australia to ASIC's request to prepare action plans to improve audit quality, noting that each firm has developed a genuine and comprehensive action plan to improve audit quality and has taken full ownership for the timely implementation of the plan and monitoring its effectiveness.

The firms will implement key aspects of the plans for audits for the year ending 30 June 2013. The firms will be monitoring the implementation and effectiveness of the plans, and ASIC will review each firm's initial progress in January and February 2014. The Institute of Chartered Accountants in Australia (ICAA) is discussing responses with the individual firms with a view to identifying whether there are common points from the plans that might be useful to share with the profession more generally.

Addressing one of the key concerns expressed by ASIC in its public report on its audit inspections, the ICAA and the Chartered Professional Accountants of Canada have released the paper, "Practical Ways to improve the Exercise and Documentation of Professional Scepticism in an ISA Audit".

Professional scepticism is critical for the assessment of audit evidence and, in accordance with auditing standards, needs to be evidenced.

As there is no single way to evidence professional scepticism, the paper offers a practical approach on how it can be done by posing a series of questions for different members of the audit engagement team at different stages to consider how to demonstrate the scepticism that has been applied during an audit.

The APPC through its Audit Quality and Public Reputation Working Group looks forward to working with the FRC to progress thinking on how to define audit quality; how the audit expectations gap can be bridged; and what improvements may be appropriate to our financial reporting framework.

We believe it is important that audit stakeholders have a broad view of what constitutes “audit quality”. In our view, and as is reflected in current international debate on this subject, audit quality relates not only to input or process issues, but needs to also focus on outputs based quality considerations holistically. The FRC has a key role to play in promoting such understanding in the community.

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Chairman  
APPC Audit Quality and Public Reputation Working Group  
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## Appendix

### Sample Audit Quality Definitions

Example Definition / Explanation	Organisation	Year	Type
<b>Australia</b>			
<p>Audit quality is the likelihood of the audit achieving the fundamental objective of the audit which is to obtain reasonable assurance that material misstatements in the overall financial report are detected, and addressed or communicated to relevant stakeholders <i>OR</i></p> <p>The likelihood that the audit process will identify when the financial report does not represent a true and fair view of the organisation's financial position and performance and the likelihood that the auditor will clearly represent this opinion.</p>	FRC	2013	Govt appointed oversight and advisory body
<p>Audit quality is the likelihood of material misstatement, the likelihood that the audit detects the misstatement and whether the auditor does anything about it.</p> <p>Audit quality concerns any matters that contribute to the auditor obtaining reasonable assurance that material misstatements in the overall financial report are detected and addressed.</p> <p>A quality audit is where the auditors performed all of the procedures necessary to obtain reasonable assurance that audited financial reports were not materially misstated.</p>	ASIC	2012, 2013	Regulator
<p>Audit quality involves a wide range of inter-related factors such as:</p> <ul style="list-style-type: none"> <li>• the legal framework relating to audit regulation (including the company auditor registration system, the auditor independence regime in the <i>Corporations Act 2001</i> and the accounting and auditing standards),</li> <li>• the ethical standards applying to the members of the professional accounting bodies,</li> <li>• the professional qualities and skills of auditors and their staff</li> <li>• the role and activities of the audit regulator — the Australian Securities and Investments Commission (ASIC) — and other bodies involved in the audit review process</li> <li>• the practices and processes adopted within audit firms, such as the culture within the audit firm and the quality of the firm's audit process, including the experience and technical expertise of the audit team and the audit methodology adopted by the firm</li> </ul>	Treasury	2010	Govt
<p>The five drivers of audit quality</p> <ol style="list-style-type: none"> <li>1. The culture within an audit firm</li> <li>2. The skills and personal qualities of audit partners and staff</li> <li>3. The effectiveness of the audit process</li> <li>4. Factors outside of the control of auditors</li> <li>5. The reliability and usefulness of audit reporting.</li> </ol>	ICAA (adopted from UK FRC)	2009	Prof Body
<b>International</b>			
<p>A quality audit is likely to be achieved when the auditor's opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that:</p> <ul style="list-style-type: none"> <li>• Exhibited appropriate values, ethics and attitudes</li> <li>• Was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work</li> <li>• Applied a rigorous audit process and quality control procedures</li> <li>• Provided valuable and timely reports and</li> <li>• Interacted appropriately with a variety of stakeholders</li> </ul>	IFAC	2012	Standard Setter

The ICGN believes that audit quality is primarily dependent on the objectivity, independence and professional scepticism of the auditor.	ICGN	2013	Investor Body
<b>US</b>			
Audit quality is “the market assessed joint probability that a given auditor will both discover a breach in a client’s accounting system, and report the breach.”	DiAngelo	1981	Academic
Since the purpose of an audit is to provide assurance on financial statements, audit quality is the probability that financial statements contain no material misstatements. In fact, this definition uses the results of the audit, that is, reliability of audited financial statements to reflect audit quality	Palmrose	1988	Academic
We define audit quality as meeting investors’ needs for independent and reliable audits and robust audit committee communications on: 1. financial statements, including related disclosures; 2. assurance about internal control; and 3. going concern warnings	PCAOB staff paper	2013	Regulator
Quality of outcomes and quality of processes that deliver those outcomes	US CAQ	2013	Prof Body
A high-quality audit is one performed “in accordance with generally accepted auditing standards to provide reasonable assurance that the audited financial statements and related disclosures are: 1. presented in accordance with generally accepted accounting principles, and 2. are not materially misstated whether due to errors or fraud”	US GAO	2003	Government
We evaluate audit quality on the basis of, among other things, how well an audit detects and reports material misstatements of financial statements, how efficient the audit process is performed and the level of dialogue about processes and controls that takes place	Blackrock	2013	Institutional Investor
<b>Canada</b>			
“High quality” audit is one where there is execution of a well-designed audit process by properly motivated and trained auditors who understand the inherent uncertainty of the audit and appropriately adjust to the unique conditions of the client	Certified General Accountants Ass’n	2012	Prof Body
<b>UK</b>			
Appropriateness of audit judgments exercised and any underlying deficiencies in the audit work and quality control procedures	UK FRC	2012	Regulator
... the ultimate objective of the audit must be quality reporting by the audited entity. The auditor’s role is to challenge, probe and encourage management in order that the reporting which the entity produces delivers a fair and reasonable presentation of the entity’s performance over the year and its state at the end of the year. The audit report and the audit opinion are a mechanism to enable this to be delivered; they are of great importance in doing so and are the only element of the audit currently visible to the investors which pay for the audit, but they do not represent an end in themselves.	Hermes	2013	Institutional Investor
Audit confirms that audited financial statements are reliable which means they: • Faithfully represent what they purport to represent; • Are fit for purpose; • Are robust; and • Do not give a false impression of the reliability of the entity.	ICAEW	2013	Prof Body