



AUDIT &
ASSURANCE
FACULTY

RELIABILITY MATTERS:

RELIABILITY AND THE CENTRAL ROLE OF THE AUDITOR

AuditQuality[®]



Since its formation in 2004, the *Audit Quality Forum* has encouraged open and constructive debate about issues which are in the broadest sense related to audit quality. It develops viewpoints on international auditing and reporting issues, contributes to the work of governments, standard-setters and regulators and generates practical ideas for further enhancing confidence in audited financial information. Its membership is drawn from investors, business, auditors and regulatory bodies.

The programmes on *Shareholder Involvement*, *Fundamentals* and *Evolution* provide a platform for the current and future work of the Forum in its *Global Challenges* programme. There are global challenges to the reliability of audited financial statements and the *Audit Quality Forum* is providing direction and promoting dialogue to tackle them.

People interested in giving feedback should send their comments to louise.sharp@icaew.com. Further information on the *Audit Quality Forum*, the current programme of work and how to get involved is available at auditqualityforum.com or telephone +44 (0)20 7920 8493.

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INTRODUCTION

BACKGROUND

This discussion paper starts from the observation that reliability matters to users of audited financial statements. Put simply, there is an expectation that 'audited financial statements should be reliable'. This simple statement reflects what people reasonably expect from audited financial statements and, as a result, sets a context for thinking about the responsibilities and accountability of the audit function. After all, to say that 'these audited financial statements are unreliable' would be very likely to invite a response that the financial statements in question had not been audited properly.

The concept of reliability should therefore be central to auditing and this discussion paper explores what might be involved in this. In particular, recognising the role reliability plays in auditing would require auditors to take greater responsibility for, and ownership of, their work but it would also give them a mandate to play a more active role in a wide range of debates, for example, about reporting and governance, an opportunity which they might welcome.

Auditors face a challenging task if they are to focus on reliability in all its aspects. However, thinking about the tangible steps auditors can take to address reliability challenges could provide a new lens through which to see long-standing issues, including audit expectation gaps, auditor scepticism and, above all, audit quality.

Over recent years, there has been much debate about what audit quality is and the difficulties of trying to measure it. This has resulted in initiatives that focus mainly on inputs to audit quality, such as auditor training and skills, and audit processes because these are relatively easy to regulate and measure. There has also been recognition of the need for greater clarity about these audit quality issues in the outputs of the audit, notably the audit report. As a result, inspections of inputs and processes have become more exacting and their value is increasingly called into question by auditors and the entities they audit.

While quality inputs and processes are essential in any audit, focusing on reliability as a central concept in auditing could shift the focus to what the end result should be. Surely audit quality should be judged by outcomes? How reliable is audited financial information in the eyes of users? To a significant extent this is likely to depend on the engagement that auditors have with users. The concept of reliability gives us a new and more tangible way to look at audit quality issues, and one that gets to the heart of what users ultimately want.

This paper has been written by ICAEW staff with input from the *Audit Quality Forum* and is designed to stimulate discussion.

THE IMPORTANCE OF RELIABILITY

It is clear that the concept of reliability is of real interest to a wide variety of audit stakeholders. There are many quotations and references that we could point to which refer to the need for reliable financial information and the role of audit and which reference the aspects of reliability that we discuss in this paper.

For example, James Doty, Chairman of the US Public Company Accounting Oversight Board has said that: 'Reliable financial and economic data is one of the fundamental assumptions of American society ...Our system of capital formation relies upon the confidence of millions of savers to invest in companies they trust', and 'auditors confirm the flight-worthiness of the engine of reliable financial data that drives our economy. They are an integral part of the basic checks and balances in the system'.

Research in 2010 by the Maastricht Accounting, Auditing and Information Management Research Center also concluded that investment analysts generally perceive that auditors' work is valuable to them by increasing their confidence in, and reliance on, financial statements.

Academic research on the views of investors and other stakeholders in the financial reporting process indicates that users look to auditors to bring reliability to that process. This is also supported by our discussions with investors during early work to develop this paper and we believe that reliability is equally relevant to other external users of audited financial statements and to boards who make decisions based on this information.



ASPECTS OF RELIABILITY

In building up a picture of what the statement 'audited financial statements should be reliable' means, we suggest that there are five key aspects of reliability and draw on insights from other areas of activity outside auditing where reliability plays an important role.

FAITHFUL REPRESENTATION



Information in audited financial statements must faithfully represent what it purports to represent in accordance with accounting standards. This is challenging for auditors because of the growing complexity of financial reporting and valuation techniques. Similar challenges in relation to measurement and consistency are faced by academics when performing research.

FITNESS FOR PURPOSE



Reliable audited financial statements need to be fit for purpose. Auditors have a responsibility to understand the purpose for which information in financial statements is intended to be used and to consider whether the information, as presented, is reliable for this purpose. Their challenge is to judge whether compliance with legal rules and accounting standards is sufficient to ensure that audited financial statements are fit for purpose. This fit for purpose aspect of reliability is very evident in manufacturing and engineering

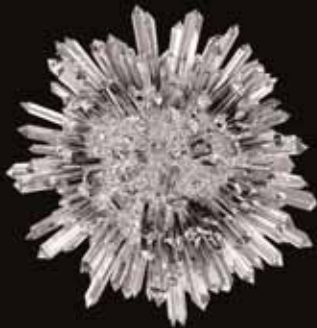
ROBUSTNESS



No matter what legislators and accounting standard-setters say about the purpose of audited financial statements, the information they contain is used in other, sometimes unpredictable, ways which may not be well understood. Auditors therefore need to actively engage with users to understand how they use audited financial statements. We refer to this aspect of reliability as robustness and look at the steps taken by software businesses to address it.

ORGANISATIONAL RELIABILITY

AUDIT FIRM RELIABILITY



The audit has a 'halo effect' and auditors are seen as 'reputational intermediaries'. By association, they give organisations an aura of being reliable and producing reliable information. While an audit doesn't prove that an organisation always publishes reliable information or is generally a reliable organisation, from a risk management and reputational viewpoint, auditors will want to concern themselves in these broader aspects of organisational reliability. To help them do this, we consider the characteristics of so-called high reliability organisations (HROs), for example in the nuclear and aviation industries where reliability is vitally important.

The auditor's reputational intermediary role demands that audit firms demonstrate that they are reliable organisations. If audited information does not faithfully represent what it purports to represent, is not fit for its intended purpose, is not robust for other purposes or gives a false impression of the reliability of the reporting organisation, then audit firms pay a heavy price through loss of reputation. This loss of reputation has a wider impact on businesses, markets and society. How do auditors address these challenges and take steps to ensure that audit firms are reliable? We look at the characteristics of HROs and also draw on insights from behavioural psychology and its application to audit.

FAITHFUL REPRESENTATION

Information in audited financial statements must faithfully represent what it purports to represent in accordance with accounting standards. This is challenging for auditors because of the growing complexity of financial reporting and valuation techniques. Similar challenges in relation to measurement and consistency are faced by academics when performing research.



RELIABILITY AND MEASUREMENT

The latest iteration by the International Accounting Standards Board (IASB) of its *Conceptual Framework for Financial Reporting* was published in 2010. It replaced the concept of reliability as a fundamental qualitative characteristic of financial reporting information with that of faithful representation. The IASB explained that this was as a result of a lack of understanding about what reliability meant. This led the IASB and the US standard-setter, the Financial Accounting Standards Board (FASB), to think about how they could better convey its meaning. They chose the concept of faithful representation.

According to the *Conceptual Framework*, financial information must faithfully represent what it purports to represent. Faithful representation has three characteristics: completeness, neutrality and freedom from error. We think that faithful representation is important but it is not necessarily the whole story.

The concept of faithful representation has similarities to the concepts of reliability and validity as used in research theory and methodology. Here reliability is a fundamental concept with characteristics of repeatability, consistency and measurement. The quality and consistency of measurement is important – a measure is reliable if it would give the same result over and over again. The concept of reliability is used in a very narrow sense in this literature but it is coupled with the concept of validity which is about whether the means of measurement are accurate and whether they are measuring what they are intended to measure.

The idea of faithful representation in accounting and the concepts of reliability and validity in research theory and methodology highlight the need for data to be capable of consistent measurement and for appropriate measurement methods to be applied.

CHALLENGES FOR AUDITORS

For audited financial statements to be reliable, information must be capable of consistent measurement and, in accordance with relevant accounting standards, must faithfully represent what it purports to represent in financial statements. Measurement is important and auditors therefore need to ensure that the appropriate measurement methods prescribed by law, standards and supporting conventions are applied and that information is properly put together.

In recent years, the world of financial reporting has had to deal with increasingly complex transactions and significant changes in how information should be prepared and presented. The rise of fair value methodology with complex valuation techniques poses significant challenges for auditors. They need to assess the appropriateness of these methods of valuation as well as consider whether technically complex valuations have been done properly and whether appropriate sources of information have been used. Auditors need the right skills for this and must use their judgement to determine when to seek expert advice and when and how they should rely on other experts.

Want to know more...

The IASB's *Conceptual Framework* is available at [ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx](https://www.iasb.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx)

A critique of the IASB's approach to reliability is set out in an April 2013 Bulletin of the European Financial Reporting Advisory Group (EFRAG), *Getting a Better Framework: Reliability of Financial Information*.

The following website and papers provide a useful source of information about the concept of reliability in research theory and methodology:

- W M Trochim, *The Research Methods Knowledge Base*, 2nd edition, www.socialresearchmethods.net/kb/, version current as of 20 October 2006.
- A Bryman, *Social Research Methods* (2008), 3rd edition, Oxford: Oxford University Press.
- M Joppe, *The Research Process* (2000).

RELIABILITY AND USES OF INFORMATION IN AUDITED FINANCIAL STATEMENTS

FITNESS FOR PURPOSE

Reliable audited financial statements need to be fit for purpose. Auditors have a responsibility to understand the purpose for which information in financial statements is intended to be used and to consider whether the information, as presented, is reliable for this purpose. Their challenge is to judge whether compliance with legal rules and accounting standards is sufficient to ensure that audited financial statements are fit for purpose. This fit for purpose aspect of reliability is very evident in manufacturing and engineering businesses.



RELIABILITY AND THE USES OF INFORMATION IN AUDITED FINANCIAL STATEMENTS

Reliability is not just about faithful representation. While applying measurement techniques properly and auditing complex calculations are vitally important, users of audited financial statements are rarely looking at individual numbers without having an overarching purpose. The measurement of an individual asset is just one of many tools that users rely on with a wider purpose in mind. For audited financial statements to be reliable they must, therefore, be fit for purpose.

Back in 1977, David Tweedie wrote about accounting as follows: 'Its purpose is not to provide stimulating intellectual exercise for those who do it, not to give them a pleasant means of passing the time. If it does not meet the test of telling the reader something which will help him, it fails in its primary purpose.'

Auditors need to have a clear understanding of the purpose of audited financial statements as prescribed by legislators and accounting standard-setters and must also be in a position to judge whether the information as presented is reliable for this purpose. This 'fit for purpose' requirement is something that is very evident in the field of reliability engineering. Products must be fit for their intended function and their reliability is measured against a specification of requirements. The engineering perspective draws attention to the fact that financial statements are meant to be useful. The engineering field can also provide helpful insights into difficult questions in financial reporting about how reliability is measured and just how reliable specific information needs to be.

The link to engineering fitness for purpose is picked up in academic accounting literature. Stephen Penman argues that: 'Simply put accounting is a product, and the understanding of good accounting or bad accounting is a matter of understanding its product features from the point of view of its customers ... Just as a new drug is tested, with side effects noted, so must accounting be judged by how it helps or hinders its users'. For audited financial statements to be seen to be reliable, the information provided in them must meet the needs of users. Penman has a very clear view that user needs are about the evaluation of equity investments although different legislators and standard-setters have different views.

CHALLENGES FOR AUDITORS

There is much debate in accounting about the purpose of audited financial statements. The IASB's *Conceptual Framework* says that the purpose of audited financial statements is to provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the reporting entity. These decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

While the *Conceptual Framework* has a clear view of the purpose of audited financial statements, auditors need to be aware that in reality there is little understanding of exactly how the information in audited financial statements is used for this purpose. Auditors need to think about whether compliance with financial reporting standards is sufficient to ensure that audited information is reliable for its intended purpose and be ready for situations where financial reporting standards and conventions permit or even require accounting treatments that do not suit the purpose that the information is supposed to be used for. This is not meant to be a criticism of standards because standards can never cover every eventuality. But it does imply that auditors need to take the initiative and engage with standard-setters and others when they have concerns about whether standards are meeting their supposed purpose. They cannot simply hide behind compliance with the standards. These issues have provided a rich vein of discussion at *Audit Quality Forum* meetings at which drafts of this paper have been discussed.

Want to know more...

The following websites highlight the importance of the concept of reliability in engineering:

- IEEE Reliability Society, www.rs.ieee.org
- www.weibull.com.

Exploring the idea of purpose from an accounting academic's perspective, Stephen Penman argues that financial reporting is for the evaluation of equity investment in, 'Accounting for risk and return in equity valuation', *Journal of Applied Corporate Finance*, vol 23, Issue 2, Spring 2011, pp50–58.

The history of efforts to identify the objectives of financial statements is explored by Stephen A. Zeff in, 'The objectives of financial reporting: a historical survey and analysis', *Accounting and Business Research*, vol 43, 2013, forthcoming.

RELIABILITY AND THE IMPORTANCE OF COMMUNICATION

ROBUSTNESS

No matter what legislators and accounting standard-setters say about the purpose of audited financial statements, the information they contain is used in other, sometimes unpredictable, ways which may not be well understood. Auditors therefore need to actively engage with users to understand how they use audited financial statements. We refer to this aspect of reliability as robustness and look at the steps taken by software businesses to address it.



RELIABILITY AND THE IMPORTANCE OF COMMUNICATION

Fitness for purpose is important for users of audited financial statements but unlike for hardware products which usually have a clearly defined purpose that enables their reliability to be easily measured, the very objective of audited financial statements is highly contentious. Even among those who believe that audited financial statements are meant to serve the needs of providers of capital, there is vigorous debate about the relative importance of stewardship and buy-sell decisions and the different needs of debt and equity providers.

In reality audited financial statements are used in varied and sometimes unpredictable ways which may not be well understood. Research by Joni Young in 2006 supports the idea that auditors and preparers of financial information do not fully understand how the information in audited financial statements is used. It's also not just external users who rely on this information; boards also make vital assessments about everything from business strategy, operations and risk to the ability to make distributions.

Software and systems reliability, a subset of reliability engineering, can provide some helpful parallels. It is often difficult to determine exactly how software is intended to operate in different contexts and human intervention makes it even more unpredictable. Reliability may be tested and confirmed in a particular context but it is difficult to say that the system will perform acceptably in another similar context. It may depend on the way it is used and how other applications being used at the same time might affect it.

CHALLENGES FOR AUDITORS

Variability of use, both in terms of purpose and context, poses challenges for auditors. Auditors should take steps to address the robustness of audited financial statements but how can they anticipate these purposes and contexts and how specific information might interact with other information that users are looking at? This is made even more challenging because not all users of audited financial statements fully understand the scope and purpose of audit and they have very different expectations of audited financial statements. Auditors often fall prey to expectation gaps, particularly in relation to going concern and fraud.

There is something to learn from the software development industry's focus on robustness of software and how it addresses reliability issues. Software developers make significant use of digital technology for example, to access online communities and audiences for webcasts and webinars. These communities bring together users to provide feedback, discuss issues, improve communication and develop solutions to problems. Another example is open-source software, where software developers publish their software with an open source license allowing others to create modifications to it, understand its internal functioning and share it with others. This approach can help produce reliable, high-quality software.

This analogy supports the need for active engagement with users of audited financial statements. There also seem to be clear education aspects to this. Users have a role to play in ensuring that preparers, auditors and standard-setters understand how they use the information in audited financial statements. Similarly, auditors, standard-setters and preparers of audited financial statements need to engage with users to help them understand how information has been prepared and whether it is reliable for how they might want to use it.

Want to know more...

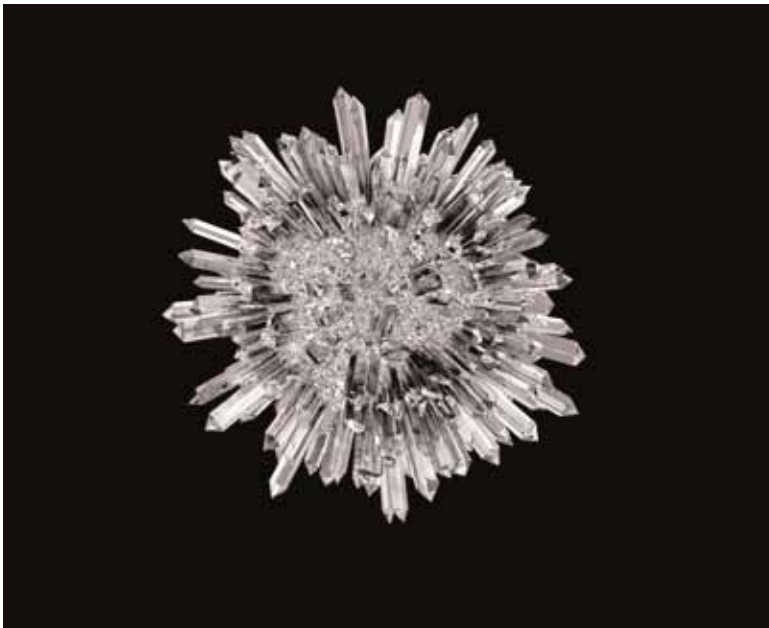
The Centre for Software Reliability (CSR) at City University London is an independent research centre (www.city.ac.uk/informatics/school-organisation/centre-for-software-reliability). Its early research concerned the reliability of software.

There are a number of articles exploring software reliability, for example:

- Littlewood and Strigini, *Software reliability and dependability: A road map* (2000), ICSE 2000, Proceedings of the Conference on The Future of Software Engineering.
- J Pan, *Software reliability*, Carnegie Mellon University 18-849b Dependable Embedded Systems, www.ece.cmu.edu/~koopman/des_s99/sw_reliability, 1999.

ORGANISATIONAL RELIABILITY

The audit has a 'halo effect' and auditors are seen as 'reputational intermediaries'. By association, they give organisations an aura of being reliable and producing reliable information. While an audit doesn't prove that an organisation always publishes reliable information or is generally a reliable organisation, from a risk management and reputational viewpoint, auditors will want to concern themselves in these broader aspects of organisational reliability. To help them do this, we consider the characteristics of so-called high reliability organisations (HROs), for example in the nuclear and aviation industries where reliability is vitally important.



RELIABILITY, THE HALO EFFECT AND THE AUDIT

The audit of financial statements has a wider halo effect. The 'halo effect' is a term invented in the 1920s by psychologist Edward Thorndike to explain a cognitive bias that plays a large role in influencing our views of people and situations. By association, auditors are seen to give organisations the aura of being reliable and producing reliable information because, to echo a phrase used by John Coffee, auditors are seen as 'reputational intermediaries'. Reputational intermediaries play a vital economic role in markets by reducing the amount of resources that investors need to devote to ascertaining the reliability of investee companies and the information they report.

A clean audit opinion on a set of financial statements may lead to an impression being formed that the organisation producing those statements is reliable and that it publishes reliable information because if it wasn't, then investors would expect the auditors to have resigned or qualified their opinion. But there are, in fact, very few auditor resignations and qualified audit reports.

In reality, while auditors play a vital role in making sure that audited information is reliable, auditors are only required to do a limited amount of work on information that accompanies audited financial statements. The audit does not prove that organisations generally publish reliable information or that they are reliable organisations. But from a risk management perspective, auditors should be concerned about being associated with organisations that produce unreliable information, whether it is to be audited or not, particularly if this information is significant to users.

CHALLENGES FOR AUDITORS

The expectations of reliability that we have described are difficult for auditors to manage. Auditors are acutely aware of the halo effect and the potential consequences of acting as reputational intermediaries, particularly when things go wrong. To protect their reputational intermediary role, auditors have a strong incentive to do work which goes beyond their strict legal responsibilities and assess the reliability of the organisations that prepare audited financial statements as well as the significance of the other information they publish.

If we want to understand the characteristics of reliable organisations, then we can gain an interesting perspective from looking at the high reliability organisation (HRO) research literature. This looks at organisations that really can't afford to make any mistakes, for example in the nuclear and aviation industries. In a similar way, although the consequences might not be so dramatic, a company cannot afford to get its communications to investors and shareholders wrong.

The Berkeley School on HROs identified conditions and relationships associated with maintaining high levels of human performance in the face of extraordinary demands. These HROs appear to demonstrate a culture of reliability, with shared perceptions, norms and informal traditions and employees who work to a clear common purpose and a goal of collective performance. Safety, accountability, interdependence, responsibility, continuous training and redundancy (in the 'belt and braces' sense) are common characteristics. HROs create a collective state of mindfulness and manage the unexpected by using processes which reflect a preoccupation with failure, commitment to resilience and deference to expertise.

Much of the HRO literature is based on organisations with highly complex operating and technical systems where failure could lead to considerable suffering. The conditions are therefore beyond the skill and capacity of many organisations. However, it draws attention to certain characteristics that might help create confidence in an organisation's ability to produce reliable information, such as accountability, responsibility, continuous training and a focus on the skills, experience and technical competence of employees. As part of their overall client acceptance and retention procedures, auditors should consider whether the organisations they audit have these qualities.

Furthermore, HROs have significant involvement with stakeholder groups and this is seen as crucial to instilling trust. This kind of direct engagement between organisations and users of their financial statements might also be a valuable guide to organisational reliability.

Want to know more...

There are various articles by Todd LaPorte and others that look at HRO characteristics, including:

- T R LaPorte, 'High reliability organizations: unlikely, demanding and at risk', *Journal of Contingencies and Crisis Management*, vol 4, no 2, June 1996.
- T R LaPorte and P M Consolini, 'Working in practice but not in theory: theoretical challenges of "high-reliability organizations"', *Journal of Public Administration Research and Theory*, 1 (1), 1991, pp19–48.

The idea of HROs possessing a collective state of mindfulness comes from K E Weick and K Sutcliffe, *Managing the Unexpected: Assuring High Performance in an Age of Complexity* (2001), San Francisco, CA: Jossey Bass.

John Coffee looks at the role of the professions in business and articulates the idea of auditors as reputational intermediaries in *Gatekeepers: The Professions and Corporate Governance* (2006), Oxford: Oxford University Press.

AUDIT FIRM RELIABILITY

The auditor's reputational intermediary role demands that audit firms demonstrate that they are reliable organisations. If audited information does not faithfully represent what it purports to represent, is not fit for its intended purpose, is not robust for other purposes or gives a false impression of the reliability of the reporting organisation, then audit firms pay a heavy price through loss of reputation. This loss of reputation has a wider impact on businesses, markets and society. How do auditors address these challenges and take steps to ensure that audit firms are reliable? We look at the characteristics of HROs and also draw on insights from behavioural psychology and its application to audit.



RELIABILITY, AUDITOR ATTRIBUTES AND THE AUDIT PROCESS

The halo effect and auditors' reputational intermediary role demand that audit firms examine their own reliability. Audit firms face huge reputational risks from perceived audit failures or from association with unreliable organisations. When audited information does not faithfully represent what it purports to represent, or fails in one of the other aspects of reliability highlighted in this paper, then users of that information will believe that the experts and the 'expert systems' that they have placed their trust in have failed. This can have devastating consequences not only for audit firms but also for confidence in other organisations those firms audit and for trust in markets and society more broadly. As well as considering the reliability of the organisations they audit, audit firms should also take steps to ensure that people believe that they are reliable reputational intermediaries.

What are the behavioural and organisational characteristics of reliable audit firms and auditors which help them to overcome the challenges identified under the aspects of reliability described in this paper? Some of the HRO characteristics discussed earlier in this paper, such as continuous training, a focus on accountability and the skills, experience and technical competence of employees would seem to be useful for audit firms in assessing their own organisational strengths and quality control systems.

However, it is also worth drawing on the significant behavioural literature relating to auditing which considers how auditors overcome inherent biases and what professional judgement means. Rather usefully, the insights that underpin much of this literature are summarised in Daniel Kahneman's best-selling book *Thinking, Fast and Slow* (2011) on the psychological research behind behavioural economics which earned him his Nobel Prize. Kahneman introduces the idea of two systems of thinking and looks at how people apply these different systems of thinking in different situations. System 1 is fast thinking, where thoughts come automatically and quickly. It is intuitive, relying on heuristics, perception, memory, expertise and experience. According to Kahneman, however, the search for intuitive solutions sometimes fails when neither an expert nor heuristic solution comes to mind. In such cases people need to switch to a slower more deliberate and effortful form of thinking. This is system 2 thinking which is all about the 'conscious reasoned self'. It requires attention and concentration.

Audit firms need to apply both of these systems of thinking. Auditors need to use experience, intuition and 'an auditor's nose' to know what to look for and when something is not right. This system 1 fast thinking and the ability to spot things that others would not is developed through a combination of learning and experience.

However, audit firms are also required to have clear and structured organisational processes. Guided by internationally accepted auditing and quality control standards, they use discipline and control to apply system 2 'slow thinking' to slow things down. They stand back from the financial statements and question assertions and help keep in check any inherent biases that are present in preparers of information because they are so close to that information.

CHALLENGES FOR AUDITORS

A major question is whether training practices and quality control processes in audit firms support the behaviours associated with reliability. In particular, as well as instilling a methodical and deliberative approach, is fast intuitive thinking based on experience and expertise being passed on to successive generations of auditors? Do these auditors feel inspired to be auditors and use these skills to best effect? Auditors are increasingly perceived as having a preoccupation with compliance and box-ticking. If auditors want to avoid this fate then they will need to examine their own behaviour, be positive about what they do and through effective training ensure that their skills are passed on. Irrespective of size, all audit practices need a combination of these two systems of thinking identified by Kahneman.

Thinking about these issues also provides a useful insight into the much-discussed concept of auditor scepticism. Auditors need to be sceptical in two ways: they have to overcome biases and be methodical in their approach to their work to ensure that nothing is missed. But they also need to have a sense of when to ask more questions and query evidence when things do not feel quite right.

Want to know more...

D Kahneman, *Thinking, Fast and Slow* (2011) introduces the idea of fast and slow thinking and this work is also informed by his research with Amos Tversky on judgement under uncertainty. The idea of expert systems is explored by Anthony Giddens in *The Consequences of Modernity* (1990), Cambridge: Polity Press.

Auditing and accounting research providing a behavioural perspective includes:

- J Shanteau's work on expert decision makers.
- J Birnberg's work on behavioural research in accounting.
- S E Bonner, *Judgment and Decision Making in Accounting* (2008), New Jersey: Pearson.
- M Power, PD Leake lecture on *Fair value: the influence of financial economics on accounting* (2009), London: ICAEW.
- L A Maines and J M Wahlen, 'The nature of accounting information reliability: inferences from archival and experimental research', *Accounting Horizons*, vol 20, issue 4, December 2006, pp399–425.
- K Kadous, L Koonce and J M Thayer, 'Do financial statement users judge relevance based on properties of reliability?', *The Accounting Review*, vol 87, no 4, 2012, pp1335–1336.

SUMMARY OF THE CHALLENGES

This discussion paper is based on a simple premise that 'audited financial statements should be reliable'. We believe that reliability plays a central role in auditing and this paper considers the practical challenges that this involves.

Auditors should apply the appropriate measurement methods prescribed by law, accounting standards and supporting conventions to ensure that information is properly compiled and measured. They need to use their expertise to assess the appropriateness and application of the techniques used and their judgement about when expert advice may be needed and to what extent they can rely on this.

Moreover, auditors need to understand the purpose of audited financial statements and judge whether the information presented is reliable for this purpose. In so doing, auditors should consider whether compliance with accounting standards is sufficient to ensure that the information is reliable for this purpose. Where they have concerns that standards do not clearly reflect the purpose for which the information in the audited financial statements is intended, they need to engage with standard-setters. It makes the role of auditors challenging because they cannot simply hide behind standards.

Even so, no matter what legislators and accounting standard-setters say about the purpose of audited financial statements, in reality audited financial statements are used in varied and sometimes unpredictable ways depending on the context. Neither auditors nor preparers of information fully understand how. Auditors need to be aware of the expectation gaps which they may therefore fall prey to and, with this in mind, they have a responsibility to engage actively with users to understand how they are using the information in audited financial statements and to help users understand how information has been prepared. This active engagement might help manage expectations.

Thinking beyond financial statements, the audit of those statements has a halo effect. By association, auditors give organisations the appearance of being reliable and producing reliable information by virtue of being reputational intermediaries. Auditors play a vital role in making sure that the information in audited financial statements is reliable but the audit does not

prove that organisations generally publish reliable information or that they are reliable organisations. Auditors should be concerned about this because they do not want to be associated with organisations that produce unreliable information. In their client acceptance and retention procedures auditors should think about the reliability of the organisations they audit and their ability to produce reliable information.

The halo effect and auditors' reputational intermediary role also demand that audit firms examine their own reliability. Audit firms need to demonstrate that they are reliable because, as reputational intermediaries, they face huge reputational risks from perceived audit failures or from being associated with unreliable organisations. Audit firms need to deal with the challenges in this paper and assess whether they have the appropriate behavioural and organisational characteristics to ensure that they are reliable. Audit firms need a successful mix of, on the one hand, organisational process, discipline, control and method and on the other hand, experience and intuition to sense when something is not right. This brings its own challenges because they need to train and inspire auditors to achieve the right combination of discipline and flair.

These challenges and the tangible actions that auditors can take to embrace their responsibilities provide a new focus for some long-standing issues, such as what is audit quality and how should auditors deal with expectation gaps and instil scepticism. Audit quality has been extensively debated and written about by policy-makers, standard-setters, the audit profession and academics but without reaching clear conclusions about what it is and how it can be measured. As a result, there has been increasing focus on the more tangible and measurable inputs to audit quality at the expense of what audit quality means in terms of outcomes. While quality inputs and processes are essential in any audit, focusing on reliability as a central concept in auditing helps us to think about what the outcomes should be. Audit quality should be judged by the reliability of audited information in the eyes of users of that information.

NEXT STEPS

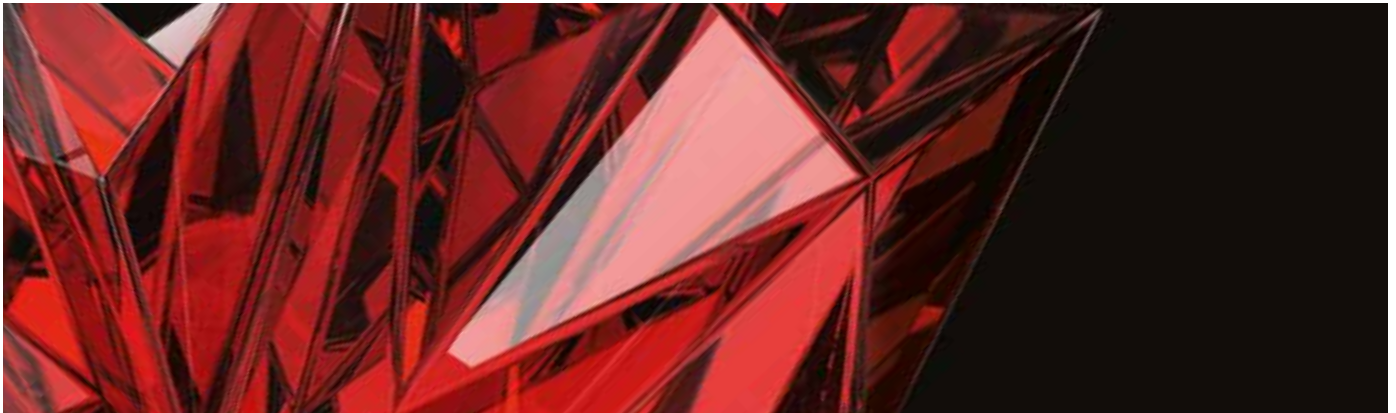
Reliability really does matter to users of audited financial statements and this paper looks at how reliability should therefore be central to auditing, exploring the various aspects of reliability and the challenges they pose for auditors. However, our work does not stop here. This focus on reliability leads us to ask four fundamental questions. These questions highlight real practical issues on which we would like to engage stakeholders. We believe that this will move the audit quality debate into new territory.

With the five aspects of reliability in mind, the *Audit Quality Forum*, with its broad range of stakeholder representatives, is well placed to explore these questions. We need to ask not just audit firms but also other stakeholders whether – as companies, investors, legislators, regulators or standard-setters – they are doing everything they can to enable auditors to stand up for the reliability of audited financial statements.



NEXT STEPS

HOW RELIABLE?



Reliability is a matter of degree rather than an absolute quality which audited information either does or does not have. Therefore, if there is an expectation that 'audited financial statements should be reliable', just how reliable does the information in audited financial statements need to be for users?

Considering the quality of faithful representation for instance, we might seek to understand the extent to which investors are interested in having conservative numbers with margins of safety built in and whether, therefore, they believe that information might be made more reliable by being more prudent. The concept of prudence comes with a lot of history and emotion attached to it, but is it really what users want, particularly in areas of high subjectivity?

Turning to fitness for purpose, should auditors be considering the degree of reliability of the information in audited financial statements for the specific purposes it might be used for and, if so, should the audited financial information include statements and, where relevant, caveats to this effect? How would auditors go about deciding how reliable information needs to be? This is where statistical work in research methodology and reliability engineering on probabilities, standard deviations and tolerances could be very useful. They introduce various measures of reliability and quality from both an input and output perspective. For audited financial statements, could failure be measured and compared to an acceptable level of reliability? It would be particularly interesting to explore with users potential tipping points between being 'reliable enough' and 'unreliable'.

The question of how reliable something needs to be can also be extended to other aspects of reliability such as the need for reliable organisations and audit firms. Even within organisations that we would consider to be highly reliable, such as in the aviation industry, we see some failures. What makes the public believe that these are just one-off accidents rather than evidence of unreliability? Likewise, in audit firms, how sceptical do we want auditors to be? There appears to be a cost-benefit balance to be struck.

NEXT STEPS

ENGAGING WITH USERS?



Recent initiatives looking at auditor reporting and changes to codes and standards to strengthen accountability and engagement highlight the growing recognition among auditing standard-setters that engagement with users is important. What practical steps can be taken by auditors to gauge and address the expectations of those using audited financial statements?

More direct and proactive interaction with users about how they use audited financial statements could build on these initiatives and help to address some expectation gaps. Armed with this additional knowledge, auditors might then be able to be more assertive and explicit in their audit reports.

Importantly, more engagement would also help to reframe the audit quality debate to focus more directly on outcomes because users will judge quality by how reliable the information in the audited financial statements is to them. Only where users feel confident enough to rely on information, are they likely to recognise audit quality.

However, while engagement with users about how they use information in audited financial statements is important for ensuring that information is robust and fit for purpose, audited financial statements are on the public record and can be used by anyone for any purpose. Unlike in the software industry, there is no licensing system that can clearly identify all users. Engagement with those users that auditors are aware of is all very well but it won't help to manage the expectations of those who they aren't aware of and, because audited financial statements are seen as a public good, when things go wrong it affects public trust among people who have never even looked at a set of audited financial statements. How can auditors tackle these challenges?

Auditors could have something to learn from models of engagement in the software development market but these examples of effective engagement are likely to be quite unfamiliar not only to auditors but also more generally to preparers of information and standard-setters. There may also be scope to use other, more creative, techniques for gauging expectations, but what is clear is that the development of successful mechanisms is likely to require changes in the way auditors approach their audits and standard-setters develop standards. Are they ready for such changes?

NEXT STEPS

AUDITING RISKY BUSINESSES?



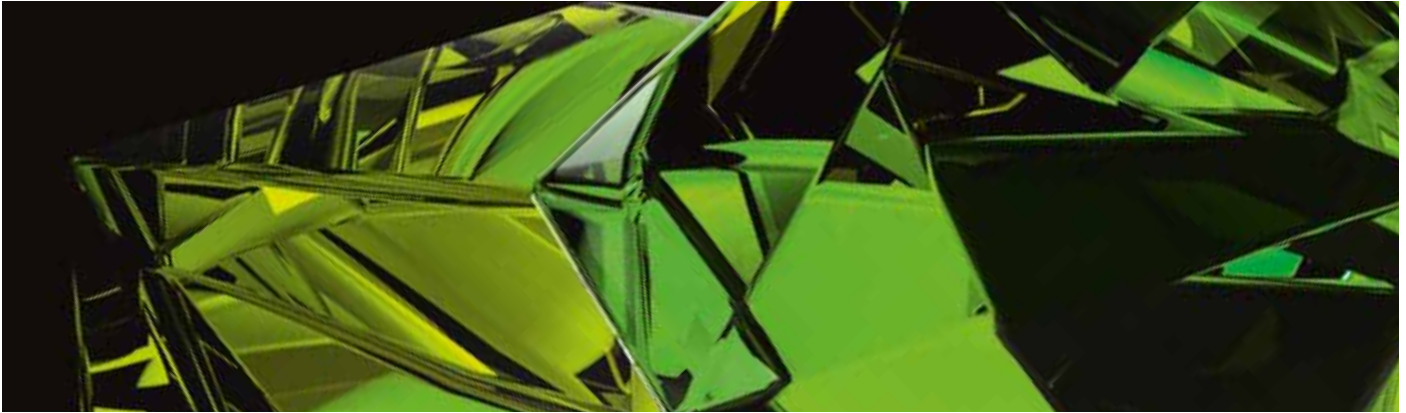
For auditors, the challenge of being seen as reputational intermediaries is a difficult one to manage. All economic activity is inherently dynamic and uncertain and financial reporting measurement and disclosure practices evolve in the light of experience. However, while all assessments of the reliability of audited financial statements need to be understood in the context of the state of knowledge and learning at the time of their preparation, there is a specific challenge associated with organisational reliability.

On the one hand we can argue, as we do in this paper, that auditors should be wary about acting for organisations that cannot produce reliable information because auditors need to guard against the consequences of halo effects. But would it really benefit society and be in the public interest for auditors to refuse to act for such organisations? In particular, what about organisations that have no proven track record, those wanting to innovate or those which are in high-risk industries?

In promoting the importance of reliability, we need to make sure that we don't stifle innovation and risk taking, as these are vital ingredients for a healthy and growing economy. As reputational intermediaries, auditors will put their reputations on the line and in some cases this might not turn out well. How do we manage this dilemma and at what stage does the risk involved become too much? Is there, for example, scope for organisations to be very open about the risks involved and for auditors to focus their efforts on the reliability of the risk information those organisations provide rather than just the financial statements? How might users, markets and the public view such an approach?

NEXT STEPS

MAINTAINING CONFIDENCE?



How should confidence in the reliability of audited financial information be maintained or, if necessary, re-established when perceived failures occur? This is a general challenge faced in many fields of activity, not just financial statement auditing, where public trust in the reliability of that activity is vital. Businesses will fail and when they do the effects are widely felt and there will often be a perception that audited financial statements were unreliable because they did not alert users to the risks and causes of failure.

An accumulation of such accounting failures can cause public outcry and attention turns to the regulation not just of the businesses involved but also their auditors. While the reputation and very existence of those businesses and the audit firms associated with them could be threatened, the ramifications do not stop there. There are wider general consequences for business, regulators and auditors.

There is a danger that perceived failures of reputational intermediaries such as auditors result in a lasting loss of their reputation if the only public policy response is to subject them to increased regulation and to look to build trust in new intermediaries such as new public oversight bodies. This can lead to a vicious spiral in which successive crises lead to a succession of failed reputational intermediaries, ever tighter regulation and the long-term erosion of public trust.

Is it possible to avoid this and for the public to continue to trust reputational intermediaries despite periodic failures? For this to happen, the role of a reputational intermediary must surely be seen as an evolving one: a role that requires a commitment to reliability, constant learning, engagement and a willingness and ability to respond to public perceptions and adapt to change. Failures will continue to happen – reputational intermediaries are powerless to stop this – but it is how they are seen to anticipate and respond to failures that will determine whether they can secure long-term trust. Is such a vision realistic?

JOIN THE DEBATE

AuditQuality[®]

The *Audit Quality Forum*, with its broad range of representatives is well placed to pursue the next steps identified in this paper and engage those with a stake in the reliability of audited financial statements.

If you have views on this paper and the questions raised or would like to discuss the issues further, please contact louise.sharp@icaew.com.

If you would like to know more about the work of the Forum or become involved please visit our website at auditqualityforum.com or telephone +44 (0)20 7920 8493.

ICAEW, which hosts the Forum, is involved in a number of initiatives that look at audit quality issues and the role of audit in society. In particular, *AuditFutures*, was set up by ICAEW's Audit and Assurance Faculty to open dialogue with a wide range of stakeholders and drive innovation through the Finance Innovation Lab, which was established in 2008 by ICAEW and WWF-UK. This initiative is designed to ask big questions about the future of the audit profession. Current public debate about audit and assurance is intense and the *AuditFutures* strategy is to address criticisms levelled at the auditing profession by promoting the value of audit and assurance to society at large and nurturing innovation. If you are interested in the role of audit in society please get involved. For further information visit auditfutures.org.

AuditFutures^{fi}



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