


# *Audit quality: how to raise the bar*





***Audit is undergoing an unprecedented level of public scrutiny. The expectations of investors and other stakeholders – including employees, customers, suppliers and pension-holders – have increased in recent years and the purpose, scope and practice of audit need to keep pace.***

ICAEW's Audit and Assurance Faculty is developing a series of thought leadership essays that consider issues directly or indirectly relevant to the international debate about the future of audit. This series is intended to help directors, audit committees, shareholders, politicians, journalists and policymakers understand the key issues and it will, among other things, help to inform the development and implementation of recommendations in the UK regarding audit, its regulation and the market for audit services.

In February 2020 ICAEW shared<sup>1</sup> five goals for UK audit reform: establishing the Audit, Reporting and Governance Authority (ARGA); an inclusive audit profession; a more reliable core audit; on-demand audit extras, focusing on an enhancement of the part played by shareholders in the commissioning of assurance; and pre-tested requirements, which involves enhancing existing requirements as preparation for introducing new requirements. These goals constitute not just a set of desirable outcomes against which any individual proposed measure or combination of measures can be assessed, but an agenda for action. The faculty will continue to develop its essays with the achievement of these goals in mind.

The faculty has published a number of papers already, which are available to all at [icaew.com/futureofaudit](https://icaew.com/futureofaudit). Further papers will be issued. If you have views on any of them, or experiences to share, we would very much like to hear from you. Please email your comments to [nigel.sleigh-johnson@icaew.com](mailto:nigel.sleigh-johnson@icaew.com)

1 Michael Izza, Getting five out of three, [ion.icaew.com/moorgateplace/b/weblog/posts/audit-reform-getting-five-out-of-three](https://ion.icaew.com/moorgateplace/b/weblog/posts/audit-reform-getting-five-out-of-three).

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## *At a glance*

The evolving debate about audit quality is complex. Audit quality transcends national boundaries, and this essay is a contribution to the global debate.

In the UK, changes to legislation, regulation and auditing standards arising from current and anticipated proposals will take time, but there are steps that UK audit committees, audit regulators, investors and auditors can and should take now, voluntarily, to improve audit quality.

In this essay, we highlight the role and responsibilities of all of those involved in the audit quality supply chain and the steps we can all take to improve audit quality. We look at who **owns** audit quality, its important **behavioural aspects** and the wider **structural drivers** that affect it.

This essay recommends 'seven steps forward':

1. Boards should do more to ensure that audit committees are properly equipped to provide a robust level of challenge to management and auditors. Audit regulators should do more to align the behaviours of audit inspectors with their aims and objectives.
2. Audit regulators, audit committees, investors and auditors need to work together to develop a framework and methodology for the calculation and reporting of Audit Quality Indicators.
3. Audit firms should continue to develop tools and techniques for flagging and managing manipulative and deceptive behaviour. Auditing standard-setters and policy makers should consider the additional tools auditors need to deal with such behaviour effectively. Audit committees should consider how they can improve audit quality by providing a more robust challenge to management assumptions.
4. Entities and audit firms should evaluate the costs and benefits associated with enhanced engagement with experts and specialists.
5. Firms of all sizes should consider adopting at least simple forms of root cause analysis at the engagement level.
6. Auditors and audit committees need to work to raise the profile of transparency reports. Audit regulators and investors need to use the information now available to further the debate on their role in promoting audit quality.
7. Standard-setters should take the opportunity to consider alternatives to the existing assumptions and models underlying auditing standards with a view to ensuring that high quality audit remains a relevant and valued service.

We invite individuals and organisations to share with us their thinking on audit quality, their experience of its challenges, and their observations on this essay. This will help us progress the debate about audit quality and the future of audit globally.

## ***COVID-19 foreword***

The groundwork for this essay was laid in wide-ranging discussions and enquiries at ICAEW prior to the onset of the COVID-19 pandemic. Challenges to auditing that were evident long before the current crisis have in some cases been exacerbated by the new ways of working that have been necessary.

Evidencing professional scepticism and awareness of fraud are a continuing challenge for the audit profession. Auditors have been thrust into a position where they not only have to continue to demonstrate these competencies, but must do so remotely, without the benefits of being immersed in the surroundings of audited entities, around staff or able to physically corroborate audit evidence.

Before the pandemic, key questions about audit quality were 'How do we improve audit quality and inspection scores in the current regulatory environment?' and 'What improvements can be made through the audit reform agenda?' More recently, other questions have emerged - 'What have we learned from the pandemic about maintaining audit quality while working remotely?' and 'Which aspects of the current ways of working would the profession like to keep, and which would it like to draw a line under?'

The Audit and Assurance Faculty will continue to explore these questions in the coming months.

**March 2021**

## *Introduction*

Audit quality is a diffuse and opaque concept. Simply describing it is challenging, as is understanding the different emphases within descriptions and definitions. Determining whether the audit performed on a set of financial statements is fit for purpose is a judgement call requiring a high level of expertise.

Expectations of audit quality are high. Audit quality is often discussed in a manner that suggests that it is a panacea for all of the ills in the financial reporting supply chain – as if the only thing needed to prevent fraud or corporate failure is better quality audits. This has never, and will never, be the case. But better quality audits undoubtedly help prevent fraud and disorderly corporate failure by deterring and helping to root out corporate wrongdoing, and ensuring that wrongdoers have fewer places to hide. Audit quality matters.

The debate about audit quality is a complex and evolving one. This essay is a contribution to some key aspects of the global debate. We demonstrate that audit quality is not just about auditors. Company boards, audit committees, audit regulators and auditing standard-setters have not just a role to play, but a responsibility for audit quality. We highlight the role and responsibilities of all of those involved in the audit quality supply chain and the steps we can all take to improve audit quality.

Audit quality is an issue that transcends national boundaries and is of interest around the globe. This essay has been developed with that in mind. In the UK the pace of reform seems likely to pick up with publication of a long-awaited consultation paper on changes to the corporate governance and audit system, building on the earlier reports of Sir Donald Brydon on the quality and effectiveness of audit, Sir John Kingman on the Financial Reporting Council, and the Competition and Markets Authority on the audit sector. These reports are all relevant, directly or indirectly, to audit quality. Changes to legislation, regulation and auditing standards arising from current proposals will take time, and there are steps that audit committees, audit regulators, investors and auditors in the UK can and should take now, voluntarily, to improve audit quality, regardless of the extent and timing of those changes.

In this essay we firstly look at the **ownership** of audit quality by looking at roles and responsibilities within the audit quality supply chain, the characteristics of audit quality and the challenges associated with describing and defining it. We look at how audit quality indicators that ‘point’ to audit quality are used, managed, measured and assessed.

Secondly, we examine the important **behavioural aspects** of audit quality, including the existing and potential new requirements for auditors to stand-back, pause, and take a properly sceptical or even ‘suspicious’ view of the information they audit. We look at the soft skills that will be needed in the next generation of auditors to enable them to function effectively within mixed teams of auditors, experts and specialists in a highly complex technical environment. We also look at root cause analysis and other quality management tools that continue to gain traction.

Finally, we address the wider **structural drivers** affecting audit quality. These include the oversight of audit quality within audit firms, the mechanisms for understanding, promoting and rewarding it, the need to raise the profile of transparency reports, the role investors need to play in supporting audit quality, and the impact of auditing standards and technology on audit quality.

Audit quality is relevant to audits of all sizes and all types of organisation. We focus in this essay on audit quality for larger corporate audits. Different factors come into play for smaller audits, but the issues discussed in this paper are relevant and we hope of interest to auditors of smaller entities and other types of organisations.

In each section, we make recommendations for auditors and others in the audit quality supply chain, which we list as seven steps forward in the last section, 'Where next?'

## *Owning audit quality*

### THE AUDIT QUALITY SUPPLY CHAIN

Audit quality is at the heart of audit but it is not the sole responsibility of auditors. Company boards, audit committees, audit regulators and others have a role to play.

#### **Company boards**

Boards need to devote a level of resource to audit committees that demonstrates a genuine commitment to audit quality. They need to appoint strong audit committee chairs, establish robust appointment processes and provide sufficient technical and other support for audit committees to provide an effective level of challenge.

#### **Audit committees**

Audit committees have, within their powers, the ability to drive audit quality up, to pay lip service to it, or to just ignore it.

High quality audit relies on audited information produced by a well-controlled, resourced and competent finance function. Independent oversight of the finance function by an effective audit committee is a prerequisite for this. Audit committee members need to demonstrate competence and be actively prepared to challenge management and auditors. Some audit committees need to meet more frequently, and all need to spend sufficient time on audit related matters to facilitate effective challenge. They should avoid being passive recipients of information for approval.

Good quality interactions between audit committees and auditors need to cover routine matters relating to planning, reporting and significant findings. But interaction with the potential to improve audit quality may require more, such as regular touch points between the audit committee chair and audit partner, and making time for the audit partner or audit team to provide feedback on the audit process while management team members step out of the meeting.

Audit committee agendas are busy but audit quality should take priority. Investing in audit quality means allocating time for the development of audit quality indicators (AQIs), a framework for evaluation, goal-setting and performance reviews.

Audit committees need to be seen to engage auditors who are prepared to provide evidence that quality is at the heart of their modus operandi. Competition between auditors on audit quality rather than price is hard to achieve, but critical to fostering ongoing improvement.

As businesses around the world continue to feel the pressure of COVID-19, there is a risk that cost becomes the primary driver in the audit tendering processes. Good corporate governance requires attention to audit quality and a robust challenge to management, especially in challenging times. Company boards should be reminded that audit is an investment rather than a cost.



It may not be possible in practice to take a fully 'fee-blind' approach to audit tenders, but audit committees should focus on those elements of proposals that focus on people, their skills, the breadth of overall and sector-specific experience within the team and the extent to which specialists are part of the team.

### **Audit regulators**

Auditor behaviour has always been heavily influenced by the behaviour of audit inspectors. The quality and clarity of audit inspection findings are important and they need to be clear about the significance of issues to avoid inconsistencies in remedial actions. Simply asserting that all of the issues are important is unhelpful.

In the UK, the Financial Reporting Council (FRC), through its thematic reviews, and its proposed successor, the Audit, Reporting and Governance Authority (ARGA), should focus more on the characteristics of good quality audits, and make greater efforts to publicise their wide understanding of audit quality, by means of case studies.

Compliance with auditing standards requires auditors to 'stand back' and consider whether they need to do more. However, audit inspectors should not routinely require auditors to show that they did 'something' more, simply to prove compliance with the stand-back, and no one should conflate compliance with audit quality. Demonstrable compliance with law and regulation are important, but they are a means to an end and audit quality requires more.

Boards should do more to ensure that audit committees are properly equipped to provide a robust level of challenge to management and auditors.

Audit committees should focus more on audit quality, particularly in challenging times.

Audit regulators should do more to align the behaviours of audit inspectors with their aims and objectives. They should be more actively focussed on audits performed well and share their understanding of audit quality to a greater extent than they do now by publishing case studies.

## THE CHARACTERISTICS OF AUDIT QUALITY

Audit quality is difficult to describe, still less define or measure consistently to everyone's satisfaction. It is understood in different ways by different stakeholders and perceptions vary even within stakeholder groups, be they supply or buy-side investors, audit and capital markets regulators, local and global standard-setters, customers and suppliers or trade unions and climate change activists.

Audit inspectors necessarily focus on process and compliance with standards when assessing audit quality. But it is not clear how and to what extent they can or should demonstrate consideration of the outcome of that process, and the extent to which the audit meets the needs of users of financial statements and the economic decisions they make. Auditors may be led to an unnecessarily process driven, defensive approach to audit quality, if they are primarily motivated by the avoidance of regulatory sanctions.

IAASB<sup>1</sup> describes the factors affecting audit quality very broadly in terms of:

- *inputs* (such as values, ethics, attitudes, knowledge, skills, experience and time);
- *process* (such as rigour, compliance with laws, regulations and applicable standards);
- *outputs* (such as audit reports that are useful and timely to the auditor, firm, entity and regulators);
- *interactions* (support from others in the financial reporting chain); and
- *contextual factors* (such as the financial reporting and accounting frameworks, corporate governance requirements, culture, the financial reporting timetable, the ability to attract talent, the litigation environment and business practice and commercial law).

The UK FRC's revised definition of audit quality in its 2018 *Developments in Audit* report is similarly wide-ranging:

High quality audit provides investors and other stakeholders with a high level of assurance that the financial statements of an entity give a true and fair view and provide a reliable and trustworthy basis for taking decisions. Auditors carrying out high quality audit act with integrity and objectivity, are demonstrably independent and do not act in a way that risks compromising stakeholders' perceptions of that independence.

High quality audit complies with both the spirit and the letter of regulation and is supported by rigorous due process and quality assurance. It clearly demonstrates how it reflects investor and other stakeholder expectations, is driven by robust risk assessment informed by a thorough understanding of the entity and its environment and provides challenge, transparency and insight in a clear and unambiguous way.

High quality audit provides a strong deterrent effect against actions that may not be in the public interest, underpins stakeholder confidence, and drives continuous improvement.

1 The International Auditing and Assurance Standards Board: *A Framework for Audit Quality*

The Brydon report noted the CFA Institute definition of a high quality audit as one that diminishes the ability of entities to obscure the economic reality, and emphasised the need for the audit to inform, and not just check compliance.

In practice, audit firms focus less on the definition of the concept of audit quality at a fairly high level, and more on what 'points' to it, in the form of audit quality indicators (AQIs).

## AQIs AND THEIR CORRELATION WITH AUDIT QUALITY

### AQIs

AQIs have been a key feature of large firm reporting in the UK since 2015, when firms auditing Public Interest Entities (PIEs) started to include a set of AQIs in their transparency reports. These AQIs were developed by the Policy and Reputation Group (PRG) – a forum of the largest audit firms and comprise eleven metrics in the following areas:

- external investigations;
- internal and external quality reviews;
- investment in audit (such as the number of hours of training);
- partner and staff surveys;
- investor liaison.

The FRC's May 2020 AQR Thematic Review on AQIs (the FRC Thematic)<sup>2</sup> provides detailed analysis of the AQIs used by firms over the previous five years, as well as recommendations for improvement. It acknowledges that the AQIs set out in transparency reports are many and varied.

A plethora of different AQIs are used by audit firms and audit regulators, and even AQIs used within audit firms vary in different jurisdictions. At present, there is little agreement regarding which AQIs are most useful, or how to calculate them. This is not surprising given that few firms have had AQIs in place for more than five years. Audit regulators have different priorities to the firms themselves, and legal, cultural and economic differences create differences globally. Nevertheless, attempts to consolidate and formalise AQIs in a systematic manner are beginning to gain traction.

The PRG was among the first to attempt this. The US audit regulator, the PCAOB, listed 28 AQIs, also in 2015.<sup>3</sup> In 2016, the Centre for Audit Quality (CAQ) in the US, a grouping of firms of auditors registered with the PCAOB, noted that making engagement level AQIs public may have unintended consequences, and that firms should report publicly only on firm-wide AQIs, even though engagement level AQIs should continue to be tracked internally.<sup>4</sup>

2 [Audit Quality Indicators AQR Thematic Review](#) based on interviews with the six largest audit firms, investors and a large number of audit committee chairs. It sets out, among other AQIs: EQCR (engagement quality control review) hours; materiality outliers; partner and senior hours as a % of total; partner workload/portfolio assessments; involvement of experts and specialists; timely completion of milestones; use of data analytics; long term sickness/excessive overtime; and number of consultations undertaken.

3 [Concept Release on Audit Quality Indicators](#)

4 [Audit Quality Indicators - The journey and path ahead](#). The CAQ feared that engagement-level AQIs would represent misleading benchmarks as investors and other readers would not be party to the complete dialogue that puts each AQI in context.

The FRC intends to consult on a core set of AQIs for public reporting with a view to making them more useful to audit committees and investors, and to develop guidance on consistent reporting and the use of comparative data and explanations.<sup>5</sup> The FRC also put forward as good practice a number of firm-specific case-studies including firms who monitor external risk indicators, such as shorted stocks reported to the UK's Financial Conduct Authority (FCA), share price movements, and information from credit agencies and others who use independent risk panels to challenge risk assessments and planning as well as audit conclusions.

### Correlating AQIs with audit quality

Are AQIs a means to an end, or an end in themselves? Are they a measurement of audit quality, a means of achieving it, or both? The FRC Thematic states that:

The holistic process of monitoring, reporting and reviewing AQIs... has a positive impact on the culture and the working environment within the firms.

This suggests that the proper use of AQIs can lead to improved audit quality. Nevertheless, the FRC notes that guidance on the calculation of AQIs set by firms at a global level is patchy and that it is difficult to establish a direct correlation between AQIs and audit quality, particularly the results of external quality monitoring.<sup>6</sup>

Audit quality indicators taken alone, it seems, may not always be reliable indicators of audit quality.

AQIs have value in context and collectively. The misuse of AQIs out of context can be misleading. Two oft-quoted AQIs are the timing of and total amount of partner time spent on an audit. A positive correlation might be expected between audit quality and higher levels of partner involvement, particularly if it starts early and is sustained, rather than being all towards the end of the audit. However, increased partner involvement may also reflect an audit not going to plan. Similarly, fewer partner hours may mean there is a strong audit manager or director in the team. Comparisons of total audit hours on two seemingly similar audits may mislead if the risk profile and complexity of accounting estimates and judgements vary, even if the entities concerned are apparently similar in terms of size or sector.

A balance needs to be struck. Cross-firm and even inter-firm comparison can be difficult because of the lack of consistency in the use and calculation of AQIs. A set of overarching audit quality objectives is needed, supported by a range of AQIs at firm and engagement level, calculated on a widely understood and accepted, transparent and consistent basis. An overall framework for the development, measurement and evaluation of AQIs is needed.

The current lack of alignment is frustrating for everyone concerned. Clarifying and aligning the collective objectives of stakeholders with different priorities, including audit regulators, audit committees, investors and auditors themselves, will be an iterative process and take time.

Audit regulators, audit committees, investors and auditors need to work together to develop a framework and methodology for the calculation and reporting of AQIs, including a disclosure framework for comparatives.

An agreed set of specific AQIs at an audit firm and engagement level will encourage high quality, consistent and comprehensive reporting.

5 A separate pilot study is being performed during 2021 by a number of larger firms in conjunction with the FRC, whereby engagement level AQIs are agreed with the audit committee and reported on throughout the audit process, to inform the audit committee's assessment of audit quality.

6 The FRC notes that this is also true of root cause analysis, and there are a few AQIs that cannot be reported externally, such as those relating to staff willingness to work on a particular audit.

## *Behavioural aspects of audit quality*

In this section we focus on behavioural issues for auditors. But without changes in the attitudes and behaviours of audit committees, management and boards, the benefits of the efforts made by auditors will be limited.

Few boards still think it acceptable to openly 'game' the auditors, but auditors have always had to resist pressure to accept, for the purposes of the audit, badly prepared financial information, provided late and poorly supported, based on aggressive accounting policies that push the boundaries of what is acceptable.

Auditors are aware that such tactics are occasionally deliberate and repeated. Some firms have policies and techniques to address such behaviour directly. But manipulative and deceitful behaviour is hard to manage in any context. It often represents abuse within a relationship of trust – such as the audit relationship. Understanding and managing such behaviour is outside the scope of this paper because the vast majority of entities do not seek to manipulate or deceive their auditors. Nevertheless, auditors continue to develop techniques to highlight a wider range of red flags, earlier in the audit process than previously, using information from outside the audited entity, and sometimes automated tools and techniques to bring together information that in the past might not have been linked, or linked too late.

The recent FRC consultation on fraud and IAASB Discussion Paper (DP) on fraud and going concern<sup>7</sup> both include proposals for the greater use of specialists, including forensic specialists, which will help develop thinking in this area.

Corporate behaviour might also be better managed if the existing penalties for misleading auditors were better enforced.

### **STAND-BACKS, SCEPTICISM, SUSPICION AND SKILLSETS**

#### **Stand-backs**

Is compliance with the auditing standards enough to deliver consistently high quality audits? Extant auditing standards acknowledge that this is not the case, and already include specific 'stand-back' provisions which require auditors to do more if application of the standards alone does not adequately respond to assessed risks.

Furthermore, the recently approved suite of new auditing standards on quality management (previously quality control) includes additional stand-backs. For example, ISA 220 Quality Control for an Audit of Financial Statements will in future require the engagement partner to stand back prior to dating the audit report, and determine whether:

- he or she (the engagement partner) has taken overall responsibility for managing and achieving quality on the audit engagement, ie, whether their own involvement has been adequate;
- independence and other ethical requirements have been fulfilled; and
- the audit report is appropriate.

International Standard on Quality Management (ISQM) 2 will reinforce this by specifically requiring the engagement quality reviewer to stand back and evaluate the basis for the engagement partner's conclusions in these areas. While it is arguable that in most cases auditors already are (or should be) doing this, introducing specific requirements does seem likely to raise the bar by making both engagement partners and engagement quality reviewers pause, and think again.

7 FRC ED Proposed ISA (UK) 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* and IAASB DP *Fraud and going concern in an audit of financial statements*

### **Scepticism and suspicion**

Neither rules nor principles-based standards can fully address how auditors demonstrate an appropriate level of professional scepticism in the pursuit of audit quality. It is also arguable that audit committees have a greater role to play in exercising scepticism regarding management assertions. Discussions about the possibility and desirability of auditors not merely being sceptical, but having a more 'suspicious' mind-set are highlighted in the IAASB DP on fraud and going concern and in the Brydon report.<sup>8</sup> That DP, the Brydon report and the FRC consultation also explore the need for auditors to engage forensic specialists in certain circumstances, or in certain types of audit, and whether separate engagements should be considered to address the risk of fraud more broadly.

New audit technologies, properly and skilfully applied clearly have a role to play in helping auditors demonstrate enhanced professional scepticism. The better the technology available, the more auditors are able to identify trends and systematic bias, to root out hidden anomalies, and thereby better challenge management assumptions in many different areas - provided of course that they apply the technology to systems and data with which they have thoroughly familiarised themselves, and whose strengths and weaknesses they have assessed properly.

### **Skillssets**

In the past, audit firms have managed audit quality behaviours through training. More recently, they have focussed on the behavioural issues affecting audit quality that are less susceptible to process. These issues include how judgement and scepticism can be developed; how they are embedded in audit team interactions, group mind-sets, the tone at the top and the firm's culture. There is also increasing focus on the characteristics, skills and competencies the next generation of auditors will need to demonstrate.

The skillsets of future auditors will include a greater element of the soft skills required to challenge management, experts and specialists effectively in technically complex areas at an appropriate level. A high level of technical expertise will still be required but increasingly, neither management nor auditors have, or can be expected to have, a detailed understanding of some highly complex areas, such as the algorithms used in the models that underpin the calculation of some material accounting estimates.

The ability and willingness to challenge those with greater seniority, and greater technical expertise, confidently and effectively, has always been important. Auditors have managed. But the need to attract the brightest and best, whose potential goes beyond technical competence and financial literacy, is more important than ever. New recruits will need emotional intelligence, resilience under pressure, adaptability, confidence, courage and sensitivity to help identify and deal with situations in which management is trying to hide fraud, bias or the active manipulation of financial information.

The need for technical expertise will remain. Familiarity with the accounting framework and with a particular sector, whether it be retail, construction or charities, always gives auditors a head start when it comes to the quality of audit judgements. Specialisation in the professions is a long-term trend and auditors, like doctors and lawyers, will need to learn to work more effectively with experts and specialists on a day to day basis.

<sup>8</sup> In our February 2021 comments on the IAASB proposals, [ICAEW Rep 11/21 Fraud and going concern in an audit of financial statements](#), we do not support taking this idea forward.

Audit firms should continue to develop tools and techniques for flagging and managing manipulative and deceptive behaviour.

Auditing standard-setters and policy makers should consider the additional tools auditors need to deal with such behaviour effectively, including reconsideration of the enforcement of penalties for misleading auditors.

Audit committees should consider how they can improve audit quality by providing a more robust challenge to management assumptions.

### **SPECIALISTS, GENERALISTS AND THE CHARACTERISTICS OF A STRONG AUDIT TEAM**

Among the many challenges to audit quality are the size and complexity of many audited entities generally. Accounting is becoming no easier. Globalisation, complex mergers and acquisitions, and few of the challenges represented by new business models or the correspondingly complex IT systems existed a generation ago.

An increasingly important element of robust financial reporting, and therefore audit quality, is recognising the need for skillsets outside of the capability of the reporting entity's management and the audit team. Work carried out by and consultations with experts and specialists are increasingly important in determining whether transactions and balances are materially misstated.

Concerns about the use, or lack of use, of experts and specialists in circumstances that demand them, and about the quality of review and challenge by the core audit team, are highlighted in audit inspection reports. The use of the work of experts and specialists drops off sharply outside the largest firms, mainly because of cost. Simply demanding that more auditors use experts and specialists is not necessarily the best way forward. Nor is simply managing without them in highly complex areas with which management and auditors are unfamiliar.

If the reform process in the UK results in requirements for more user-driven assurance, more assurance on non-financial information and greater involvement in audits of IT, forensic and other experts and specialists, the audit teams of tomorrow will look different to those of today. In future it will be important for audit committees and auditors to establish more robust quality management systems covering their engagement with experts and specialists, both internal and external.

Entities and audit firms should evaluate the costs and benefits associated with enhanced engagement with experts and specialists, including the need for robust oversight.

## ROOT CAUSE ANALYSIS

Root cause analysis (RCA) is intended to improve audit quality by identifying the underlying causes of external inspection or internal review findings, on an audit or firm-wide basis. It should improve a firm's ability to prevent recurrence of negative outcomes and promote positive outcomes.

RCA commonly involves individual and/or group interviews with members of an audit team, to discuss a certain audit issue. Causes of issues are then explored and worked back until a root cause, or causes, are determined. Everything is on the table: skills, knowledge and training issues; issues with judgements and technical accounting treatments; relationships within the team and with management; methodologies, process, and software; and softer areas, including the tone at the top.

It is hard to measure the impact on audit quality of the interaction of different personalities within the audit team. Managers may work well with some partners but not others. A partner and manager who are both detailed reviewers, but weaker when it comes to seeing the 'big picture', will be less effective than those whose skillsets complement each other. RCA is one way of assessing the quality of these human interactions, and if there was friction that compromised audit quality, or synergies that enhanced it.

Until now, RCA has been primarily about what went wrong. A common response initially was more and better training. More recently, and in response to regulatory pressure, a more sophisticated and broader range of responses have been developed, particularly where similar issues arise in subsequent periods, despite remedial training.

Audit regulators increasingly ask for evidence of RCA performed at the firm level, and in response to inspection findings. Responses now include better communications within the firm, methodology enhancements, real-time monitoring, better integration of internal specialists, improved project management, and a focus on recruitment and attrition.

ICAEW first produced a guide to RCA in 2016<sup>9</sup>, but it is still an emerging area. The airline industry's innovative response to failures include a very effective focus on communications, and the use of technology to better manage those communications. People are the key to the avoidance of both aviation and audit failure.

RCA for auditors in practice involves consideration of a broad range of AQIs, including audit hours, partner and manager involvement in an audit in terms of time and phasing, previous inspection results, fee recovery, utilisation rates, and engagement risk ratings.

Best practice is beginning to emerge. Some believe that RCA is most effective starting with a blank sheet of paper, rather than established AQIs and identified root causes, but few firms actually perform it this way. There is nevertheless an emerging consensus that RCA operates best in a 'no blame' culture, in which causes can be dealt with openly and constructively, without the fear of fault finding adversely affecting the appraisal rating of a participant. The process requires time, empathy and communication skills across professional, social, generational and sometimes jurisdictional and cultural boundaries.

9 ICAEW's 2016 publication, [Improving audit quality using root cause analysis: What, why, how, who and when?](#) is a notable exception.



RCA is no longer a new idea. Audit regulators demand evidence of it and reference is made to it in the new IAASB standards on quality management. However, ICAEW guidance aside, guidance on what a comprehensive RCA might look like for audit has yet to be developed. The FRC's consultation on AQIs may move this agenda forward.

Firms of all sizes should consider adopting at least simple forms of root cause analysis at the engagement level to help drive improvement in firm-wide quality management. Firms and audit regulators should be more focused on the dynamics of good quality audits.

## *Structural drivers*

### **OVERSIGHT AND REWARD**

The largest audit firms have independent audit oversight boards led by non-executives to challenge the firm's quality management environment. The use of AQIs by such boards to monitor quality management within the firm is a developing area.

The belief that risk and reward in audit firms may be misaligned, and that this misalignment is at the heart of audit quality issues is important. Advances made over the last twenty years mean that there are strong links between audit quality, promotion, rewards and remuneration. But more can be done. Reward may no longer be based on the provision of non-audit services to audited entities but the perception lingers. Having audit quality unequivocally at the heart of a firm's appraisal process is important. The FRC Thematic notes that firms make 'some use' of AQIs for appraisals and the remuneration of partners and directors.

Internal reviews of completed audit files - 'historic' or 'cold' reviews - are still central to many firms' quality management systems, as are 'hot' reviews conducted by managers and partners during the course of the audit. 'In-flight' reviews are also conducted during the course of the audit but by an independent, internal team and are becoming more common, partly as a result of regulatory pressure. Audit inspectors rightly observe that assessing audits after the event is simply too late. A key element of reviews for some larger firms is the use of audit 'milestones', monitored by the firm quality teams, which build reviews and sign offs into different stages of the audit process, such as at the file set up, planning, and interim stages, to help identify issues as they arise.

An important part of this is the availability of real time information, and the automatic production of AQI reports showing when milestones were reached and sign offs were evidenced, for example. When combined with the automation of reports on other audit quality metrics, such as online training modules completed on time, and files archived on a timely basis, firms are increasingly able to paint a holistic picture of audit quality and build it into the appraisal process.

There should be greater acknowledgment of the relevance to audit quality of the link between risk and reward. Reward needs to take into account the level of risk that the firm takes on board when accepting a new client and when performing the audit. It is also important to acknowledge that it is harder to achieve a high inspection rating on a highly complex, risky audit than it is on a straightforward audit.

## RAISING PROFILES: TRANSPARENCY REPORTS AND THE ROLE OF INVESTORS

Auditors of UK PIEs are required to publish transparency reports. Those with more than twenty listed entities (currently eight firms) are required to comply with the Audit Firm Governance Code, which requires the disclosure of governance KPIs, appointment processes, independent non-executive details and activities, and a business risk assessment.

The FRC Thematic notes that of the 100 UK audit committee chairs who responded to a survey, almost 75% were unaware of transparency reports or their content, and only 10% were aware of AQIs.<sup>10</sup> This is worrying as well as disappointing. If audit committees are to make informed decisions about auditors, the availability of transparency reports needs to be better publicised. Auditors could do more to raise the profile of these important publications, but some audit committees could and should be more pro-active than they are in seeking out information about audit quality, for which they are, after all, responsible. Audit firm transparency reports are not hard to find.

The number of audit firms publishing transparency reports in the UK has increased, as has the quality of information therein. However, those audit committee chairs who were aware of transparency reports suggested that they were too long, and that shorter summaries would be useful. While the FRC reports little consensus regarding which AQIs are important to audit committee chairs, they do appear to value the results of staff surveys, and partner and manager hours as a percentage of the total.

The FRC acknowledges that engaging investors in a meaningful dialogue about audit quality is challenging, but notes that the investors they engage with would value more comparative information - a 'consistent set of metrics with a three to ten-year historical trend', together with explanations of changes. In particular, they expressed interest in attrition and tenure rates by grade, ethical breaches and professional tribunals.

Investors are the ultimate beneficiaries of audit quality. Corporate investors have to date had little interest in this area but there is more publicly available information about auditor performance than ever before. Further debate is also needed on a role for investors in the appointment of auditors.

Auditors and audit committees need to work to raise the profile of transparency reports.

Audit regulators and investors need to use the information now available to further the debate on their role in promoting audit quality.

<sup>10</sup> Although this is better than the FRC's 2019 Thematic Review [Transparency Reporting](#) which showed that 85% of audit committee chairs surveyed were 'not even aware of transparency reports'.

## AUDITING STANDARDS AND AUDIT TECHNOLOGY

### New quality management standards

In ICAEW's recent thought leadership essay, [Audit quality: the role of standard-setting](#), we argue that auditing standards matter because they have a direct impact on audit methodologies, and because audit regulators and auditors are both interested in auditor demonstration of compliance.

After an exceptionally lengthy project, in September 2020, IAASB approved a suite of three quality management standards to replace the two existing standards on quality control.<sup>11</sup> The main features of the new regime are a new auditing standard on engagement quality control reviews, and a requirement in ISQM 1 for firms to implement a system of quality management.

The standards deal in some detail with networks and service providers, to date often areas of confusion and disagreement between auditors and audit regulators. They also attempt to clarify the demarcation of the responsibility for quality management between firms, engagement partners and engagement quality control reviewers.

It is not expected that there will be any significant additions in the UK to the IAASB requirements. While the implementation date is effectively for periods ending during 2023, systems will need to be in place by 15 December 2022. Some firms, including smaller firms, already have quality management systems in place that go above and beyond the existing requirements. Such firms may need to do little more than reflect to ensure that all areas are covered, and to revise their documentation. For many, however, more will be required and audit regulators such as the FRC and professional bodies such as ICAEW will need to work together with practitioners to ensure that the transition is well planned, and that firms do not find themselves trying to second-guess the approach of audit regulators.

Efforts are now being made to improve the agility and efficiency of auditing standard-setting more generally, and thereby the quality of auditing standards and the quality of audit. The Monitoring Group's July 2020 proposals now being implemented relate to the reform of standard-setting and include a reduction in the size of the international auditing and ethics standard-setting boards (IAASB and IESBA) and the greater use of staff to perform the detailed drafting work currently performed by volunteer members of the boards. The proposals also focus on the need for proportionality in standards overall. IAASB's current project on the audit of less complex entities offers further scope for enhancing audit quality for SME audits.

### Technology

Until now, auditing standards have said little about the use of technology in audit. The March 2020 FRC Thematic Review [The use of technology in the audit of financial statements](#) and the associated discussion paper (DP) [Technological Resources: The Use of Technology to Enhance Audit Quality](#) are therefore timely. They deal with the curiously tricky issue of the impact of audit data analytics (ADA) and other technologies on audit quality.

Technology has the potential to improve both audit quality and audit efficiency. However, the FRC reports concerns about firms conflating the two. They also report reliance on untested and unproven models in the past.

On the other hand, some have complained that audit regulators have effectively hampered the development of new technologies because of, at least initially, a lack of resources within the

<sup>11</sup> [International Standard on Quality Management \(ISQM\) 1 \(formerly ISQC 1 \(Revised\)\), Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements; ISQM 2, Engagement Quality Reviews; ISA 220 \(Revised\), Quality Management for an Audit of Financial Statements.](#)

regulatory community to address the issue. In some jurisdictions regulators have refused to accept audit evidence produced using new technologies because auditing standards do not explicitly permit their use.

Audit firms and audit regulators have, fortunately, moved on. The FRC notes that the use of ADA 'is now routine at the largest UK audit firms', with considerable investment in onshore and offshore specialist hubs, infrastructure, methodology and training. It notes the increasing use of bespoke ADA on entities with complex systems and that the quality of evidence on files relating to their use, including the use and findings of specialists, has improved. Detailed observations on the validation, stabilisation, review and evidencing the operation of algorithms demonstrate the FRC's understanding of the area.

Areas in which these tools are now commonly used include general ledger analysis at the risk assessment stage, revenue analytics and journal entry testing, but the link between the use of ADA and audit quality still seems tenuous for the FRC. It states that while ADA 'continues to have a role to play in the improvement of quality for the audit of revenue, we have not seen the increased use of ADA when auditing revenue lead to the identification and adjustment of significant audit differences',<sup>12</sup> although the FRC does acknowledge that it leads to better understanding of the business.

Furthermore, the FRC clearly acknowledges that aspects of artificial intelligence, and specifically machine learning, natural language processing and predictive analysis, while still largely at the research and piloting stage, all have the prime objective of improving audit quality, rather than efficiency, to the extent that 'the primary attraction is one of coverage (and hence quality) rather than speed'.<sup>13</sup>

What is less evident in these developments is any real commitment on the part of auditing standard-setters to deal now with audit technologies systematically within auditing standards, which might promote their use and move the understanding of audit quality to a different level.

A recent Staff Audit Practice Alert by IAASB dealing with the concurrent use of ADA as risk assessment and substantive analytical procedures, is part of a series of non-authoritative publications by IAASB. These complement a very limited number of references to automated tools and techniques (ATT) in auditing standards. A measure of the limited linkage between audit technology and audit quality in the view of the FRC is reflected in the questions it asks in the DP,<sup>14</sup> including whether respondents believe that the use of ATT improves audit quality beyond efficiency gains. It goes on to ask whether the current assurance model or auditing standards represent obstacles to innovation, which suggests that the FRC does not believe that the basic risk model underlying auditing standards is called into question by ATT, a position not universally agreed.

Auditing standard-setting is in a period of transition, nationally and globally. Standard-setters should take the opportunity to consider alternatives to the existing assumptions and models underlying auditing standards with a view to ensuring that high quality audit remains a relevant and valued service.

12 It also states that auditors must '...be careful to direct audit effort at that which is potentially significant or material rather than populations or items that are merely interesting.'

13 The FRC cites the standard example of the use of natural language processing in identifying the use of standard contract terms in large numbers of contracts, and the potential of predictive analysis to improve the challenge to management. It suggests that robotic process automation, drones and smartphone apps are tools relating to efficiency only. Process mining was deployed by one firm only, and blockchain technology, sensor technology and virtual and augmented reality were not considered in detail.

14 ICAEW's response, [Rep 44/20](#), dated 3 July 2020.

## *Where next?*

### CONCLUSIONS

Audit quality is an issue that transcends national boundaries and is of interest around the globe. In this essay we have demonstrated that audit quality is not just about auditors, that company boards, audit committees, audit regulators and auditing standard-setters all have not just a role to play, but a responsibility for audit quality. We have highlighted the role and responsibilities of all of those involved in the audit quality supply chain and steps they can and should take now – set out below – to improve audit quality, regardless of proposals for changes to legislation, regulation and auditing standards as part of the current drive to reform audit.

Our ideas are, however, also presented as a contribution to that ongoing process of reform, including in the UK, where the long-awaited government consultation paper on radical changes to the UK corporate governance and audit system is likely to have profound implications for audit quality.

### SEVEN STEPS FORWARD

Boards should do more to ensure that audit committees are properly equipped to provide a robust level of challenge to management and auditors.

Audit committees should focus more on audit quality, particularly in challenging times.

Audit regulators should do more to align the behaviours of audit inspectors with their aims and objectives. They should be more actively focussed on audits performed well and share their understanding of audit quality to a greater extent than they do now by publishing case studies.

Audit regulators, audit committees, investors and auditors need to work together to develop a framework and methodology for the calculation and reporting of AQLs, including a disclosure framework for comparatives. An agreed set of specific AQLs at firm and engagement level will encourage high quality, consistent and comprehensive reporting.

Audit firms should continue to develop tools and techniques for flagging and managing manipulative and deceptive behaviour.

Auditing standard-setters and policy makers should consider the additional tools auditors need to deal with such behaviour effectively, including reconsideration of the enforcement of penalties for misleading auditors.

Audit committees should consider how they can improve audit quality by providing a more robust challenge to management assumptions.

Entities and audit firms should evaluate the costs and benefits associated with enhanced engagement with experts and specialists, including the need for robust oversight.

Firms of all sizes should consider adopting at least simple forms of root cause analysis at the engagement level to help drive improvement in firm-wide quality management. Firms and audit regulators should focus more on the dynamics of good quality audits.

Auditors and audit committees need to work to raise the profile of transparency reports.  
Audit regulators and investors need to use the information now available to further the debate on their role in promoting audit quality.

Auditing standard-setting is in a period of transition, nationally and globally. Standard-setters should take the opportunity to consider alternatives to the existing assumptions and models underlying auditing standards with a view to ensuring that high quality audit remains a relevant and valued service.

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\* Source: CAW, 2020 - Interbrand, Best Global Brands 2019