THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty

AuditQuality@

Fundamentals – Principles-based auditing standards

What are 'principles-based' or 'objectives-oriented' auditing standards? This paper explores the perceptions of the nature of such standards. How do they differ in practice from 'rules-based' standards? Implementation issues are also explored including the capacity of such standards to deliver real improvements in audit quality and the need to balance the promotion of professional judgement with the need for auditor accountability.

AuditQuality@

The *Audit Quality Forum* brings together representatives of auditors, investors, boards and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The initial focus of the *Forum* was to improve audit transparency and support shareholder involvement in the audit process. At is meeting in May 2005 the *Forum* agreed to explore a broader agenda which examines the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit.

Anyone interested in providing feedback on this paper should send their comments to **katharine.bagshaw@icaew.co.uk**.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at **www.auditqualityforum.com** or telephone 020 7920 8493.

Law and regulations referred to in this paper are stated as of 24 May 2006.

ISBN 1 84152 454 9

AuditQuality@

Fundamentals – Principles-based auditing standards

Contents

Executive summary

What are 'principles-based' or 'objectives-oriented' auditing standards? This paper explores perceptions of the nature of such standards and how they differ in practice from 'rules-based' standards. Implementation issues are also explored including the capacity of standards to deliver real improvements in audit quality and the need to balance the promotion of professional judgement with the need for auditor accountability.

There are references throughout this paper to 'stakeholders' who are investors, regulators and the profession. 'Investors' are shareholders, holders of debt securities and the investing public. 'Regulators' are auditor oversight bodies, standard-setters, securities regulators and governments.

Stakeholders in the auditing standard-setting process all have an interest in high-quality audit and they are all represented on the working group ('the group') responsible for this paper. The individuals who served on the group and the organisations they work for are listed in Appendix 2. Without them, this paper would not be possible and the *Audit Quality Forum* is grateful for their time and input.

Key issues

The key objective of the group was to:

> *... identify issues relating to the development of principles-based auditing standards given differing perceptions of the purpose of an audit and different regulatory frameworks.*

The group identified and concluded on nine key issues. The group hopes that the articulation of these issues will help all of those affected by auditing standards better understand each others' positions. Three of these issues are particularly challenging: there are cultural and structural barriers to the development of principles-based auditing standards, described as 'hurdles', which require careful thought by stakeholders in the auditing standard-setting process.

It became clear during the development of this paper that people mean different things when they refer to terms such as 'objectives', 'principles' and 'rules'. Looking forward, a more fruitful focus for debate might be on *why* these terms are understood differently, why stakeholders believe that principles-based standards are useful, and what they mean by 'principles-based standards'. This involves understanding differing perceptions amongst stakeholders as to the role of auditors, the purpose of auditing standards, the role of judgement in auditing standards and the extent to which the behaviour of auditors can and should be influenced through auditing standards. The challenge for an international standard-setter is in reconciling these views.

The development and promulgation of principles-based standards is no easy task. There may be limits to the capacity of auditing standards to meet the needs of very large entities and audit firms, much smaller entities and audit firms, jurisdictions in which the profession is well-established, and those in which it is less so. Nevertheless, the pursuit of auditing standards that are more principles-based than they are at present is worthwhile because the quality of auditing standards affects the credibility of the audit opinion.

The conclusions below are taken from the body of this paper.

1. Understanding the terms, 'objectives' 'principles' and 'rules'

Distinctions between objectives, principles and rules are not clear cut. Superficial similarities in language can hide significant differences in understanding. But the fact that many jurisdictions subscribe to the idea of principles-based standard-setting is important.

Differences of opinion as to whether there is a right length for auditing standards and how long that might be are less important than the need to recognise that with limited resources, detailed and lengthy auditing standards that attempt to cover all possible situations are unlikely to improve audit quality.

Cost-benefit analyses or regulatory impact assessments need to be performed before the introduction of new standards in order to restrain the proliferation of unnecessary detail, enhance the quality of auditing standards and the transparency of their development, and to promote their acceptance.

2. How do rules affect judgement, integrity and consistency in the conduct of audits?

Behind the view that auditors need more rules on how to do their jobs lie a lack of trust in the use of judgement by auditors and a lack of experience and confidence on the part of some regulators. It will take time to change this but rules do not necessarily reduce, and certainly do not eliminate, the need for judgement and integrity. Nor do rules necessarily promote consistency. In standards that are more rules-based, the role of judgement and the need for integrity are simply transferred, in part, to the application of those rules. Current auditing standards do not require more procedures and less judgement than before, but more procedures and more judgement.

3. What do we mean by audit quality? Can audit quality be measured and improved?

Audit quality may be hard to define but there are different qualitative and quantitative ways to measure it. Whilst measurement techniques are fallible, audit quality should be measured and it can be improved. Those concerned with improving audit quality, including auditor oversight bodies, academics and audit firms may in the past have focused on quantitative measures. They should be encouraged to focus more on qualitative factors that affect auditor behaviour including the quality of judgements, training, and feedback from shareholders and audit committees.

4. To what extent do auditing standards affect audit quality?

Auditing standards are an important part of the auditors' toolkit. Their primary purpose is to enable auditors to perform audits. Auditing standards are also helpful to regulators. But auditing standards cannot be a substitute for the proper training of auditors or regulators, the maintenance of ethical standards or professional integrity. Audit failures tend to relate to errors of judgement, the failure to uphold ethical standards or an absence of professional integrity rather than failures in auditing standards *per se*.

5. Why professional integrity underpins auditing standards

Principles-based auditing standards only work if the auditors who use judgement in applying them display professional integrity. The solution to the problem of a lack of integrity in some parts of the profession is not the promulgation of detailed rules, which perpetuate an avoidance mentality, but the development or restoration of high-quality, clear and unambiguous auditing standards and an effective principles-based system of oversight.

6. How far has the IAASB's clarity project moved auditing standards in the direction of principles-based standards?

The IAASB's clarity project has highlighted the importance of principles-based standards and recognises the need for a 'stand-back' to determine whether objectives have been achieved. Nonetheless, work is needed and a top-down approach should be taken such that:

> Overarching objectives of an audit are developed.

> A full and integrated set of objectives are derived from the overarching objectives to guide the conduct of the audit.

> The requirements of standards are derived from the full and integrated set of objectives.

In other words, objectives should not simply be derived from the existing requirements in individual standards.

Hurdles

7. Should each jurisdiction determine its own appetite for detailed rules?

If global harmonisation of auditing standards is a worthwhile and achievable objective – some dispute both assertions – allowing for important legal, regulatory, cultural and other differences by permitting jurisdictions to determine for themselves the right level of detail in auditing standards may be a recipe for spurious harmonisation and lowest common denominator standards. But ignoring or playing down the importance of such differences is a recipe for failure. The consistent application of standards both within and across jurisdictions is one measure of audit quality and standards that do not accommodate important differences would not be applied consistently. This would lead, eventually, to the discrediting of the standards. The pull of the marketplace, rather than the push of standard-setters and regulators, may well be the better driver of audit quality in the longer run.

8. Principles-based standards, differing legal systems, litigation risk and the need for an incremental approach

Principles- or objectives-based standards are well-supported on both sides of the Atlantic and quite well understood, albeit differently, despite differences in legal systems, regulatory frameworks and litigation risk. There is general agreement that better auditing standards have more robust principles and should need fewer rules. Nevertheless, the structural barriers in the US to the removal of detailed rules and development of more principles- or objectives-based standards should never be underestimated.

9. What criteria and processes are needed to strike the balance between principles and rules?

The proliferation of rules in auditing standards is not inevitable. Conflicting objectives in accounting standards give rise to uncertainty and the need for detailed rules, but this problem is unlikely to be as acute in auditing standards.

The tension between those who believe that auditing standards are too long, detailed and prescriptive and those who believe otherwise is healthy. Standard-setters should consider the needs of all concerned and reject demands for certainty where there is none, principles-only standards, or standards that seek to prescribe auditing procedures so as to minimise the need for the use of judgement.

The process of the exposure of auditing standards and hammering out a consensus between stakeholders, some of whom need to be more actively engaged than they are at present, will help ensure that in the long run, a better balance will be struck.

Only if standard-setters fail to understand the issues, become indifferent to the need for consensus, or give undue regard to the interests of one group at the expense of another, will the process fail.

Introduction

Background

In May 2005, the *Audit Quality Forum* agreed to explore a broad agenda, which would examine the relationships between shareholders, boards, auditors, regulators and other stakeholders in the audit. All of these stakeholders have an interest in high-quality audit that is performed by a strong audit profession, which, amongst other things, demonstrates integrity and objectivity, professional judgement, scepticism and expertise. One of the key issues raised at the *Forum* was concern over the differing perceptions amongst stakeholders of the purpose of the audit and the impact this therefore has on the development of principles-based global auditing standards and on reporting by auditors.

In the light of these concerns, working groups were established to take forward a project to understand and articulate the purpose of an audit and other closely related projects on auditing standards and reporting.

This paper explores the perceptions of the nature of 'principles-based' or 'objectives-oriented' auditing standards and how they differ in practice from 'rules-based' standards. It also considers implementation issues including the capacity of such standards to deliver real improvements in audit quality and the need to balance the promotion of professional judgement with the need for auditor accountability.

Key objective of the group

The key objective of the group was to identify the issues relating to the development of principles-based auditing standards given differing perceptions of the purpose of an audit and different regulatory frameworks. The group's discussions centred on the following themes:

> **Principles, judgement and accountability:** different perceptions of stakeholders as to the nature and purpose of principles, objectives and rules in the context of auditing standard-setting and, in particular, the issues associated with the exercise of judgement by auditors, stakeholders' reliance on auditors and the need for auditor accountability.

> **Effect of principles-based standards on audit quality:** the extent to which stakeholders believe that auditing standards that are principles-based or objectives-oriented, are likely, of themselves, to improve audit quality, and the barriers to establishing such standards.

> **Opportunities and barriers in international convergence:** ways in which international stakeholders might seek to move towards convergence in their understanding of principles, objectives and rules in the context of auditing standard-setting.

> **Perceptions in the UK, Europe and the US:** areas of commonality and difference in all of the areas noted above between the perceptions of stakeholders in the UK, continental Europe and the US.

The key conclusions of the group and issues for further consideration are highlighted in this paper. The differing perceptions of stakeholders were considered during detailed discussions on the first three themes.

Principles, judgement and accountability

Understanding the terms, 'objectives', 'principles' and 'rules'

There have been numerous attempts to define terms such as 'objectives', 'principles' and 'rules' but there is no clear, generally accepted or even common understanding of the differences between them. And whilst there is general agreement amongst most stakeholders that excessive rules are undesirable, there is little agreement as to how much is excessive. People mean different things when they talk about objectives, principles and rules and there are different types of objectives, principles and rules. As a result, there is a certain level of spurious agreement on the subject. The problem is not a new one and references to the problem have been traced, albeit in the context of accounting standards, back to 1938.[1]

Some principles seem to be absolute and have no exceptions. Such principles might be better described as either definitions, such as 'all leases are either operating or finance leases', or as principles of behaviour, such as 'do as you would be done by'. The former is found more commonly in accounting standards, whereas behavioural principles, which might be better described as aspirations or objectives, are more commonly found in auditing standards.

Other principles do admit to some exceptions. Generalisations such as 'all swans are white', are akin to definitions. Generalisations affecting behaviour such as 'auditors should obtain sufficient audit evidence to support their audit opinion' may admit to exceptions in circumstances in which sufficient appropriate evidence may not be available. In both cases, such principles may need further principles or guidance to deal with the exceptions, depending on the extent to which they are deemed necessary to control the accuracy of categorisations or to control or guide auditor behaviour.

It is the behavioural principles, or aspirations or objectives that cause most difficulties. Some believe that by definition, there should be no exceptions to principles and others believe that there should be no exceptions to rules. So for some, 'do as you would be done by', is not a principle but a rule, because there are no exceptions to it. For others, the fact that there may be exceptions to the need for auditors to obtain sufficient audit evidence means that the statement that auditors should obtain it is not a principle, either.

Whilst definition-type principles, generalisations and behavioural principles all require some level of judgement in applying them, the overlap between judgement and exceptions is not clear. For some, the fact that sufficient audit evidence is not always available means that auditors will have to use their judgement in deciding what is sufficient, and in deciding what to do when it is not available. There is no exception to the principle. For others, further principles or guidance will always be needed to steer the

[1] Littleton commented in 1938 that: 'the word "principles" has undoubtedly been overworked in accounting literature. It has been extensively used by both accounting practitioners and academic writers with little discrimination...each book usually contains a mixture of axioms, conventions, generalizations, methods, rules, postulates, practices, procedures, principles, and standards. These terms cannot all be synonyms. And little effort has been expended in showing that they are not, although the need for separation becomes more apparent as time passes.' *Accounting Review*, March 1938, pp. 16-24.

More recently, Hendriksen and van Breda claim that the term '"generally accepted accounting principles" (GAAP)...is as empty of meaning today as when it was first coined, because, there is still no consensus on what constitutes a principle.' *The Journal of Accountancy*, June 1972.

The most recent attempt at a definition in the context of accounting standards appears in *Principles Not Rules*, ICAS, 2006.

use of judgement in determining what is sufficient. The fact that evidence may not be available means that there is an exception to be dealt with, also by means of further principles or guidance.

The issues at stake here seem to be the extent to which auditor behaviour can and should be influenced or managed though auditing standards, the extent to which auditors need to be given an objective and left to achieve it, and the extent to which auditors need to be told how to achieve it.

The distinctions between objectives, principles and rules are not clear cut. The reasons behind the absence of a common understanding of these terms lie in differing perceptions as to the role of auditors, the purpose of auditing standards, the extent to which auditors should be permitted to use their judgement in conducting audits and other criteria for 'good' auditing standards, such as whether they should be about processes or outputs, or both.

Whereas in an ideal world, high-level principles cascade down into more detailed rules (i.e. a top-down approach), it is more common in practice for principles to be abstracted (or synthesised) from, and overlay, existing rules (i.e. a bottom-up approach). The IAASB is grappling with this problem as part of its clarity project.

Whilst it is important that those discussing the subject understand that superficial similarities in language can hide significant differences in understanding, it is nevertheless significant that many jurisdictions at least subscribe to the notion of principles-based standards. Global harmonisation of principles-based auditing standards will not be achieved overnight but the first steps towards this goal have already been taken. Hammering out a better balance between principles and rules may take a long time but a belief that the objective is achievable and worthwhile is important.

> Distinctions between objectives, principles and rules are not clear cut. Superficial similarities in language can hide significant differences in understanding. But the fact that many jurisdictions subscribe to the idea of principles-based standard-setting is important.

The proliferation of principles and rules

There is general agreement amongst stakeholders that excessive length and complexity in auditing standards help no-one. Excessively detailed principles or rules lead to a lack of clarity, the very opposite of what they are intended to achieve. Answers to technical accounting and auditing questions are much less clear than they used to be, or ought to be. This is damaging to financial reporting and audit quality, external perceptions thereof, and ultimately to business and the capital markets. Principles and rules may proliferate because of:

- Poor and unclear drafting and the use of ambiguous terms, requiring interpretation.
- Conflicting principles or rules.
- Principles or rules that do not achieve their intended objectives.
- A fear on the part of the profession of being second guessed leading to demands for more guidance on how principles or rules are to be applied.
- Exceptions and exceptions to exceptions.
- The standard-setting process itself, which seeks to accommodate a wide variety of views.
- Inertia on the part of those affected until it is too late.

> A desire for consistency, clarity and comparability, where in fact there may be none.

> A refusal to contemplate the removal of or significant changes to existing principles or rules, for fear of perpetuating the mischief the principles or rules were intended to remedy.

Some consider that part of the problem lies in the absence of an adequate framework for accounting or auditing. They believe that it is necessary to have a robust overall objective or framework from which to derive principles but that current frameworks for accounting standards provide poor examples. Some conclude from this that a framework for auditing would make little difference. There is neither a conceptual framework nor any fundamental principles for auditing. The IAASB decided not to develop fundamental principles as part of its clarity project and a conceptual framework may only be developed in the longer term.

Even where there is a framework, the process of deriving rules from principles may result in rules defeating or falling short of overall objectives either individually or collectively (as a result of sheer volume or a lack of logic). This in turn leads to a further proliferation of rules, largely because of a reluctance to alter 'established' principles. For example, the two-line requirement for reporting on internal control in Section 404 of the US Sarbanes-Oxley Act, which is often described as a rule but can also be viewed as analogous to a principle, has (necessarily) resulted in PCAOB Auditing Standard No. 2. This standard has within it certain requirements with which auditors must comply (i.e. rules), and this in turn has resulted in 57 FAQs, which could be described as implementation guidance (225 pages in total). History teaches us however, that within the 225 pages there are:

> Areas lacking in clarity or requiring the exercise of judgement in which inconsistent practice arises.

> Areas in which judgement is permitted which may be abused.

> Matters that cast doubt on the usefulness of the basic two-line requirement,

any or all of which will eventually, directly or indirectly, lead to calls for both further rules and implementation guidance, because changing the basic two-line requirement might be seen as suggesting that it was in some way flawed.

In the context of auditing, many in the profession believe that the recent increase in procedural requirements in auditing standards (principally the risk and fraud ISAs and the PCAOB auditing standards) have resulted in some limited improvement to audit quality, but at a disproportionate price. The increase in audit documentation required by the risk, fraud and documentation standards, in particular, are perceived as principally for the benefit of regulators i.e. for 'compliance' purposes only. This comes at a price, with little concomitant improvement either to audit quality or to the value that auditors can provide to their clients, particularly their smaller clients. This is regarded as deleterious to audit quality to the extent that clients have a limited capacity for the absorption of fee increases leading to too much time being spent on compliance work and too little on other audit work which does improve audit quality and provides value to clients. In other words, regulators are attempting to have their work performed by auditors and have shareholders pay for it, although shareholders ultimately pay for regulation anyway.

Others point to the fact that the client is the entity's shareholders, and that the aggressive promotion of the 'value added audit' over the last 20 years generally referred to value added to management. They take the view that the concept of audit quality cannot and should not be decoupled from the notion of value to shareholders. The documentation prescribed by the risk, fraud and documentation standards is something that should have been done in any case by auditors applying the spirit of existing standards and they believe that this does improve the quality of the audit opinion. Those taking this somewhat 'old-fashioned' view, which now seems to be enjoying something of a renaissance, point to the values and status of the profession before it was damaged in the 1980s and 1990s. They also look back to the introduction of audit regulation in the UK, for example, and hear echoes of the same arguments put forward then by the profession. The greater scrutiny of auditors then introduced is now generally accepted, albeit without much grace in some cases.

In general, the emphasis on documentation and compliance seems to depend on the state of the capital markets. When things are going well, people have other things on their minds. When things go wrong, oversight bodies and regulators are charged with tightening things up and the profession, to an extent, welcomes additional ammunition which it can use in dealing with clients who seek to push boundaries on accounting issues. But the old issue of whether audit procedures that are not documented have any value, and whether oral explanations by the auditor regarding audit work or thought processes are admissible or necessary to supplement audit documentation, is still not settled. Some take the view that if something has not been written down, it has not been done. Others take the view that it is simply impossible to write down everything that happens during an audit and that a pragmatic stance is necessarily taken by experienced regulators in any case, if not by litigators.

The increase in detail and prescription in auditing and accounting standards, to the extent that it derives from the US, can partly be explained by the fact that many more lawyers are engaged in the standard-setting process there than is the case in Europe, and the fact that there is more punitive litigation in the US, which tends to entrench rules. As such, US standards are written in part to enable accountants and auditors to defend themselves by demonstrating their compliance with specific requirements.

The length of auditing standards

Polarised views that standards need to cover all possible eventualities or to consist entirely of principles are held only by those on the margins. Most agree that some level of detail is needed in standards and that rules are sometimes useful, particularly in steady state situations where there is little regular or radical change. But the business environment in which auditing and accounting standards operate can no longer be described as steady state, if indeed it ever could be.

The move towards principles- or objectives-based standards in accounting and auditing is nevertheless well-established although there is little support for principles-only standards. The practical problem appears to lie in differences of opinion as to the purpose of auditing standards and the extent of rules supporting the principles. All stakeholders agree that transparency is healthy and regulators, in particular, have specific obligations with regard to the transparency of their own processes and of the markets that they seek to protect. But it is becoming clear that transparency has a price; it goes hand in hand with a high level of detail and there is often a trade-off between transparency and simplicity.

Standard-setters have always recognised that part of the function of auditing standards is to enable reviewers, including external regulators, to consider whether compliance with standards has been achieved. This emphasis is now greater than it used to be and regulators are more vociferous in their demands of auditing standard-setters. This has led, in part, to very much longer auditing standards.

One commonly-cited justification for increases in rules is increased complexity in the world. Complex engineering in modern cars cannot be made transparent to most drivers because they are unable, and do not need, to understand the technicalities. The complexity is necessarily covered up by a dashboard to facilitate ease of use. It is nevertheless vitally important that complex engineering is transparent and properly controlled because if it is not, no one will be able to repair it when it goes wrong. Similarly, the users of audit reports necessarily rely on the audit report because anything significantly more complex might not be comprehensible. But the auditing standards that are covered up by the 'audit report dashboard' do need to be transparent. Auditing follows accounting and as accounting has become more complex, so has auditing. And yet the changes to auditing standards in recent years can only partly be explained by increasing complexity in accounting standards.

Some argue that the absolute length of standards should not matter: haiku is no less impenetrable than *War and Peace* simply because of its length. But many believe that length does matter. With infinite resources, the scope for the use of judgement in interpreting documents will probably be the same, regardless of their length. But resources are not infinite and longer auditing standards shift the focus of professional judgement from the bigger picture to lower level details. Some regulators see this as a positive development because some auditors have failed to use their judgement, abused it or displayed a lack of professional integrity. Others again believe that length is only an issue if standard-setters seek the impossible ideal of covering all possible situations; standard-setters should desist in this and should permit auditors to use their judgement at a higher level. Trying to develop rules about how long auditing standards should be is also unhelpful. The important point is to be clear and realistic about the extent to which standards can and should attempt to cover all possible eventualities.

Differences of opinion as to whether there is a right length for auditing standards and how long that might be are less important than the need to recognise that with limited resources, detailed and lengthy auditing standards that attempt to cover all possible situations are unlikely to improve audit quality.

Cost-benefit analyses

Standard-setters are being encouraged to make more use of cost-benefit analyses, regulatory impact assessments and similar techniques as part of their due process. Such assessments and analyses are now common at the highest levels amongst standard-setters and oversight bodies. Some believe that such assessments have a tempering effect because they act as a brake on the proliferation of rules that will not actually achieve the intended objectives for all of the constituencies affected, and focus attention on unintended consequences, however imperfectly. They also help to promote acceptance of changes. Assessments of qualitative effects highlight the behavioural consequences of proposed regulatory changes and it is by no means always necessary to quantify the effects of proposed changes. Only where there is significant uncertainty about an effect is quantification of costs desirable, and it is widely recognised that cost estimations are always difficult, often wrong (or at least wide of the mark) and should therefore be used sparingly.

Cost-benefit analyses or regulatory impact assessments need to be performed before the introduction of new standards in order to restrain the proliferation of unnecessary detail, enhance the quality of auditing standards and the transparency of their development, and to promote their acceptance.

How do rules affect judgement, integrity and consistency in the conduct of audits?

Behind the view that auditors need more guidance and rules on how to do their jobs lies a belief that auditors cannot be trusted to use their judgement properly. The argument goes something like this: professional judgement has too long been used by the profession as an excuse for opaque technical and ethical decision-making and inadequate documentation. Had auditors used their judgement transparently and with integrity in the first place, the new regulatory landscape with its plethora of oversight and monitoring bodies might not have been necessary. Auditors' pleas to the effect that they must be permitted to use their judgement and that the documentation of judgements is all very burdensome and counterproductive is a simple attempt to preserve the old order, which has been found to be wanting.

There is also a strong suspicion that anyone lacking in confidence, including some regulators, and fearful of the need to deal with some high-powered auditors, might seek the comfort of a bigger rule book for their armoury.

Auditors use their judgement in different ways in parallel with the established hierarchies of principles and rules. Judgement is applied to facts, to the meaning of words and expressions, and to the application of facts to words and expressions. Auditors use their judgement in determining how principles or rules should be applied to facts: is this an operating lease or a finance lease under the rules of IAS 17, for example? And at a higher level, auditors determine whether the objective of the rule or principle has been met: even if this is technically an operating lease under IAS 17, is it in substance a finance lease? It is in these two areas in which auditors' judgement is often most perceived as failing.

It would be possible to simply require auditors to obtain sufficient appropriate audit evidence. However, when it becomes clear to some people that there are too many variations in what auditors deem to be sufficient, requirements are introduced stipulating that third-party evidence and documentary evidence are better than internally generated or oral evidence. And then further requirements are introduced relating to specific types of evidence, regarding attendance at stocktakes and debtors' circularisations, for example.

The argument to the effect that rules reduce the need for judgement and integrity and promote consistency is not watertight. Firstly, a certain level of consistency of inputs may be imposed by mandating certain audit procedures but this does not achieve consistency of outputs (in terms of the quality of the audit opinion) if the procedures are ineffective and auditors are, either directly, or as a result of market pressures, encouraged to do what is required and no more. Not all regulators wish to encourage auditors to hide behind auditing standards and leave their judgement at home, by imposing a spurious level of consistency. In the context of oversight, rules may effectively transfer the responsibility for the use of judgement to the regulator. Some regulators such as the FSA do not consider that detailed rules are required for oversight and that they may even hamper it.

Secondly, in a rules-based system, the role of judgement and the need for integrity are not reduced, but simply transferred, at least in part, to the *application* of those rules. History shows that thickets of rules are easily manipulated by the unscrupulous. The recently issued risk and fraud standards are more procedural than their predecessors but at the same time, they require auditors to probe more deeply and appear to require more focus on judgements relating to fraud in an attempt to deal with the expectation gap. It is not a case of more procedures and less judgement, but more procedures *and* more judgement.

Behind the view that auditors need more rules on how to do their jobs lie a lack of trust in the use of judgement by auditors and a lack of experience and confidence on the part of some regulators. It will take time to change this but rules do not necessarily reduce, and certainly do not eliminate, the need for judgement and integrity. Nor do rules necessarily promote consistency. In standards that are more rules-based, the role of judgement and the need for integrity are simply transferred, in part, to the application of those rules. Current auditing standards do not require more procedures and less judgement than before, but more procedures and more judgement.

Overrides, stand-backs and the conflict with procedural requirements

Few principles-based systems are perfect and the application of principles in complex situations often has unintended consequences. These issues can be dealt with by means of overrides and stand-backs, or by means of exceptions.

Overrides are generally associated with accounting issues. The 'true and fair override' requires overrides of specific accounting rules if they defeat the overarching requirement for financial statements to give a true and fair view. The fact that such overrides are rarely invoked does not mean that they lack value because the mere ability of auditors to invoke them is important.

Stand-backs are generally associated with auditing issues: auditors are required under auditing standards to stand back and consider whether the procedures they have applied are sufficient to achieve the objectives of auditing standards, such as the gaining of sufficient appropriate audit evidence.

Neither stand-backs nor overrides generally lead to the proliferation of rules because they rely on the use of judgement.

However, there are many, particularly those from civil law jurisdictions, who take the view that the need for either overrides or stand-backs within a framework is evidence of a flawed framework, or a lack of confidence in the ability of auditors to use their judgement in relation to a framework. These arguments mostly apply to the true and fair override in the context of accounting frameworks. IFRS, for example, is supposed to be a comprehensive framework. If it is truly comprehensive, why should there be any need for an override? In the US and parts of continental Europe, there is a long-standing assumption that if accounts are prepared in accordance with GAAP, they are by definition not misleading. Such GAAPs increasingly have override requirements imported into them from IFRS but simply inserting the words has not changed hearts and minds and it is widely acknowledged that such overrides are often effectively ignored.

In the context of auditing standards the position is less clear. There is a strongly held view in some jurisdictions that if auditors have complied with all the mandatory requirements of auditing standards they have done all that is required. There is an equally strongly held view that auditors should be required to stand back and assess whether they have in fact done everything that is required to achieve the objectives of auditing standards. The IAASB's clarity project clearly requires the auditor to use judgement to go beyond the requirements of the standards in order to achieve the objectives. This could be an important development because this concept is not widely understood or accepted in some jurisdictions.

The alternative to the use of overrides and stand-backs is the use of exceptions.

For accounting issues, where there is no override that enables auditors to modify or ignore a rule that, in the particular circumstances of a case fails to achieve a higher-level principle or objective in an accounting standard or legislation, the only option is to petition the standard-setter for some exception to be made to the rule.

For auditing issues, where there is no required or permitted stand-back that enables auditors to perform additional procedures where they consider that the specified procedures are inadequate to achieve the objective of the audit, it may be difficult for the auditor to justify the performance of such procedures to the client. Once again, the auditor can only petition the standard-setter for some additional procedure to be written into a standard.

Clearly, the use of exceptions in order to preserve principles by means of additional rules, rather than permitting the use of judgement, leads to the proliferation of rules. Such systems implode when exceptions and exceptions to exceptions become too unwieldy. Some consider that we are at, or are close to reaching this stage.

Bright lines

Little generates more heated debate in accounting standards than proposed bright lines. They are less of a problem in auditing standards but they do exist. Should they be there at all, and if so, where should they be struck, and where do they belong within standards?

It is generally agreed that the judicious use of bright lines in accounting standards has been helpful in some cases and not in others. Broadly speaking, if the effect of the bright line is to discourage manipulative arrangements and encourage consistency where there was abuse before, such bright lines are perceived as a good thing. And it is widely recognised that bright lines usually need to be embedded within a robust qualitative framework to prevent further abuse. The problem lies in the fact that the effectiveness or ineffectiveness of bright lines usually only become apparent after the event. Some maintain that any bright lines invite abuse by preparers of accounts and auditors, and over-rigid interpretation by ill-informed regulators, and that they should therefore be assumed to be ineffective.

For auditing standards, there is a fear that bright lines in the context of groups and materiality, for example, may be treated as rules, departures from which auditors will be expected to justify, even though standards are generally at pains to point out that they are only examples. Less experienced auditors may find them useful or even necessary, and some regulators argue that they should therefore be mandatory. More experienced auditors may feel straitjacketed by them and believe that if they must be there, they should be for guidance only.

Effects of principles-based standards on audit quality

What do we mean by audit quality? Can audit quality be measured and improved?

Audit purpose

Audit quality is ultimately about the purpose of the audit. This issue has been dealt with by the *Audit Quality Forum* publication *Audit Purpose*. There are fears, particularly on the part of some investors, that some of the distinctive features of the purpose of the audit in the UK are not properly recognised by international standard-setters, resulting in inappropriate standards being imported into the UK. But audit quality, though related to audit purpose, is a nebulous concept. One view is that the measure of audit quality is whether the auditor has given an appropriate audit opinion, as evidenced, perhaps, by the absence of audit failures. This view emphasises audit judgement. It is predicated on the assumption that auditors will detect material misstatements through the application of judgement and process and that they will report them. Another narrower view focuses on process: a measure of audit quality is whether auditors have done all that is required of them.

The measurement of audit quality

Audit quality is hard to define. Its measurement, like the measurement of quality in other respects, is also problematic. Reports by some oversight bodies, academics and audit firms have in the past focused on quantitative measures such as the number of audit failures, the numbers and identities of those who read audit reports and/or claim to rely on them, the numbers of companies who find the audit useful and survey information on which audit firms are better than others. Despite the fact that the audit is for the benefit of shareholders, responses have generally been elicited much more readily from the management of the companies audited, although the scope for communications between audit committees and those assessing audit quality has increased in recent years.

There is a need for more focus on qualitative issues such as the quality of judgements, training, internal reviews, feedback from shareholders and audit committees and other factors affecting the quality of auditors (in terms of their experience and competencies), their behaviour, and external perceptions. No measurement metrics, whether qualitative or quantitative, are perfect, even with hindsight. Audit failure may not show if the entity audited has not failed, the fact that an entity has failed does not mean that there has necessarily been an audit failure,[2] and the most diligent and searching of regulators' reports on the performance of audit firms will not necessarily show up poor audit quality, even though much valuable evidence regarding audit quality may be gleaned from such reports.

[2] A research project commissioned by the European Contact Group entitled *Classification and Analysis of Major European Business Failures* (October 2005) and performed by the Maastricht Accounting, Auditing and Information Management Research Centre examined 60 major business failures in the EU over the last 25 years. It noted that the vast majority of such cases in which the role of the auditor was questioned (22 cases) related to frauds perpetrated by managers or employees, and particularly dominant owner-managers. Alleged auditor failure related in some cases to a lack of independence or audit quality but in only three cases was action taken against the auditor on these grounds. The report notes evidence of the deep pocket theory; auditors were sued even though in none of the cases were the auditors held directly responsible for the failure of the entity. The report also notes that the differences between European and US business models means that there is less incentive in Europe for short term accounting manipulation or creative accounting than in the US.

Regulators such as the FSA, FRC, SEC and PCAOB place increasing emphasis on the quality of judgements. The FSA in particular has taken steps to emphasise the importance it attaches to the enforcement of principles and a change in the tone is evident in recent FSA[3] and SEC[4] speeches. The FRC's Regulatory Philosophy states that it will emphasise principles and clarity in its standard-setting and rule-making and seek to ensure, as far as it is appropriate to do so, that it is consistent with international standards. It recognises the importance of professional judgement in the way in which standards and rules are applied and enforced.

Auditing standards are about behaviour and behaviour is not always best managed using rules. Some UK regulators have made the first steps towards regulating behaviour on the basis of principles. Some US oversight bodies believe that this should be the case but have not yet made a real start.

Audit quality may be hard to define but there are different qualitative and quantitative ways to measure it. Whilst measurement techniques are fallible, audit quality should be measured and it can be improved. Those concerned with improving audit quality, including auditor oversight bodies, academics and audit firms may in the past have focused on quantitative measures. They should be encouraged to focus more on qualitative factors that affect auditor behaviour including the quality of judgements, training, and feedback from shareholders and audit committees.

To what extent do auditing standards affect audit quality?

It may be tempting to draw parallels between auditing and accounting standards with regard to increases in the level of rules. But there are limits to these parallels because of differences in the nature, purpose and intended audience for auditing and accounting standards.

The abuse and non-application of accounting and auditing standards have both resulted in financial scandals and there are similarities in the false sense of security created after the event by the imposition of rules. But auditing standards are more about behaviour than accounting standards. In very general terms, auditing standards seek to make auditors do things where perhaps they did not do them before. Accounting standards are at one level less about what accountants do and more about what should be permitted in terms of distorting the true financial picture. Accounting standards can be viewed as 'public' property because they are used on a daily basis by a wide variety of people including accountants, auditors, analysts, investors, governments and businesses. To that extent, it is right and proper that non-practitioners have a say in how accounting standards are developed. Auditing standards are not used on a daily basis by anyone other than auditors. Unlike accounting standards, they are more of a means to an end than an end in themselves. Investors and analysts, businesses, regulators and governments are mainly interested in the quality of the product of the audit, the audit opinion. They have little interest in the contents of the auditors' toolkit unless the product appears to go wrong. And even then, the blame often lies with the mechanic rather than his tools. Most would rather leave the mechanics of auditing to auditors, in the same way as most would rather

[3] A speech by John Whittaker, Director, General Counsel Division at the FSA noted the FSA's commitment to principles-based regulation in the FSA Fountain Court Chambers Conference on Better Regulation on 31 January 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0131_aw.shtml.

[4] A speech by SEC Chairman Christopher Cox at the 2005 AICPA National Conference on Current SEC and PCAOB Developments emphasised the importance of the exercise of professional judgement in accounting and financial reporting, www.sec.gov/news/speech/spch120505cc.htm.

leave bridge building standards to engineers.[5] But the abandonment of self-regulation for the professions in many jurisdictions reflects the prevailing view that, left *entirely* unsupervised, the professions will tend to serve themselves first, rather than the public interest. Calls for greater oversight of, and within, the IAASB reflect this view.

Nevertheless, auditing standards are important to investors who place reliance on auditors as well as to auditors and regulators, particularly those in jurisdictions in which there is relatively little tradition of audit education. However, audit quality is not primarily about auditing standards but about the quality of people, their training and ethical standards. Auditing standards are no substitute for the exercise of audit judgement, which is where mistakes are made.

Auditing standards are an important part of the auditors' toolkit. Their primary purpose is to enable auditors to perform audits. Auditing standards are also helpful to regulators. But auditing standards cannot be a substitute for the proper training of auditors or regulators, the maintenance of ethical standards or professional integrity. Audit failures tend to relate to errors of judgement, the failure to uphold ethical standards or an absence of professional integrity rather than failures in auditing standards *per se*.

Why professional integrity underpins auditing standards

The traditional professions may be characterised by the mastery of specialised knowledge through apprenticeship, training and formal examination, membership of a professional association, a system of licensing and certification, the 'profession' of its members to uphold an ethical code, a high level of integrity and, for the most part, the absence of a rulebook. Ethical principles and auditing standards are only effective if the people who uphold them abide by their spirit as well as to the letter, and do not seek to subordinate them to commercial considerations. This requires the courage to stare down a client who says 'show me were it says I cannot do this'. The problem lies in the fact that there are differing perceptions as to the level of professional integrity demonstrated by auditors within and across different jurisdictions and differing concepts as to what in practice is meant by professional integrity.

The view that the unprofessional behaviour of some within the profession has led to its non-professional treatment can lead insidiously to a self-fulfilling prophecy; if auditors are treated as if they are not professionals, will they not eventually become so? Will the sins of a few be visited on the entire profession, and the profession dumbed-down by a rulebook which will ultimately attract lower quality people to the profession and lead to a race to the bottom?

Principles-based auditing standards only work if the auditors who use judgement in applying them display professional integrity. The solution to the problem of a lack of integrity in some parts of the profession is not the promulgation of detailed rules, which perpetuate an avoidance mentality, but the development or restoration of high-quality, clear and unambiguous auditing standards and an effective principles-based system of oversight.

[5] The Roman practice of making the architects and engineers who designed bridges stand under them as the first carriages drove over might be viewed as an effective alternative to oversight.

How far has the IAASB's clarity project moved auditing standards in the direction of principles-based standards?

The IAASB believes that its standards are principles-based but more work is needed on higher-level principles or objectives for this to be the case. It is necessary to understand a little of the background to the clarity project in order to evaluate whether this project is moving auditing in the right direction. The project will most certainly have a profound effect on auditing standards for many years to come.

The IAASB's clarity project is designed to make the requirements of ISAs clearer. It became apparent that different jurisdictions understood the present tense statements ('auditors do this or that') in existing ISAs in different ways; some jurisdictions regarded the statements as almost mandatory, others regarded them as optional or ignorable. The IAASB has taken the opportunity to clarify standards in other ways, to make use of shorter sentences and bullet points and to eliminate repetition, for example.

The initial clarity proposals indicated that the principal changes to be made involved dividing existing ISAs into objectives (which auditors must achieve), requirements (with which auditors shall comply in all but very exceptional cases) and essential explanatory material and application guidance to be included in a separate section of each ISA.

Requirements would be derived largely from existing present tense statements and much of the focus has been on the extent to which the IAASB has properly applied its own criteria for requirements. In order for a present tense statement to become a requirement rather than to become part of the application material, it would amongst other things need to be applicable in 'virtually all cases'.

The IAASB has exposed a number of clarified ISAs, including the long and complex risk and fraud ISAs showing how clarification will affect standards.

The response to the proposals

Responses to the proposals from the profession and others in the UK as they relate to principles, focus on the need for overarching principles or objectives, dealing with the purpose of the audit, from which a full and integrated set of high level objectives or principles are derived, from which, in turn, the requirements of the standards are derived. Currently, and perhaps inevitably, the objectives have been derived on a bottom-up basis from existing present tense statements that have been turned into requirements.

There seems to be general agreement that clarified standards are in fact shorter and more readable but that this has come at the price of increased prescription. A great deal more effort seems to have gone into the detail of the requirements (the rules) than has gone into the construction of adequate principles or objectives, to date.

The IAASB's clarity project has highlighted the importance of principles-based standards and recognises the need for a 'stand-back' to determine whether objectives have been achieved. Nonetheless, work is needed and a top-down approach should be taken such that:

> Overarching objectives of an audit are developed.

> A full and integrated set of objectives are derived from the overarching objectives to guide the conduct of the audit.

> The requirements of standards are derived from the full and integrated set of objectives.

In other words, objectives should not simply be derived from the existing requirements in individual standards.

Opportunities and barriers in international convergence

Excessive proliferation of rules needs curbing but this is a tall order in a climate of rapid legal and regulatory change where international standard-setters need to set standards for very different cultures.

Should each jurisdiction determine its own appetite for detailed rules?

Much of the content of auditing standards may be regarded as educational in nature, or as amounting to a methodology, perhaps for the benefit of jurisdictions in which the auditing profession is less well developed. If this material were removed from auditing standards in order to facilitate international harmonisation, professional bodies in less well-developed jurisdictions would need to promote those educational materials and the methodology in other ways. The international representatives of professional bodies (such as IFAC) would need to put mechanisms in place to ensure that this approach did not have the perverse effect of encouraging those with low standards to adopt the bare minimum.

Audits are services and, despite protests that they have become commoditised, global standards for auditing will never be as uniform as they are for microchips. Uniformity will never be achieved unless and until differences in training, cultural attitudes, business and regulatory models, legal systems, the type of people entering the profession and a whole host of other variables are ironed out, which is unlikely.

The desire for global harmonisation of auditing standards arises for a variety of reasons: the desire to conform global audits to global businesses and markets, the belief that this will lower the cost of capital, and the desire to make global business and markets more transparent and accountable. People have differing views on the desirability, necessity and inevitability of harmonisation. But the idea of harmonisation is giving way to the notion of convergence. A strongly-held view in Europe is that if the harmonisation of IFRS with US GAAP means identical standards, and harmonisation is all one way (i.e. IFRS to US GAAP), it will never be achieved either technically or politically. And there are many in the US who have similar difficulties in understanding why US standards should be changed to accommodate IFRS which may be unsuitable for the US market. Identical standards are not an end in themselves. Convergence permits accounting standards to be regarded as equivalent, even if certain differences remain.

The barriers to global harmonisation arising from differing cultures, people, business and regulatory models suggest that we should all agree to a set of fundamentals, be they principles or objectives, and that each jurisdiction should then move at its own pace towards the achievement of those objectives. The problem for auditing standard-setters is that this is precisely what they say they have been doing for the last twenty years. Auditing standards used to be characterised by bold type that everyone signed up to and grey type which was perceived as best practice but not necessarily mandatory. In attempting to raise standards now by imposing a higher level of both quality (and uniformity), auditing and accounting standard-setters are accused of effectively attempting to destroy local business cultures, in the same way as large supermarket chains are accused of destroying local communities. The audit of smaller entities is often held up as an example here. It is all very well for global standards to be imposed on global businesses but, if they are not designed with the needs of smaller entities in mind, there is a serious risk that the interests of those smaller entities, which are just as significant socially and economically as larger entities, will be damaged. IFAC's development of an SME audit toolkit and the involvement of its

Developing Nations Task Force and SMP Committee in its standard-setting activities have yet to bear fruit in terms of allaying such concerns.

There is general agreement that to permit jurisdictions to add to, or take away from standards indiscriminately is a recipe for spurious harmonisation and lowest common denominator standards. Yet no-one wants to have their own way of doing things effectively pushed aside by the imposition of standards developed outside their immediate sphere of influence.

Some argue that the focus of attention on standard-setters is misplaced and that the solution to these conundrums lies in understanding and accepting the reality of how standards of auditing are changed in practice. They argue that the role of firms in influencing auditing standards is underestimated and the role of standard-setters overestimated. The consolidation of companies in the global market place drove the consolidation of audit firms and this is evidenced by the fact that larger firms have explicitly or implicitly indicated for some time that their methodologies exceed the requirements of any particular jurisdiction, including the requirements of international standards. They argue that such firms have had to learn from their mistakes, and that they have protected themselves from the pain of litigation by improving their methodologies, training and quality control procedures. On this view, the market place drives auditing standards up, and poor quality audits out, standard-setters follow the best practice amongst large firms, and this is the only effective way of improving audit quality on a global basis. Others argue that the lack of competition that has arisen as a result of consolidation in the market has resulted in a lack of concern regarding audit quality and that auditors are now more concerned about protecting themselves than they are about audit quality.

If global harmonisation of auditing standards is a worthwhile and achievable objective – some dispute both assertions – allowing for important legal, regulatory, cultural and other differences by permitting jurisdictions to determine for themselves the right level of detail in auditing standards may be a recipe for spurious harmonisation and lowest common denominator standards. But ignoring or playing down the importance of such differences is a recipe for failure. The consistent application of standards both within and across jurisdictions is one measure of audit quality and standards that do not accommodate important differences would not be applied consistently. This would lead, eventually, to the discrediting of the standards. The pull of the market place, rather than the push of standard-setters and regulators, may well be the better driver of audit quality in the longer run.

Principles-based standards, differing legal systems, litigation risk and the need for an incremental approach

Many believe that the different legal systems which drive auditors to do different things in different jurisdictions, and the associated litigation risks, are the biggest variables internationally between jurisdictions. They are the most important drivers of different approaches to standard-setting, and the principal pressures on international standard-setters. Jury-based civil litigation in the US involving non-proportional punitive damages awards is a major obstacle to principles-based standards. Changing the culture of fear in which regulators, auditors, accountants and others are caught in a seemingly self-defeating impasse between the need for clarity and boundaries and the need to cut down an already over-large and complex rulebook is no easy task. Structural changes in the environment in which auditors operate are needed and the litigation risk cannot be overcome simply by courage or leadership. An incremental approach is required. The rule books and legal infrastructures were not developed overnight and they will not be dismantled overnight.

Nevertheless some would say that it is time for the pendulum to swing back towards principles.

Many standard-setters wish to move away from prescription and towards more principles-based standards but they believe that their efforts are hampered by some regulators who believe otherwise. Regulators have the final say in how auditing standards are implemented and enforced and for that reason their influence on auditing standards is significant. Even those domestic regulators who support principles-based standards may have their hands tied by international standard-setters. In the US however, the distinction between standard-setters, regulators and enforcement agencies does not exist in the same way as it does in Europe and indeed there are significant differences within Europe itself. Regulators and oversight bodies need to be encouraged to look at people and their training rather than legislating their expectations in terms of process. They need to experiment with more robust principles, to resist the calls for more rules and reject the simplistic view that principles or objectives are without teeth or value and are mere aspirations or summaries of process.

Principles- or objectives-based standards are well-supported on both sides of the Atlantic and quite well understood, albeit differently, despite differences in legal systems, regulatory frameworks and litigation risk. There is general agreement that better auditing standards have more robust principles and should need fewer rules. Nevertheless, the structural barriers in North America to the removal of detailed rules and development of more principles- or objectives-based standards should never be underestimated.

What criteria and processes are needed to strike the balance between principles and rules?

Determining how many, and what sort of rules are enough to guide judgement without stifling it is an intractable problem for standard-setters dealing with many different jurisdictions and stakeholders. What is reasonable, appropriate, adequate or sufficient varies from culture to culture. Some cultures hold their auditors in low regard and require little of them in terms of qualifications and training. Such cultures regard auditing as barely worthy of the title profession. Others hold an encyclopaedic knowledge of the rules in higher regard than the exercise of judgement. More rules may be appropriate in such cultures. Reconciling standard-setting for such cultures with cultures that value qualifications, training, high ethical standards and a balance of knowledge and professional judgement, and hold their auditors in high regard, is not easy.

There is a great deal of capital invested in the notion of principles; that capital should not be wasted for want of a proper understanding of the issues. Standard-setters finding themselves between irresistible forces and immoveable objects should not despair. The role of the standard-setter is to find a middle way between the extremes of those who hold out for the bare minimum of principles or rules in general but demand additional guidance for every novel situation in order to avoid being second-guessed, and those who genuinely believe in a greater level of prescription in order to regulate effectively a profession that is perceived to have failed. Auditing standards that are written in order to enable inexperienced regulators to do their jobs and those written by and for the benefit of auditors will both ultimately fail the users of audit reports. Neither will improve audit quality. Standard-setters should consider the needs of all concerned and reject the self-serving demands of those who seek the comfort and ease of certainty where there is none. Standard-setters also need to engage a wider range of stakeholders much more actively than they do at present, and learn to speak their language. Inertia and misunderstanding can undermine adequate exposure processes and render consultation meaningless.

The proliferation of rules in auditing standards is not inevitable. Conflicting objectives in accounting standards give rise to uncertainty and the need for detailed rules, but this problem is unlikely to be as acute in auditing standards.

The tension between those who believe that auditing standards are too long, detailed and prescriptive and those who believe otherwise is healthy. Standard-setters should consider the needs of all concerned and reject demands for certainty where there is none, principles-only standards, or standards that seek to prescribe auditing procedures so as to minimise the need for the use of judgement.

The process of the exposure of auditing standards and hammering out a consensus between stakeholders, some of whom need to be more actively engaged than they are at present, will help ensure that in the long run, a better balance will be struck.

Only if standard-setters fail to understand the issues, become indifferent to the need for consensus, or give undue regard to the interests of one group at the expense of another, will the process fail.

Appendix 1

Glossary of abbreviations

APB	Auditing Practices Board: the UK auditing standard-setter, operating under the auspices of the Financial Reporting Council
FRC	Financial Reporting Council (UK)
FSA	Financial Services Authority (UK)
GAAP	Generally Accepted Accounting Principles
IAASB	International Auditing and Assurance Standards Board: the international auditing standard-setter, operating under the auspices of the International Federation of Accountants
IAPSs	International Auditing Practice Statements issued by the IAASB
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards issued by the International Accounting Standards Board
ISAs	International Standards on Auditing issued by the IAASB
PCAOB	The US Public Company Auditing Oversight Board: the US auditing standard-setter for public company audits
SEC	The US Securities and Exchange Commission
SMEs	Small and Medium Sized Entities
SMPs	Small and Medium Sized Practices

Appendix 2

Working group membership

We are grateful to the following people for their input to this paper issued to the *Audit Quality Forum*. Their input does not necessarily reflect the views of the organisations they work for or are attached to.

Bob Landwehr – Chair
Ernst & Young LLP

Katharine Bagshaw
Audit and Assurance Faculty, ICAEW

David Chopping
Moore Stephens LLP

Ian Dennis
Oxford Brookes University

Clive Jones
Retired Practitioner

Paul Lee
Hermes Investment Management Ltd

Derek Scott
National Association of Pension Funds Investment Council

Dr Claire Stone
Deloitte & Touche LLP

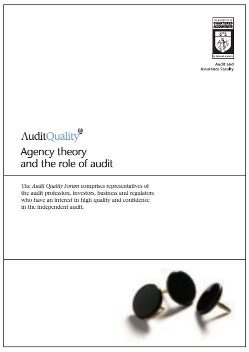
Pat Sucher
Financial Services Authority

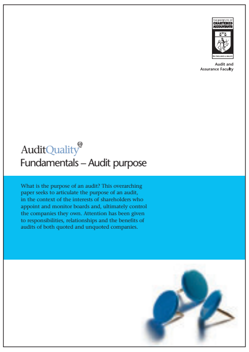
Observers:

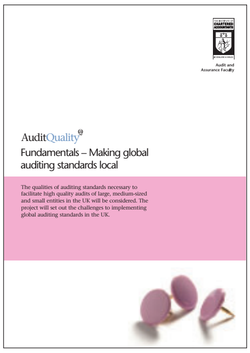
Hazel O'Sullivan
Financial Reporting Council

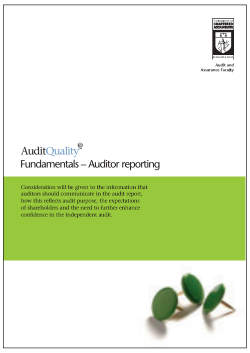
Emma Ward
Department of Trade & Industry

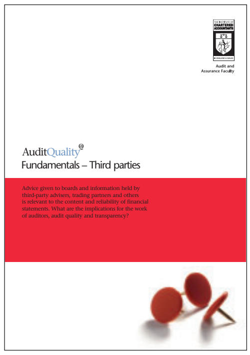
AuditQuality@ Fundamentals











Agency theory and the role of audit

This paper focuses on the role and importance of the agency relationship in the development of audit historically and how the relationship may be useful in understanding the role of the statutory audit in the UK today. It also introduces other issues, interests and relationships, which impact on the application of this theory and point to potential alternative purposes of an audit.

Audit purpose

What is the purpose of an audit? *This overarching paper seeks to articulate the purpose of an audit, in the context of the interests of shareholders who appoint and monitor boards and, ultimately control the companies they own. Attention has been given to responsibilities, relationships and the benefits of audits of both quoted and unquoted companies.*

FORTHCOMING TITLE

Making global auditing standards local

In practice how can auditing standards have global reach yet deal with local challenges? *The qualities of auditing standards necessary to facilitate high quality audits of large, medium-sized and small entities in the UK will be considered. The project will set out the challenges to implementing global auditing standards in the UK.*

FORTHCOMING TITLE

Auditor reporting

Is current auditor reporting, in particular the audit report, helpful to shareholders? *This paper will consider the information that auditors should communicate and how this reflects audit purpose, the expectations of shareholders and the need for further enhancement of confidence in the independent audit.*

FORTHCOMING TITLE

Third parties

How does the extent of disclosure of third-party information and advice to the board impact on audit quality? *Advice given to boards and information held by third-party advisers, trading partners and others is relevant to the content and reliability of financial statements. What are the implications for the work of auditors, audit quality and transparency?*

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Audit and Assurance Faculty
Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8493 **Fax** 020 7920 8754 **Email** auditquality@icaew.co.uk
www.auditqualityforum.com

TECPLM5527