


Audit quality: the role of standard-setting





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 shared¹ 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. 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

1 Michael Izza, Getting five out of three, ion.icaew.com/moorgateplace/b/weblog/posts/audit-reform-getting-five-out-of-three.

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Introduction

Auditing standards are rarely top of the agenda when it comes to audit reform. Auditor behaviour is particularly sensitive to the demands of audit inspection teams and audit regulators, and structural approaches to auditor performance are believed to be more effective than tinkering with auditing standards or the standard-setting process. Nevertheless, audit methodologies are underpinned by auditing standards, and audit methodologies affect behaviour. Audit quality is therefore affected, directly or indirectly, by auditing standards and the standard-setting process, particularly if standard-setters fail to address the right issues or approach them in the wrong way.

Audit quality is hard to describe, still less define or measure. Furthermore, there are two divergent approaches to it that are not easy to reconcile.

The first approach confines audit quality to compliance with auditing standards. In simple terms, complying with the requirements is all that is needed. This approach to auditing is prevalent in many developed jurisdictions, but not in the UK. If this approach is right, and compliance with auditing standards is the sole determinant of audit quality, it is critical that those standards are fit for purpose and that changes to them demonstrably impact auditor behaviour.

The second approach requires auditors to do more than just comply with auditing standards in order to achieve audit quality. To an extent, this approach is already embedded in auditing standards, which require auditors to stand back at various stages of the audit and consider whether further work is needed. However, in practice, this requirement is applied in different jurisdictions with varying degrees of rigour. If this approach is right, it is critical that auditors, audit regulators, auditing standard-setters and other stakeholders are all clear, at least in general terms, about what more is needed and when.

These approaches represent genuine differences of opinion and a clear indication that the relationship between auditing standards and audit quality – and indeed the nature and scope of audit – warrant further attention. Both approaches, but particularly the first, suggest that auditing standards, far from simply being technical documents, are highly relevant to the debate on the future of audit.

By combining analysis of the current position and fresh thinking, we seek to add to the momentum for change by advancing the debate on the relationship between auditing standards, the standard-setting process, and audit quality. The issues are not clear-cut and the nuance is sometimes hard to grasp. But if auditing standards affect auditor behaviour and audit quality, what those standards say, and the way they are developed, represent more than mere technicalities.

This essay is a contribution to the next stage of audit reform which, to date, has not focused significantly on the standard-setting process. The continuing debate seems likely to involve more intense discussion about how to make real progress in this area and we acknowledge in this essay the significant and renewed efforts being made by standard-setters and oversight bodies to address the issues we identify. We are encouraged by the recent Monitoring Group proposals for changes to standard-setting, which have been widely welcomed.²

2 *Strengthening The International Audit And Ethics Standard-Setting System* 14 July 2020

In this essay we consider:

- different views of the nature of audit quality and the challenges associated with measuring it;
- the reasons why current auditing standards are the way they are; and
- the determinants of auditor behaviour, how auditing standards affect auditor behaviour and audit quality, and how auditing standards and the standard-setting process could be enhanced to better support audit quality.

We also reflect on the UK auditing standard-setter's role, how its standard-setting process might be refreshed, and how it might ensure that it continues to play a leading role in global auditing standard-setting. Our reflections are provided in the context of the transition of regulatory responsibilities for audit, including auditing standard-setting, from the Financial Reporting Council (the FRC) to the Audit, Regulatory and Governance Authority (ARGA).

Over 40 years ago, work started on building a set of international guidelines on auditing designed for use anywhere in the world, in any audit. That vision has not changed and, as of June 2019, 130 jurisdictions, including the UK, had adopted or committed to adopting International Standards on Auditing (ISAs) – a significant achievement, reflecting widespread recognition of the benefits of global convergence. The International Auditing and Assurance Standards Board (IAASB) is now a leading global standard-setter, committed to raising standards of auditing globally. Its strategy and work plan address many of the areas covered in this essay. The only other auditing standard-setter with global reach is the US Public Company Accounting Oversight Board (PCAOB).

How do auditing standards affect audit quality?

WHAT IS AUDIT QUALITY?

It is generally accepted that an audit must be conducted in accordance with auditing standards in order to be of good quality. However, it is not easy to describe, still less define, what more, if anything, is required, above and beyond compliance.

Sir Donald Brydon has suggested that a high-quality audit would be one that meets certain parameters of ethics, operations, judgements, outputs and effectiveness.³ In February 2020, ICAEW CEO Michael Izza set out **five goals** for UK audit reform, the third of which is a more reliable core audit, with a renewed focus on internal controls, going concern and viability, and fraudulent financial reporting.

Audit quality is not easily assessed, even with specialist knowledge. It is invariably when something appears to have gone wrong that audit quality is highlighted. Only those with the opportunity to review audit files and to question auditors – ie, audit inspectors – can evaluate whether a good quality audit has been performed. Even then, the evaluation is subjective as there are few defining metrics. Judgements have to be made about, for example, auditors who exercise professional scepticism appropriately but fail to document it, and those whose documentation is good but whose underlying processes and procedures are weak.

Auditors, audit committees and audit regulators tell the world a great deal more than they once did about what auditors do and what they find, but audit quality is still opaque and all three could say more. Stakeholders want auditors and audit committees to tell them more about their respective evaluations of audit findings. Pressure is building for auditors to expand on their evaluation of key audit matters, and for audit committees to be more open and detailed in their reporting. Auditors are also being urged to explain changes to their audit approach, and changes in the nature of the matters they report, year on year. Audit regulators have a wealth of information about audit quality, which some believe can and should be made public.

Despite the difficulties associated with describing and measuring audit quality, standard-setters, audit regulators, professional bodies and auditors are trying continuously. IAASB's 2016 *Framework for audit quality* sought to raise awareness of the many elements of audit quality, ranging from auditor values and attitudes, through audit methodologies and quality management procedures, to the audit report, corporate behaviour and the likelihood of litigation.⁴

The FRC's 2019 *Audit Quality, Practice aid for audit committees* deals with a similarly broad range of issues from a regulatory perspective. The US approach, however, is more granular and quantitative. The PCAOB's 2015 *Concept Release on Audit Quality Indicators* set out a series of 28 quantitative measures relating to staff, manager and partner workload, for example, training hours and turnover of staff, the results of external reviews, quality assessments and remuneration, the frequency of restatements, and trends in enforcement and litigation.

3 *Assess, Assure and Inform: Improving Audit Quality and Effectiveness, Report of the Independent Review into the Quality and Effectiveness of Audit*, 18 December 2019, paragraph 7.4

4 IAASB has subsequently undertaken significant projects on quality management and group audits.

AUDITING STANDARDS, INTERPRETATION AND AUDIT QUALITY

Corporate failure and audit failure may occur at the same time but they are not the same thing, and the former does not necessarily entail the latter. Furthermore, auditing standards have long made it clear that a properly performed audit may not necessarily detect a material misstatement or provide a warning of impending corporate collapse.

It is often suggested that audit failure and a lack of an acceptable level of audit quality are about the absence of professional integrity, errors of judgement, a failure to apply auditing standards or failures in enforcement, rather than weaknesses in auditing standards themselves. But the response of audit regulators and IAASB to perceptions of audit failure almost always involve changes to auditing standards in the form of prescriptive additions. If these additions draw auditor attention away from the key audit areas that require focus, they actually have the potential to compromise audit quality rather than improve it.

LENGTH, COMPLEXITY AND DOCUMENTATION REQUIREMENTS

A great deal – and arguably too much – is expected of auditing standards.

To the extent that audit quality involves an element of consistency, any enhancement to consistency in auditor performance through standards represents a potential improvement. But consistency is not enough. There is a strong belief that auditing standards which have been through due process have the capacity to improve audit quality, which is why standard-setters rarely seek to remove requirements – despite an absence of evidence one way or the other. Always adding and rarely subtracting results in ever-longer standards.

Increasing levels of documentation required in audits, form-filling and box-ticking are often referred to in pejorative terms as ‘compliance’ work, as if it is somehow superfluous or irrelevant to the ‘real’ audit, in which experience and judgement come to the fore. When asked for more details, however, auditors struggle to identify which particular requirements are of little value, and there are different views on whether such work could be removed without compromising audit quality. Most auditors agree that the scope for routine error and omission can be reduced by the effective use of checklists – in the same way that checklists introduced into surgical procedures have demonstrably reduced the level of surgical errors. Auditors are in agreement that checklists can be a way of operationalising auditing standards through audit methodologies, rather than being a feature of the standards themselves.

Auditors often struggle with requests by audit inspection teams to document explanations of why they have not performed a required procedure when the rationale, to them, seems obvious. While auditors generally accept the interpretations of audit inspection teams, they do not always agree with them.

THE REGULATORY APPROACH TO AUDITING STANDARDS

The approach taken by audit regulators and individual audit inspection teams to audit quality is a significant determinant of auditor behaviour.

The demands of individual audit inspectors matter, and audit regulators in different jurisdictions sometimes take different approaches to the same auditing standards. Auditors in some jurisdictions are asked increasingly to demonstrate what *more* they have done, beyond compliance with the specific requirements of auditing standards, to achieve audit objectives. Auditing standards themselves require auditors to do so, but there are concerns about audit inspectors appearing to assume that compliance with requirements is *never* enough, not even for less complex audits. Failing to go the extra mile is seen as a failure to exercise an appropriate level of professional scepticism, regardless of the audit area under consideration. Auditors must somehow demonstrate that they have challenged hard facts just as vigorously as they have challenged highly subjective, significant management judgements.

The risks are that individual audit inspectors effectively determine audit quality on an arbitrary basis, that auditors respond by finding additional procedures to perform for the sake of it, or simply reclassify what they have already done. If this happens, evaluating audit quality consistently becomes even harder.

Do auditing standards need to be so detailed?

The basic requirements of the auditing guidelines issued by the International Auditing Practices Committee (IAPC) in 1978 are all still recognisable. They covered, among other things, engagement letters, planning, documentation, internal controls, audit evidence, inventory counting, third-party confirmations, bank reports, group audits and the audit report.

While interpretations have changed and requirements and guidance have been added, many of the fundamentals embodied in those early pronouncements have not changed in substance, or been challenged. On the face of it, this is not unreasonable: principles-based standards should stand the test of time. However, an unwritten assumption that material that has been through due process should not be discarded has resulted in a large volume of material that is quite difficult to navigate without significant technical resources. Important questions arise about the value of this level of detail and its impact on audit quality. It is one reason why compliance with auditing standards is becoming harder to demonstrate.

New, prescriptive requirements are increasingly justified on the basis that they help auditors demonstrate how they have exercised professional scepticism and judgement. While prescription and the exercise of judgement are not mutually exclusive, they tend to pull in opposite directions. The overall increase in the length and complexity of auditing standards in recent years has arisen largely from a perceived need to tell auditors what to do in terms of process, rather than what they must achieve. Judgement is still required in demonstrating how they have done what they are required to do, but such judgements are exercised in increasingly narrow spaces.

As far back as 2006, the Audit Quality Forum paper *Principles-based auditing standards* attempted to explain why the scalability of a single set of auditing standards was, even then, proving hard to achieve. The paper questioned the capacity of auditing standards to accommodate all audits. It also noted the need for a systematic top-down approach, to rationalise pronouncements that had grown organically over some 40 years, starting with the overarching objectives of an audit from which a full and integrated set of more detailed objectives might be derived. This has not yet happened.

A few years later, IAASB's three-year clarity project, which was finalised in 2010, attempted to extract from IAASB's standards 'requirements' applicable in 'virtually all cases' leaving the rest as non-mandatory 'application material'. The 'objectives' introduced at that point were in effect retro-fitted. Such actions are necessary when a rulebook becomes unwieldy but the project was completed to meet a deadline and the distinction between objectives and requirements remains unclear. Some audit regulators and audit inspection teams treat application material as mandatory and some auditors treat such material as entirely optional.

IAASB's project on the audit of less complex entities (LCEs) attempts to deal with length, complexity and detail. Discussions about a 'building blocks' approach, and potential distinctions between 'core, conditional and listed entity' requirements and between 'what, how and why' auditors do things, all represent progress. IAASB has also commenced an audit evidence project, although documentation – a critical aspect of compliance with standards – will not be covered. These developments are a step in the right direction, but the ultimate outcome matters: auditing standards must in fact be clearer, less detailed, and less complex as a result of these projects. In order for that to happen, IAASB, and audit regulators, must be prepared to 'let go' of material, regardless of the amount of due process to which it has been subjected. Equally, other stakeholders need to acknowledge their role in creating length and complexity and consider more carefully their calls for further explanation and examples in every new area.

It is unlikely that auditing standards will ever be re-written from scratch. However, it would be wrong to ignore the fact that some fundamental assumptions may no longer be relevant. Material that went through due process long ago should not be treated as if it is incapable of substantive or radical improvement.

A WAY FORWARD: SIMPLIFY AND STREAMLINE

In addition to IAASB's work on LCE audits and audit evidence, as a mature standard-setter it should now consider developing:

- a paperwork reduction policy, to which resources should be devoted, to systematically eliminate unnecessary duplication, redundancy and overlap;
- tools facilitating the high-quality and systematic evaluation of major proposals, including cost-benefit analyses; and
- more effective techniques facilitating the development of auditing standards on a holistic basis, preventing the proliferation of excessive detail.

What changes to standard-setting might improve audit quality?

REFLECTING AUDIT INNOVATION AND CHALLENGING BASIC ASSUMPTIONS

Today's auditing standards were written in an era in which sampling and extensive substantive testing of transactions and balances were necessary because automation was less reliable than it is today, and because it was not practical to test full populations.

If auditing standards were written from scratch now, they would not be based on the same assumptions. The ability to test full populations impacts the focus of audit effort, which is shifting from finding problems to solving them. Respondents to the 2019 IAASB consultation on its strategy and work plan noted the need for more emphasis on changing technologies and IAASB has re-affirmed the importance of this work stream. But there are few references to the subject even in the most recently revised standard on risk assessment,⁵ which is the most common area in which data analytics is used.

IAASB needs to deliver and provide output in this area. Some have suggested that the lack of explicit acknowledgement of new technologies in auditing standards and related guidance may be hampering innovation. If audit inspectors are unable or unwilling to deal with the evidence provided by simple data analytics tools and techniques, they are less likely to be used.

The explanation generally offered for this is that the area is too fast moving to be embedded in auditing standards. Other explanations include the possibility that stakeholders are not confident about how these new technologies fit into the framework of auditing standards, or in their respective competencies therein.

A WAY FORWARD: EMBRACING NEW TECHNOLOGIES

IAASB has no need for excessive caution with regards to data analytics and other new technologies. To help ensure that opportunities to enhance audit quality are exploited fully by these tools and techniques, it should actively reconsider some of the basic assumptions on which the extant suite of auditing standards are based, and take a more robust approach to referencing the use of new technologies in ISAs. For their part, where auditors are confident in the integrity and value of new technologies, they should not be discouraged by audit regulators from using them in meeting the requirements of auditing standards, simply on the basis that auditing standards do not explicitly permit them.

MODERNISING IAASB'S SUITE OF AUDITING PRONOUNCEMENTS

IAASB issues two basic types of auditing pronouncements: authoritative standards (ISAs and an ISQC)⁶ and non-authoritative material (an IAPN⁷ and staff publications).

Authoritative standards: material in ISAs and ISQC 1 is split between mandatory requirements and non-mandatory application material. The tendency of audit regulators and audit inspection teams to treat *all* material as mandatory, regardless of its actual status, renders this distinction less important than it should be. Some auditors also observe that it is increasingly necessary to refer to application material – and to increasingly lengthy introductions – to make sense of the requirements.

5 International Standard on Auditing (ISA) 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

6 International Standards on Auditing and International Standards on Quality Control (ISQC). There is one ISQC, ISQC 1, which is being revised. International Standards on Quality Control will in future be referred to as International Standards on Quality Management (ISQM)

7 International Auditing Practices Note, IAPN 1000 *Special considerations in auditing financial instruments*

Non-authoritative material: authoritative material is from time to time supplemented by non-authoritative IAPNs and staff publications. Staff publications summarise and collate requirements and guidance material in a particular area but they do not provide guidance or interpretation.

Staff publications include Staff Audit Practice Alerts and Staff Questions & Answers. They cover useful areas such as professional scepticism, significant, unusual or highly complex transactions, the proportionality of standards, external confirmations, fair value estimates, going concern and 'letterbox' audits. However, the most recent of these is dated 2015.

A measure of the caution with which IAASB approaches such material is perhaps the negative language used to describe it: staff publications are described as having 'no authoritative status' because they are not subject to due process. They are 'not meant to be exhaustive' and reading them 'is not a substitute for reading the standards'. They are 'not rules of the IAASB and do not reflect any IAASB determination or judgment', and 'do not constitute authoritative or official pronouncements'.

Even the positive statements made about them are narrow: they are there to 'help raise practitioners' awareness' of significant new issues, and to 'direct their attention to relevant provisions of IAASB pronouncements, or to provide clarification to emerging questions by referring to existing requirements and application material'. The main purpose of non-authoritative material then, is to direct auditors back to the ISAs. This can be useful, but some consideration might be given to the production of guidance and interpretation that builds on the ISAs, rather than simply repeating them.

IAASB seems reluctant in practice to expand the nature or extent of the material it produces. Stakeholders ask for more examples and guidance but at the same time to reduce the length and complexity of standards. Examples can always be misused, developing guidance material draws on resources, it risks being mistaken for the 'real thing', and it can lead to a backlash when used, appropriately or otherwise, as a stick with which to beat the very auditors it is intended to help.

A WAY FORWARD: REVIEW AND REVISE NON-AUTHORITATIVE GUIDANCE

IAASB should consider more active engagement with audit regulators and auditors to develop an understanding of how application material within the ISAs and non-authoritative material could be developed in a more agile and innovative manner to improve audit quality and enable faster reactions to developments. It could review its range of non-authoritative pronouncements and redefine the nature and purpose of staff publications to facilitate better quality and more useful guidance material, especially examples, and not limit the pronouncements to statements made in the ISAs. It could reinforce and clarify the status of guidance material to encourage a more consistent approach by audit regulators and auditors.

BRINGING DUE PROCESS UP TO DATE

There is a tension between the need to develop standards quickly to meet changing circumstances, and the need to build consensus, which takes time. Does IAASB's due process have the right balance of consensus building and agility? IAASB has reformed its governance, operating procedures and membership more than once in recent years and the scope of its work is clearly wider than it once was. Despite all of this, the basic processes and procedures for developing and promulgating its output now are not dissimilar to those in place when it replaced IAPC in 2002. IAASB continues to meet for a week, four or five times a year, with detailed drafting performed by working groups and taskforces supported by staff between those meetings. The full board still considers the detailed wording of all authoritative material.

ADJUSTING TO THE COVID-19 CRISIS

Working practices had to be adapted as a result of the coronavirus pandemic and physical meetings were replaced with video calls. However, the pressures and constraints of video calling meant that it was not possible to simply replicate one with the other. Managing a board with members from all over the world attending lengthy calls in their home time zones has resulted in board activity being spread over longer periods, involving more frequent but also shorter meetings. It seems likely that at least some aspects of this way of working will become permanent and might result in more efficient standard-setting.

Length and complexity in ISAs are undoubtedly attributable to globalisation and increasing complexity in business itself. But it is hard to avoid the impression that they may also result, at least in part, from the development of ISAs by a large and somewhat unwieldy committee. Length, if not complexity, are undoubtedly also the result of regulatory pressure.

This scenario is far from unique to auditing standard-setting – accounting standard-setting is similarly pressurised – but the overall result is less than satisfactory. Auditors and training providers must guess how audit inspection teams will interpret the requirements, and consistency and other enhancements to audit quality take longer to achieve than they should.

THE MONITORING GROUP PROPOSALS

The **Monitoring Group** is a grouping of international financial institutions and regulators ‘committed to advancing the public interest in areas related to international audit standard-setting and audit quality’.⁸

In February 2016, the Monitoring Group proposed radical reforms to standard-setting processes, including the rationalisation of the two standard-setting boards, IAASB and IESBA,⁹ greater use of staff, and full independence from the International Federation of Accountants (IFAC) and its member bodies. When the Monitoring Group consulted on these proposals it drew criticism because of an apparent assumption that standard-setting was broken, because the proposals were not costed, and because proposals for the new funding mechanism were not set out in detail.

The consultation paper¹⁰ articulated three main concerns:

1. a continuing perception of auditors exerting undue influence over the standard-setting boards;
2. the resulting perception that auditing standards are not developed fully in the public interest; and
3. the relevance and timeliness of standard-setting.

IAASB’s practice of engaging in detailed drafting at board level can appear rather cumbersome, lacking in agility and responsiveness. Its defenders point out with some justification that the board’s legitimacy derives from the level of consensus it achieves, which takes considerable time and effort.

⁸ www.iosco.org/about/?subsection=monitoring_group

⁹ The International Ethics Standards Board for Accountants.

¹⁰ Monitoring Group Consultation, *Strengthening the governance and oversight of the international audit-related standard-setting boards in the public interest*, November 2017 www.iosco.org/library/pubdocs/pdf/IOSCOPD586.pdf

IAASB is in the unenviable position of being criticised for both tardiness and excessive haste. Nevertheless, there is surely scope for greater efficiency and changes to aspects of IAASB's operating procedures that might speed the standard-setting process, without compromising consensus or quality, or draining resources.

Shortly before the publication of this essay, the Monitoring Group issued its *final proposals*, after an extended delay. The recommendations in *Strengthening The International Audit And Ethics Standard-Setting System* were welcomed by IFAC, IAASB and IESBA. They include important enhancements to the existing regime and notably:

- the retention of the existing two-board structure for auditing and ethical standards, a reversal of the original proposal for a merged board, and a retention of the existing two thirds majority required for the approval of projects and standards;
- a reduction in the number of board members from 18 to 16, the elimination of the role of technical advisers, who currently play an important role in board meetings and activities, and a concomitant increase in the number of paid technical staff;
- the remuneration of all board members, not just the full time chair;
- control of the process for board nominations by the Public Interest Oversight Board (PIOB); and
- a Public Interest Framework (PIF) to direct standard-setting - a set of six principles intended to help the standard-setting boards and the PIOB in the execution of their respective public interest mandates.

These proposals were made while acknowledging that further effort is needed to secure a long-term sustainable funding model that reduces the contribution of the profession to under 50%. It remains unclear whether the proposals can be implemented if additional funding cannot be secured.

Regardless of the Monitoring Group's proposals, IAASB should consider its day to day working procedures now, in the light of its experience during the coronavirus pandemic, with a view to improving efficiency and to ensure that current inefficiencies are not perpetuated in any new regime.

A WAY FORWARD: IMPLEMENTING THE MONITORING GROUP PROPOSALS

IAASB should consider now how it might operate more efficiently on a day-to-day basis to enhance the quality of standard-setting, and with a view to ensuring that the Monitoring Group's proposals, as and when they are implemented, are effective in the public interest. This might include requiring that better developed proposals are brought to the board, and that the board engages in less-detailed drafting.

Can IAASB continue to serve both SMEs and the world's capital markets?

IAASB has a mandate to serve the public interest. It sets standards for the audit of entities of all sizes. Some believe that this compromises its ability to enhance audit quality at both ends of the spectrum.

IAASB has long acknowledged the different needs of auditors of the most complex entities, and those of the others that comprise the great majority of audits. Its project on LCE audits, now under way, reflects long-standing calls to review issues associated with the audits of such entities. The project includes consideration of the possibility of separate standards for such audits. It also reflects calls for differentiation between requirements applying to all audits, and those only applying to audits of listed and other public interest entities. The IAASB's extended auditor reporting requirements is the most obvious example of such differentiated requirements already in place, but there is some resistance to the idea of more generalised differential requirements and standards.

One view is that IAASB's public interest mandate requires it to focus its efforts on the needs of the world's capital markets and that it does not have a mandate to serve smaller, less complex or non-PIE audits. Auditing standards for such audits might instead be set globally by IFAC, working with regional groupings of professional accountants and national standard-setters. There is precedent for two sets of auditing standards: in the US, since 2003, the PCAOB has set standards for the audit of registrants on the US capital markets and the American Institute of Certified Public Accountants (AICPA) has set standards for the audit of all other entities. In other jurisdictions too, separate standards have been developed for the audit of smaller entities.

Another view is that IAASB is a mature standard-setter whose brand and status are established and well-deserved. The only real threats to its locus as a global standard-setter are that:

- national standard-setters or others, develop their own simpler auditing standard for the audit of smaller or less complex entities; and/or
- capital market regulators at the other end of the scale, also address their concerns by taking standard-setting into their own hands. Recent proposals to fold the PCAOB into the SEC demonstrate that this is more than just possible.

In an attempt to please everyone, IAASB risks pleasing no one.

IAASB's project on the audit of accounting estimates is instructive. It started out as a project on the audit of expected credit losses for financial institutions. During scoping, it became clear that the issues to be addressed were relevant to all accounting estimates and the project became a full revision of ISA 540.¹¹ At the outset, attempts were made to avoid excessive complexity for lower-risk estimates, but as the project progressed concerns also arose about whether it met the needs of banks and their auditors – those whose needs gave rise to the project in the first place.

In the end, compromises were made in an attempt to satisfy both constituencies, but the approved standard remains vulnerable to criticism for being excessively complex for simpler estimates, and insufficiently detailed for the most complex.

11 International Standard on Auditing (ISA) 540 (Revised), *Auditing accounting estimates and related disclosures*.

A WAY FORWARD: PROGRESS WORK ON LESS COMPLEX AUDITS

IAASB should consider:

- the benefits and risks associated with continuing to provide a single set of auditing standards;
- whether the necessary compromises required at both ends of the scale are still justified by the benefits; and
- the possibility of developing a more workable set of requirements and application material for the audit of non-PIE entities, within a single set of standards, with incremental requirements dealing with the audit of more complex entities.

LESSONS FROM ACCOUNTING STANDARDS

Comparisons between auditing and accounting standards are often made in the context of standards for smaller entities. The International Accounting Standards Board (IASB) describes the International Financial Reporting Standards (IFRS) for Small and Medium-sized Entities (SMEs) primarily in terms of simplification and redrafting in plain English, which is important for standards that are translated into many different languages. Some of the difficulties associated with auditing standards also arise from seemingly excessive and unnecessarily complex drafting, as well as issues of substance.

Many of the fears expressed about the IFRS for SMEs were not borne out after it was finally issued: the IFRS brand was not damaged and there is no evidence that the market is confused, for example. The IFRS for SMEs is intended for use by entities without public accountability, the determination of which is made locally. There are few reports of entities or jurisdictions systematically misusing the IFRS for SMEs, although some jurisdictions have made significant adaptations to it. Nevertheless, similar concerns have been raised again in responses to IAASB's consultation on the audits of LCEs and its suggestion that a separate auditing standard might be developed for them: the gold standard of ISAs might be diluted, the market might be confused, and a new standard might be applied to audits for which it is not intended. There would also be little advantage to a separate standard for some audit regulators who might regard it as an administrative inconvenience.

Standard-setting in the UK: some reflections

The UK adopted ISAs in the mid-1990s and continues to base UK standards on the ISAs promulgated by IAASB, with a few notable UK additions in areas such as audit reports, in which the UK led the international agenda, and more recently, going concern.

The UK continues to play a leading role in the development of ISAs and has devoted considerable time and effort over the years to global standard-setting. The FRC's work on extended auditor reporting was taken up by IAASB, and what started in the UK now represents the global standard. That said, audit is a global business, and although divergence can deliver benefits if used to good effect, there is a trade-off to be made.

The establishment of a new UK audit regulator and auditing standard-setter (ARGA) to replace the FRC provides an opportunity to reconsider and enhance the UK model of auditing standard-setting. ARGA could use that opportunity to consider:

- how it might build on, revise and modernise the FRC's existing auditing standards and its model for standard-setting; and
- which areas of UK auditing standards warrant specific attention at a UK level, including areas in which it might lead internationally, as with auditor reporting. In doing so, it is important that ARGA considers issues in a holistic manner and deals with related corporate governance and reporting issues. Audit issues cannot be dealt with in isolation.

Sir Donald Brydon recommended in December 2019 that ARGA should determine a new framework for all corporate auditing, that a set of principles of corporate auditing should be established to govern the behaviour of corporate auditors, and that standards and rules should sit within that framework. While this idea is not entirely new, and while stakeholders will look for continuity in a new regulator, opportunities to make changes to the overarching framework for UK auditing and to the standard-setting process are rare, and will not arise again in the near future.

As with standard-setting internationally, any changes made should be, and be seen to be, substantive. The FRC showed itself to be capable of driving through real, radical and valuable reform, both nationally and internationally, when it launched its auditor reporting project in 2013. Few would have believed even a few years before then, that such changes might be possible. But some other changes presented as major shifts of policy, position, procedure or process in recent years have sometimes promised more than they have delivered.

The debate on auditing standards and standard-setting in the UK is relevant to the achievement of the first of the **five goals** for UK audit reform published by ICAEW in February 2020. The first of these goals is to establish ARGA as quickly as possible, while avoiding weighing it down with multiple priorities or unrealistic expectations. A paramount priority for ARGA must be to improve audit quality.

BUILD, REVISE AND MODERNISE

The FRC's existing model for standard-setting has stood the test of time. Broadly speaking, it has adopted and modified the ISAs issued by IAASB by:

- addressing UK legal and regulatory requirements (which include the 2016 EU Regulation and Directive); and
- providing guidance for the UK legal, cultural and business context.

Nevertheless, ARGA might consider whether:

- the FRC's suite of auditing pronouncements remains appropriate;
- it can and should continue to set auditing standards for the audit of all entities, given its public interest mandate and its focus on the UK's capital markets;
- it can take further action to resolve the issues arising from the cut-and-paste approach taken to the incorporation of the EU Regulation and Directive into ISAs (UK); and
- it can develop innovative thinking to better promote the consistent application of ISAs (UK).

The FRC's suite of auditing pronouncements: this has stood the test of time, but ARGA could also consider whether the suite might be expanded to include high-quality implementation guidance, particularly if it continues to set standards for non-PIE audits. ARGA could also consider the possibility of developing a new style of standard on an experimental basis to deal with the fundamental shifts in assumptions underlying an ISA audit created by data analytics and similar technologies.

Non-PIE audits: there are alternatives to setting standards for all audits and the restrictions that entails. ARGA might consider whether or not it should focus its efforts on PIE audits. It might also consider the various pros and cons of delegating auditing standard-setting for non-PIE audits - or smaller or less complex audits - to other bodies.

EU Regulation and Directive: the recent changes to auditing standards arising from the EU Regulation and Directive have resulted in overlap, duplication and a lack of clarity in a number of areas as a result of the cut-and-paste approach adopted by the FRC. There is precedent for the adoption of such legislation in a different manner that permits wording that achieves the objectives and substance of the legislation, without necessarily repeating it verbatim. ARGA should build on the work performed by the FRC in its July 2019 [consultation](#) on revisions to ethical and auditing standards by considering how the relevant pluses can be better and further integrated with existing standards.

Consistent application of ISAs: much disquiet among auditors relating to regulatory intervention arises from a lack of certainty and clarity about the specific demands audit inspection teams are likely to make and how they will interpret auditing standards. For example, there is often a lack of clarity about:

- assumptions about how far auditors must go beyond the requirements of auditing standards to achieve the overall objective of the audit;
- the degree to which documentation will be required for procedures not performed; and
- the manner in which auditors are expected to demonstrate professional scepticism.

The FRC has a wealth of understanding of these issues and ARGA must find innovative ways to share that resource if audit quality is to improve.

TAKING A HOLISTIC APPROACH TO AUDITING AND REPORTING

Common sense dictates that reporting by directors, management and audit committees should be considered before any changes to audit and reporting are developed. It is important that audit and accounting issues are dealt with in a more holistic manner than they have been in the past. There is little that can be said about audit that has no implications for corporate governance, corporate reporting, audit committees, directors and management, and the need for ARGA to actively engage with these stakeholders on audit issues has never been greater. Sir Donald Brydon also stresses the need to consider the context in which audit takes place and the interactions between the auditor, the audit process and a range of other participants.

The recommendations already made by Sir Donald Brydon, and further recommendations expected later in 2020, make it likely that a number of new requirements, including some form of reporting on internal controls and enhanced viability reporting, will be considered in the near future. Furthermore, the audit of historical financial information in isolation is becoming increasingly untenable in the face of rising expectations about the involvement of auditors in the narrative of the annual report, and more.

Just as the FRC's work on extended auditor reporting broke new ground globally in 2013, ARGA has a rare opportunity to lead the way in changes to the scope of the audit as the proposals arising from the current reviews emerge.

Recommendations and next steps

In this essay we have identified a number of strands in the web of relationships between auditing standards, the standard-setting process and audit quality. We noted at the outset that the issues are not clear cut, and that the nuance is sometimes hard to grasp.

ICAEW is a long-standing champion of global auditing standards and IAASB. IAASB and other standard-setters, including the FRC in the UK, are being asked to address a very wide range of issues and have limited resources. To guarantee IAASB's continued standing as the global auditing standard-setter, it must consider changing what it does and the way it does it, to maintain confidence in its ability to develop auditing standards that genuinely improve audit quality.

In the UK, the establishment of a new UK audit regulator and auditing standard-setter provides an opportunity to reconsider and enhance the UK model of auditing standard-setting. We have reflected in this report on some of the issues that might be addressed.

Our main recommendations to IAASB are repeated in full below for convenience. **We invite individuals and organisations to share with us their observations on this essay and, in particular, our recommendations.** Please email your comments to nigel.sleigh-johnson@icaew.com. This will help us to develop our contribution to future debate in this area.

OUR MAIN RECOMMENDATIONS

In addition to IAASB's work on LCE audits and audit evidence, as a mature standard-setter it should now consider developing:

- a paperwork reduction policy, to which resources should be devoted, to systematically eliminate unnecessary duplication, redundancy and overlap;
- tools facilitating the high-quality and systematic evaluation of major proposals, including cost-benefit analyses; and
- more effective techniques facilitating the development of auditing standards on a holistic basis, preventing the proliferation of excessive detail.

IAASB has no need for excessive caution with regard to data analytics and other new technologies. To help ensure that opportunities afforded by these tools and techniques to enhance audit quality are exploited fully, it should actively reconsider some of the basic assumptions on which the extant suite of auditing standards are based, and take a more robust approach to referencing the use of new technologies in ISAs. For their part, where auditors are confident in the integrity and value of new technologies, they should not be discouraged by audit regulators from using them in meeting the requirements of auditing standards, simply on the basis that auditing standards do not explicitly permit them.

IAASB should consider more active engagement with audit regulators and auditors to develop an understanding of how application material within the ISAs and non-authoritative material could be developed in a more agile and innovative manner to improve audit quality and enable faster reactions to developments. It could review its range of non-authoritative pronouncements and re-define the nature and purpose of staff publications to facilitate better quality and more useful guidance material, especially examples, and not limit the pronouncements to statements made in the ISAs. It could reinforce and clarify the status of guidance material to encourage a more consistent approach by audit regulators and auditors.

IAASB should consider now how it might operate more efficiently on a day-to-day basis, to enhance the quality of standard-setting, and with a view to ensuring that the Monitoring Group's proposals, as and when they are implemented, are effective in the public interest. This might include requiring that better developed proposals are brought to the board, and that the board engages in less-detailed drafting.

IAASB should consider:

- the benefits and risks associated with continuing to promulgate a single set of auditing standards;
- whether the necessary compromises required at both ends of the scale are still justified by the benefits; and
- the possibility of developing a more workable set of requirements and application material for the audit of non-PIE entities, within a single set of standards, with incremental requirements dealing with the audit of more complex entities.

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www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com

ICAEW

Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA
UK

T +44 (0)20 7920 8100
E generalenquiries@icaew.com
icaew.com

ICAEW AUDIT AND ASSURANCE FACULTY

The ICAEW Audit and Assurance Faculty is the professional and public interest voice of audit and assurance matters for ICAEW and is a leading authority in its field. Internationally recognised as a source of expertise, the faculty is responsible for submissions to regulators and standard setters and provides a range of resources to professionals. It also offers practical assistance in dealing with common audit and assurance problems.

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For more information on the faculty, the current work programmes and how to get involved, visit icaew.com/audit. For information on individual or corporate membership of the faculty, open to all, contact louise.thornton@icaew.com



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