The importance of Audit Quality for Trust in Business

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Audit quality in a changing environment

Audit quality is integral to the effectiveness of the financial reporting system. The objective of an external audit is to provide confidence to investors in the quality of financial reports and improve trust in corporate reporting. However, sudden and surprising collapses or major reporting gaps from companies around the world have precipitated questions about audit quality and the role of the external auditor.

The value of audit is inextricably linked to the relevance and usefulness of information provided in a company’s annual report and accounts. At the same time, it is important to view audit quality not in isolation as it is dependent on the wider financial eco-system, which includes legislators, standard setters, companies (management and audit committees), investors, regulators, and external auditors.¹ Audit quality requires all stakeholders involved to undertake their roles in financial reporting robustly, competently and diligently.

This is particularly important as the ecosystem is changing, and stakeholders and the public at large are increasingly taking an interest in companies and thus in audit quality. At the same time, businesses are becoming more complex, global companies are becoming more diverse, businesses are growing and failing faster, and value is increasingly intangible and reflected in various ways in financial statements. These developments highlight the need to have an inclusive discussion on how the different stakeholders can best work together to ensure audit quality. The OECD Corporate Governance Committee could play an important role as a convenor of such a dialogue.

The importance of trust

In today’s complex and more inter-connected environment, with growing expectations from society at large, trust in both business and institutions is more important than ever. It is a key factor for continued growth and economic development, efficient allocation of capital, and

¹ In the UK, Sir Donald Brydon’s Report of the Independent Review into the Quality and Effectiveness of Audit provides recommendations on audit quality not only for the auditors but also for other stakeholders.
long-term value creation. Globalization, climate change, changing demographics and rapid technological disruption affect the place of business in society and how it generates value for the long term. How well companies navigate these megatrends will determine to what extent their stakeholders trust them. Governance, reporting and audit/assurance can all play an important part in facilitating that trust.

Over the last decade, auditors, audit committees and audit regulators have undertaken a range of efforts to enhance audit quality, which has in turn enhanced confidence in audited financial statements. One indicator of progress is the decrease in the number of restatements reported for US public companies.

While regulators internationally have noted progress, they have also raised some concerns in relation to the quality of audits. Globally an annual survey of inspection findings of its members by the International Forum of Independent Audit Regulators (IFIAR) in 2018 indicated findings in 37% of public interest entity (PIE) including GSFi audits the IFIAR members inspect. It is in everybody’s interest to identify the reasons for such findings and address them. IFIAR, in regular dialogue with the largest global audit networks, is focused on the root causes, which has resulted in a downward trend in the level of findings. Going forward IFIAR has challenged the global networks to reduce the percentage of listed PIE audits that have inspection findings by at least 25% over a four-year period using its 2015 survey results as a baseline.

**Investors’ needs for high-quality information**

Professional investors consider the outputs from the audit, i.e. quality of financial disclosures, reported episodes of fraud within audited companies, and the quality of the information in the auditor’s report as some of the most important factors that influence their perception of audit quality. They seek high quality and insightful communication on the state of the company. Investors also see a clear link between audit quality and the quality of the financial report, which demonstrates the key role auditors play in contributing to the quality of financial reporting.

Demand is also rising from investors for the scope and nature of audit/assurance to expand to incorporate a review of risk, of ESG factors and more broadly a review of forward-looking non-financial information and measures for determining long-term value. The need for high audit quality will remain constant, even in this broader view of audit and assurance. Of key importance is the capacity of auditors to challenge management on their assumptions and judgements made in the course of development of financial information.
Specific topics being discussed include the following:

- Going concern judgements and disclosures;
- Developing and monitoring audit quality indicators; and
- Ascertaining the appropriate level of assurance on Non-GAAP Financial Measures (NGFMs) as well as Non-Financial Information (NFI).

To investors, the independence of auditors (i.e., independent standard setting and enhanced standards for auditor independence) is crucial as is auditor competence and robust monitoring, and enforcement of audit quality.

**How to support audit quality**

As noted above, it is important to view audit quality as part of the wider financial eco-system which includes numerous stakeholders. Quality audits require all stakeholders involved to undertake their respective roles in financial reporting robustly, competently and diligently. Focus points for the key stakeholders are described below:

- **Audit Committees**
  
  Increasing focus on the governance of the financial reporting process within companies, and on the expertise on and work of audit committees: This may include a stronger selection process for audit committees to ensure a more expert and independent composition; and a report from the audit committee on its activities including a statement on the company’s internal controls signed by management to prevent fraud, misconduct and financial reporting errors. The audit committee statement might include a statement on how it came to its ‘going concern’ decision and other estimates and judgements the company made in the development of the financial reports. Audit committees are encouraged to be more challenging in their assessment of the external auditor and of the quality of the audit. The audit committee, with the support of the board, is essential to ensuring that there is the right amount of challenge to the external auditor during the process.

- **Audit Firms**
  
  Audit firms regularly execute quality audit, however consistent audit execution remains a challenge for firms to varying degrees. Audit firms need to focus on consistent audit execution as an important way to enhance audit quality. Avenues to
address consistent execution include root cause analysis, setting the right tone from the top, effective audit policies, improvements in technology and methodology, quality management systems, training and culture, dialogue with engaged investors, and a review of forward-looking information and measures for determining long-term value.

In the absence of the global regulatory body, audit firms are regulated at the national level so there is no “one size fits all” approach or methodology. As national regulators are often focused on finding solutions to the challenges faced in their respective markets, the exchange of best practice in this area would be helpful. Currently there are discussions of avenues to be considered by regulators in some markets to address the perceived challenges in those markets including: a review of how audit partners are incentivized and remunerated; a review of the financial statements by more than one audit firm; auditor skepticism and the level and experience of staff working on the audit, especially on-site activities; training and culture, and the audit firm’s internal second reviewer process being made more transparent. If implemented, these would prompt auditors to collect bigger samples and apply best technologies and analytics to the audit process for deeper analysis, so that they can better assess the material risk of fraud, misconduct and financial report anomalies and provide better predictive information. In addition, self-monitoring by audit firms would supplement efforts by the regulators. Greater transparency on how the auditor concludes on the audit opinion is also being discussed.

With the pace of change accelerating, audit teams across all firms need to be equipped with the most advanced technology and be in a position to leverage the experience and expertise of specialists in their firms in areas such as tax, fraud, valuation, cyber and IT. This multidisciplinary model, combined with the application of new technology, better identifies risks and enhances audit quality.

- **Regulators and Standard Setters**

  Audit regulators promote sustainable audit quality through proactive regulatory oversight. Audit regulators protect the investing public’s interests and deliver value to the various stakeholders through effective regulation and by promoting high-quality, independent auditing, fulfilled through inspections and by involving a broader range of stakeholders in a discussion about and better understanding of the audit process. This requires a multi-faceted approach to stakeholder engagement and inspection methodology, including root-cause analysis, risk assessment and value-added recommendations.
Regulators should also facilitate dialogue with national and international stakeholders and engage at global level to lead the debate and develop thought leadership on the future role of audit. Regulators are in a unique position to contribute to the state of audit quality, audit committee effectiveness and international audit regulatory development. They can make a significant contribution to enhancing audit quality and investor protection by providing content that can help stakeholders have a significant impact on audit quality and perform their role more effectively.

Market regulators should maintain, facilitate and improve the performance of the financial system and entities in it and contribute to public confidence in the integrity of financial reporting, which supports the capital markets.

High-quality international standards for auditing, assurance, and quality control strengthen public confidence in the audit. The global audit standard setter (IAASB) has been active in reviewing applicable audit standards and is making proposals to strengthen audit firm quality control systems and engagement quality reviews. We support IAASB in focusing on improvements in the way professional firms address key public interest issues related to management of audit quality. Greater focus on firm leadership, culture and resources dedicated to audit and on firm management for improved quality audit outcomes is important. Increased emphasis on professional skepticism during an audit and its review and consideration of the public interest in an audit would be welcome.

- Investors

Investors are encouraged to engage with the company and challenge/test the quality of its financial reporting governance and of its audit quality. Companies could consider providing investors with an opportunity to lead or participate in the selection and removal of the auditor not just the ratification of the auditor selection at the AGM. More engagement between investors and auditors as well as investors and audit committees would contribute to greater understanding.

The importance of inclusive dialogue

Good governance, the right tone from the top, transparency and audit quality are all important factors for improving trust in business. In this context, companies, including management and audit committees, regulators, standard setters and audit firms need to work together. Audit quality requires a comprehensive approach,
recognizing the importance of dialogue among all stakeholders involved for the benefit of capital markets, our economies as well as trust in business and government.

A number of avenues should be considered to address audit quality, including root cause analysis, setting the right tone from the top, engaged audit committees, effective audit policies, improvements in technology and methodology, quality management systems, training and culture, dialogue with engaged investors, and a review of forward-looking information and measures for determining long-term value.

Business at OECD thanks the OECD for the organization of the roundtable on audit quality on the occasion of the October 2019 meeting of the Corporate Governance Committee and encourages further fact-based dialogue and the exchange of best practice in this area.