Audit Quality in Practice: A Critical Analysis of the Financial Reporting Council (FRC) Discussion Paper

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The efforts by the Financial Reporting Council (FRC) in the United Kingdom (UK) to stimulate audit firms to improve audit quality manifest in its Discussion Paper: Promoting Audit Quality warrant further analysis. The discussion paper identified factors such as audit firm culture, the quality of people, the effectiveness of audit process, and outside factors such as management and audit committee (AC) which can affect level of audit quality in practice. Reporting upon the analysis of responses to the discussion paper, the objective of this study is to analyze views from the respondents about various issues related to audit quality. This study composes of how subject of audit quality is seen in practice, which contributes to our understanding of conditions, events, or processes that can affect audit quality in practice.

Keywords: audit quality, content analysis, regulation, United Kingdom (UK)

Introduction

The efforts to motivate audit firms to improve quality of their services underlying standard-setting activities and doubts about the quality of audit have motivated investigations and other actions by regulators (Panel on Audit Effectiveness, 2000; International Auditing and Assurance Standards Board [IAASB], 2011). In an effort to restore trust and confidence in the audit profession and capital market, various changes to the regulatory regime for auditing and governance practices have been made in the United States (US) and in other jurisdictions including the United Kingdom (UK) and the European Union (EU). In addition, in the process of regulatory change to enhance audit quality through various initiatives and projects, public discussion has become a regular aspect to legitimize regulator activities (Financial Reporting Council [FRC], 2006; European Commission [EC], 2010).

This paper analyzes responses to the Discussion Paper: Promoting Audit Quality issued by the FRC which took place in 2006. The consultation paper aims to seek views from all interested parties in the audit process about factors that influence audit quality in practice. There are two primary aims of this paper: (1) to develop the understanding of how concept of audit quality is understood by respondents as expressed in their
submission; and (2) to consider factors which respondents consider to have an influence on the attainment of high audit quality in practice.

This study enhances the understanding of the nature of audit quality from the practical perspective of those responded to the discussion paper that is also drawn from the context of auditing within the UK. Whereas much of the prior research has been dominated by studies conducted with reference to the US environment, the authors adopt a large-scale market-based approach or survey-based approach to investigate the association between some “input” and “output” measures of audit quality (Watkins, Hillison, & Morecroft, 2004; Francis, 2004; Humphrey, 2008). Therefore, an important motivation for this study was a concern to go beyond existing approaches to audit quality. This study attempts to contribute to the understanding and knowledge of audit quality by researching this issue within the context of regulation of audit quality. In addition, assessing views of responses to the discussion paper contributes to the growing literature on regulation and its potential impact on audit quality or audit practice.

The remainder of this paper is organized in five sections. Section two provides a review of relevant literature. Section three describes the research methods used in the study. Section four explains discussion and interpretation of findings. Finally, section five ends with conclusions of the study.

Audit Quality

The concept of audit quality has proved difficult to define with certainty. It is not immediately or directly observable and is difficult to measure (Power, 1997). Moreover, audit markets’ participants have conflicting roles and different expectations that lead to different interpretations of audit quality (Sutton, 1993). As a result, different people tend to have different definitions and ways of measuring it (Rasmussen & Jensen, 1998; Watkins et al., 2004), which suggests ambiguity and subjectivity in the term audit quality.

The regulator in the UK and professional practitioners have never defined the term precisely, although various initiatives have been built around the term and serve to influence contemporary understandings of such concepts (Institute of Chartered Accountants in England and Wales [ICAEW], 2002; FRC, 2007). The professional literature is inclined to define audit quality in relation to meeting the requirements of the auditing standards during the course of the audit (Krishnan & Schauer, 2001; McConnell & Banks, 1998).

In comparison, various academic research approaches that are relevant to audit quality have defined and measured audit quality in a number of ways, involving a combination of measures that linked inputs (such as industry expertise, the amount of non-audit services, and tenure and size of the audit firm) to audit outcomes, such as audit failures (Feroz, Park, & Pastena, 1991) and the quality of financial reporting (Becker, Defond, Jiambalvo, & Subramanyam, 1998; Gul, Sun, & Judy, 2003), process measures that are related to auditor performance (such as audit procedures, judgment and decision-making, and quality-threatening behavior) (Sutton, 1993; Malone & Roberts, 1996), and to capture quality attributes of relevance to users and preparers of financial statements (Carcello, Hermanson, & McGrath, 1992; Duff, 2009).

Overall, research on audit quality shows various concepts attached to audit quality. Nonetheless, there is limited research that examines the impact of contextual factors (people, processes, and audit environment such as the role of regulation, audit committee (AC) members, and audit clients) on attainment of high audit quality in practice (FRC, 2006; IAASB, 2011). This research aims to add to understanding of this issue by investigating widely-held views of interested people on various issues of audit quality published in the discussion paper.
Research Method

The FRC published a discussion paper on promoting audit quality and sought answers to 17 specific questions that relate to five main drivers of audit quality:

1. Culture within an audit firm;
2. Skills and personal qualities of audit partners and staff;
3. Effectiveness of audit process;
4. Reliability and usefulness of audit reporting;
5. Outside factors beyond the control of auditors that affect audit quality, such as the approach taken by management and the contribution made by the AC.

The structured nature of the discussion paper with its 17 questions determined, in most cases, the structure and content of the responses received. Nonetheless, respondents are not obliged to structure their answers in a particular way, and any very strong feelings about the issues under review would likely to emerge regardless of the structure. As such, the respondents made a significant number of additional comments in their covering letters.

Respondents and Content Analysis

Thirty nine sets of responses were received in response to the discussion paper (see Table 1). Although the self-selected sample provides some limitation of the study, nonetheless analysis of responses to the discussion paper offers an opportunity to access the views of a wide group of interested parties and thus to develop a richer insight into varying perspectives on audit quality. This paper is based on the content analysis of the comments received by the FRC. Content analysis refers to quantify text for recurring words or phrases, or themes (Patton, 2002; Berg, 2006). In analyzing the comments, a set of themes or categories were developed from the data and were then counted and reviewed to ensure that all of the issues had been identified.

Table 1

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Number of responses</th>
</tr>
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<tbody>
<tr>
<td>Audit firms</td>
<td>8</td>
</tr>
<tr>
<td>Professional bodies</td>
<td>11</td>
</tr>
<tr>
<td>Investors</td>
<td>8</td>
</tr>
<tr>
<td>Corporate respondents</td>
<td>2</td>
</tr>
<tr>
<td>Others</td>
<td>10</td>
</tr>
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</table>

Discussion and Interpretation of Findings

This section provides findings of the study. Table 2 provides a summary of the significant aspects of the detailed analysis.

Audit Firm Culture

In general, respondents agreed that the culture of the audit firm was an important driver for audit quality. Auditors, investors, professional bodies, and companies all made similar comments on this point. They viewed the indicators identified by the FRC, such as leadership, auditing and ethical standards, promotion of consultation, partner and staff development systems, and information infrastructure as essential to achieve high-quality audits. A professional body, the ICAEW, emphasized the significance of good technical support and the culture of leadership throughout the audit firm that drives audit quality.
Table 2

Key Issues of the Comments

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Audit firm</th>
<th>Professional body</th>
<th>Investor</th>
<th>Corporate respondent</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of respondents</td>
<td>8</td>
<td>10</td>
<td>9</td>
<td>2</td>
<td>10</td>
</tr>
</tbody>
</table>

The culture of the audit firm

Concern about tick-box mentality culture | 5 | 4 | 0 | 1 | 1 |
Concern about focus on documentation | 4 | 2 | 0 | 0 | 0 |
Concern about commercialization of the audit firm | 0 | 0 | 3 | 0 | 1 |
Suggest professionalism as part of culture of the audit firm | 0 | 0 | 4 | 0 | 0 |
Sought greater information about governance and control of the audit firm | 0 | 2 | 7 | 0 | 1 |

The quality of people

Diverse and up-to-date skills and knowledge | 8 | 5 | 7 | 1 | 5 |
Concern about attractiveness of the profession | 7 | 1 | 2 | 0 | 1 |
Concern about availability of audit staff | 7 | 5 | 0 | 0 | 0 |
No fundamental review of the qualification and training requirements | 4 | 5 | 3 | 0 | 0 |
Concern about requirement of partner rotation | 3 | 1 | 0 | 0 | 0 |

The effectiveness of the audit process

Concern about overly complex audit standards and regulations | 7 | 6 | 1 | 1 | 3 |
Concern about move to prescriptive audit approach | 7 | 5 | 3 | 2 | 2 |
Regulators should promote and enhance principles-based audit approach | 5 | 6 | 2 | 2 | 0 |
Important role of audit client to audit process | 7 | 6 | 5 | 1 | 2 |
Important role of AC to audit process | 7 | 6 | 4 | 1 | 1 |

The reliability and usefulness of audit report

Reputation of audit firm and audit profession | 2 | 3 | 1 | 1 | 1 |
Greater information from audit firm | 2 | 1 | 5 | 0 | 1 |
Understand ability of audit report | 1 | 2 | 5 | 0 | 1 |

Other factors affecting audit quality

Important role and support of the management | 7 | 2 | 0 | 0 | 0 |
Important role and responsibilities of AC | 7 | 6 | 7 | 1 | 1 |
AC discharging adequate responsibilities | 4 | 1 | 3 | 1 | 1 |
Sought detailed guidance for AC to evaluate effectiveness of audit | 3 | 3 | 2 | 1 | 4 |
Sought summary of work of AC in annual reports | 7 | 4 | 1 | 0 | 5 |

Other issues

Welcomes references to discussion paper | 8 | 10 | 8 | 2 | 6 |
Concern about lack of empirical evidence to support some of the assertions | 3 | 3 | 5 | 0 | 0 |
Insufficient attention to other critical dimensions of audit quality | 6 | 4 | 1 | 1 | 0 |
Resource concern | 5 | 5 | 1 | 1 | 1 |
Concept or definition of audit quality requires clarification | 0 | 1 | 0 | 1 | 0 |

While accepting the importance of culture to audit quality, most of the audit firm respondents were keen to describe concerns and problems about the changing culture in the audit firm created by the current regulatory framework. Eleven respondents claimed that the changes have diverted audit firms' attention from the principles to rule-based procedures that could create a culture of a “tick-box” or compliance approach in audit. The compliance approach has also created an excessive focus on documentation that could reduce the use of knowledge and professional judgment in the conduct of the audit. The respondents argued that the prescriptive...
approach was restricting the auditor’s ability to exercise professional judgment and shifting the nature of the audit to compliance work, thereby affecting the quality culture of the audit firms and impacting the effectiveness of the audit process. These eventually would undermine the quality of the audit.

In comparison, it was frequently claimed by a number of investor respondents that commercial interests have become a major aspect of the culture of the audit firms and could compromise the audit quality. The investors voiced concern about the commercial objectives of the audit firms that could create a threat to audit quality. Further, they suggested that the audit firms should promote and encourage culture of professionalism—an audit that serves the public interest for the benefits of shareholders and other users of the accounts as part of the indicators of their quality culture. Eight respondents advocated that greater information about quality initiatives and the governance and control of the audit firms could enhance their confidence in the quality culture of the audit firm. In general, the respondents highlighted the lack of information about the audit firm’s policies and actions that they take to embed a culture of quality within the firm.

Overall, the majority of the respondents agreed that culture is imperative and will influence the quality of audit practice. The user group representative, that is, the investors mentioned a great concern on culture of commercialization of audit firms that could undermine audit quality. The audit firms and professional associations pay attention to the negative effect of the audit regulation on the culture of the audit firms. Identification of culture as one of the key drivers of audit quality may indicate considerable concerns for the regulator concerning “commercialized professionalism” that promotes a culture of client-centered services (Hanlon, 1994) that may be viewed as detrimental to audit quality. As the Audit Inspection Unit (AIU, 2006) pointed out, commercial considerations and measures continued to be a driver of performance measurement in the audit firms rather than audit quality. The investor respondents in this study voiced concern regarding the commercial business approach of the audit firms that had contributed to a decline in audit quality in recent years. In like manner, some prior research has shown that deterioration of the culture of professionalism causes conflicts in values and practices within the audit profession that affect audit performance (Wyatt, 2004; Baker, 2008). Recent corporate scandals have raised the question whether accounting firms have nurtured cultures that emphasize an appropriate level of professionalism and commitment to serving the public interest (Jenkins, Deis, Bedard, & Curtis, 2008).

The Quality of People

Almost all of the respondents fully agreed with the importance of the auditor’s knowledge, skills, and personal qualities of the audit personnel for attainment of high audit quality. Investors, auditors, companies, and professional bodies all made similar observations on this point. For example, the investors pointed out the necessity for auditors to keep their technical skills up to date with the changes in the business environment. Likewise, a professional body respondent believes that technical skills, personal qualities, professional skepticism, and practical experience are key drivers of audit quality.

The audit firm respondents asserted that it is important for the auditors to have diverse and up-to-date skills and sufficient experience. These attributes are important in supporting professional judgments and an effective audit process during the conduct of the audit. As such, the audit firm respondents emphasized the importance of academic qualification, entry and selection requirements, and training procedures in the audit firm to advance the knowledge and skills of auditors to achieve high audit quality: quality audit judgment. The audit firms and the professional bodies frequently stressed points concerning the potential adverse impact of the
current regulatory environment on the quality of people in the audit firm. They argued that excessive regulation resulted in changing the nature of audit work to a more compliance-based activity. It also had an unfavorable impact on the attractiveness of the profession to hire and retain quality audit staff: “There are concerns that the attractiveness is being impacted by regulators that place too much emphasis on the application of the rule rather than principles” (Klynveld Peat Marwick Goerdeler [KPMG], 2007, p. 3).

Overall, the majority of the respondents in this area support the importance of quality of people to audit quality. Nonetheless, analysis of the responses shows that respondents were inclined to highlight concern with unfavorable impact of current regulatory environment to expertise and judgments of the auditors. While accepting potential negative impacts of the changes in audit regulation on the quality of people, the responses provided by the audit firms and professional bodies can also be seen as an important defense against the imposition of more prescriptive regulations that may be detrimental to market dominance, social status, and jurisdiction of their work. Analysis of responses also shows that there is a considerable tension around regulation and concern of the audit firms concerning further regulation that might be proposed as a result of the debate around the discussion paper. Given this context, responses from audit firms on this issue can be viewed as an objection towards development in the audit regulation and eventual independent oversight and direct regulation of the audit profession. As such, an emphasis on expertise and professional judgment is entirely to be expected, as it reflects an aspect of firms’ self-interest. Attributes of professional claims to special knowledge and expertise are necessary to sustain and legitimate professional status and the related social and economic rewards (Richardson, 1987). For this reason, professionalism often involves a traditional stance against regulation.

**The Effectiveness of the Audit Process**

The FRC asserts that factors such as characteristics of the audit team, technical support, audit methodology, auditing standards, and quality control procedures contribute to the effectiveness of the audit process. Analysis of the responses shows that the respondents were fully in accord with the assertions. The majority of the respondents also emphasized the important role of the audit client and ACs for an effective audit process. Other factors that influence the effectiveness of the audit process include application of business risk audit approach in an audit and experience of the audit partners. Eighteen respondents expressed deep concern about the effect of excessive complex standards and regulation that shift auditing from principles- to rules-based approaches. As a result, some respondents believed that as the audit approach becomes more prescriptive, compliance exercises rather than the use of professional judgment would be prompted. This would significantly affect the effectiveness of the audit process and audit quality in consequence. In response to that issue, 15 respondents took the view that regulators should promote and support the principles-based audit approach in their initiatives and projects in the audit arena to ensure high audit quality. Overall, one pertinent issue that emerged from the analysis concerning the effectiveness of the audit process is in relation to the impact of various factors such as regulation, audit client, AC, individual auditors, and firms’ policies and procedures on the effectiveness of the audit process to achieve audit quality.

**The Reliability and Usefulness of the Audit Report**

The FRC identified reliability and usefulness of audit reporting that command confidence as one of the key drivers of audit quality, which attracted many comments from the institutional investors. Analysis shows that the respondents generally viewed that the concept of audit quality is closely linked to the accuracy and credibility of the audit opinion that enhances quality of financial statements. As such, they suggested that the
audit report should be accurate and the auditors should be seen as an independent professional entity. For example, “The value of the audit opinion is strongly linked to the usefulness of the accounts” (Coal Pension Trustees, 2007, p. 2).

Some other comments put forward by the commentators concerning factors affecting confidence in audit opinions include greater information from audit firms regarding their process and policies and reputation of audit firm and audit profession. In comparison, some of the factors identified which could reduce confidence in audit opinion are related to the format of the audit report (length and legalistic wording) and prescriptive audit approach in audit.

Other Factors Affecting Audit Quality

On the whole, the respondents supported the significant contributions made by the management of the audit client and ACs to audit quality. The professional bodies pointed out the important role of the audit client for audit performance. Similarly, audit firms identified that the culture of the audited company and the skills and personal qualities of its board and executive management could enhance the effectiveness of the audit process. Respondents also recognized the important role of the members of ACs in audit quality. There was a consensus among the audit firms concerning the important role of AC in the auditing and financial reporting process. Ernst and Young (2003) noted that based on their experience, the ACs had become stronger and more questioning of what auditors do. The audit firm respondents acknowledged the increasing quality of communication between them and ACs. They also believe that detailed evaluation of audit guidelines would help ACs to function more effectively. On the other hand, investors requested more disclosure about the work performed by ACs that enhances users’ confidence in audit quality. These were illustrated by the following quotations: “The culture of the audited company and the skills and personal qualities of its board and executive management are very important drivers of audit quality” (Ernst and Young, 2007, p. 3).

“The responsibilities ACs have undertaken in relation to the audit process can give confidence to shareholders that the auditor/client relationship is sufficiently independent and that sufficient attention is being paid to audit quality” (Deloitte, 2007, p. 2).

Prior research shows mixed results concerning the effect of ACs on audit quality (Carcello & Neal, 2000; Abbott, Parker, Peters, & Raghunandan, 2003a, 2003b; Lee & Mande, 2005; Piot & Janin, 2007). Further, these archival studies failed to document the processes involved between the auditors and ACs members and its impact on audit quality. Hence, this provides an opportunity to investigate further how ACs’ understanding of the concept of audit quality influences their operation and process and its effect on audit function and audit quality in the new auditing environment.

In general, the respondents expressed a high degree of support for the initiative and the audit quality framework proposed by the FRC. In particular, almost all respondents were in favor of the attempt of the FRC to recognize a broad set of significant issues relating to audit quality through identification of drivers and threats that could enhance and undermine the audit quality. While acknowledging the positive contribution of the discussion paper, some respondents expressed adverse comments. For example, a few respondents referred to the lack of relevant and empirical evidence to support the assertions stated in the discussion paper. Three of the audit firm respondents had significant criticisms of some of the threats to audit quality identified in the discussion paper, which were unsubstantiated. The discussion paper failed to recognize other critical drivers, such as auditor independence and audit regulation.
“Qualities of independence in the audit and the auditor are crucial, but this is a dimension that receives insufficient attention in the paper” (Association of British Insurers, 2007, p. 1).

Overall, most of the respondents welcomed the initiative and project in the audit arena in the name of understanding and enhancing audit quality. However, there are limited comments from the respondents that provided any detailed analytical assessment of the concept and definition of audit quality. Only two of the respondents to the discussion paper sought clarity about the definition of audit quality. For example, the corporate respondent, the Hundred Group of Finance Directors suggested that audit market constituents such as auditors and ACs should define more clearly the meaning of audit quality by providing qualitative and quantitative measures that could be used to assess the quality of the audit. Another respondent, the ICAEW, raised concern about the imbalance in the definition of audit quality and its drivers as proposed by the FRC.

Issues relating to the effect of changes in audit regulation were significant features of almost all responses to the discussion paper. Although the changes are aimed at enhancing audit quality, several of the respondents expressed adverse opinions. Thirteen respondents mentioned resource concerns arising from the current audit regulations. For instance, five of the audit firms referred to the increased time and cost needed to fulfill various regulatory requirements. Increased oversight activities have caused additional workload for the audit firms, because more staff are needed to spend time in meeting the regulatory requirements. Analysis suggests that staffing and cost become major concerns to firms. In light of the ongoing debate about the benefits of the new regulation, it seems worth investigating the costs and benefits of the oversight function to audit firms and overall audit quality.

Conclusions

The study presents a snapshot of a small part of the audit quality debate, through the eyes of those who responded to the discussion paper. This study did not intend to draw specific generalized conclusions about the research topic from these responses; instead, it is necessary to provide an additional information source to draw out areas that are potentially relevant for further investigation and that can enhance our knowledge about audit quality in practice.

First, while questions of how audit quality is defined and understood by professional practitioners are indeed important (Carcello et al., 1992; Duff, 2004), analysis of the responses draws attention to the lack of a practitioners’ construct of the meaning of audit quality. The meaning of the term audit quality remains implicit rather than clearly articulated. The practitioners said relatively little about the “technical” definition of audit quality in terms of what it means. They discussed more on drivers of audit quality, such as expertise, skills, professional judgment, and culture of the audit firm. While there may be advantages to understand the term audit quality based on its drivers and threats, the relationship between audit quality and the factors in the new audit environment remains unclear.

Second, as illustrated in this study, the concept of audit quality develops dynamically and is influenced by many factors which are prevalent in the auditing setting. The process and impact of regulatory development may be significant, so are the economic environment and the influence of interactions among different parties (such as AC, regulator, and audit client) with particular roles in the auditing system.

Overall, this paper demonstrates the value of understanding of how internal and external factors in auditing environment might influence quality delivered in practice. One of the most significant findings emerged from this study is that audit quality has to be seen in the context of a range of interwoven laws,
regulations and guidance, cooperation of executive management, participation of AC, and the effectiveness of the audit firm’s procedures and policies, all of which promote high audit quality. The results of this investigation show that audit quality is influenced by various elements within and outside the audit firm. However, the overall impact that these various elements have on audit quality is subjected to further examination.

References


Ernst and Young. (2007). *FRC discussion paper: Promoting audit quality*. Ernst and Young, United Kingdom.


