Original Article

A discussion of auditor judgment as the critical component in audit quality – A practitioner's perspective

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ABSTRACT Interest in issues related to auditor judgment by parties outside the profession has shown a substantial increase since the events that led to the passage of the Sarbanes–Oxley Act in the United States. Changes in the regulation of the activities of auditors of public companies in the United States have placed an increasing emphasis on the role of professional standards and of inspections in monitoring and influencing auditor judgment. There is a fundamentally important difference in judgments made by auditors in forming and expressing audit opinions and those made by third parties in evaluating the effectiveness of these judgments after release of the auditor's report. This difference should be recognized by users of financial statements and regulators. Audit judgments are unique to each individual audit and comparing audit judgment across audits presents significant challenges that should be addressed carefully to avoid unintended consequences. In recent history, changes in accounting principles have increased the inherent variability of financial statement amounts and, correspondingly, have increased the importance of disclosures. Although the primary focus of good auditor judgments and audit quality is at the engagement level, the current regulatory environment and the structure and business model of audit firms are of increased importance in influencing those judgments. These factors also influence the independence and professional skepticism of auditors.

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INTRODUCTION

The influence of regulation and audit firm structure, policies and business models on auditor

judgment is increasingly important in understanding and improving the appropriate exercise of judgment in the performance of audits of financial statements. In this article, I hope to identify issues related to these influences that warrant additional research and consideration. I will use the term 'auditor judgment' to describe any decision or evaluation made by an auditor, which influences or governs the process

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and outcome of an audit of financial statements. The focus of this article is on judgments that could reasonably vary between competent auditors using the same facts. The term 'audit quality' refers to the degree to which an audit provides a basis for belief that financial statements do not contain material misstatements after the completion of the audit. The quality of auditor judgments directly determines audit quality.

Current discussions of auditor judgment, audit quality and professional skepticism are heavily oriented toward judgments made at the individual audit engagement level. The emphasis of professional standards and of oversight activities has historically been on judgments made by the audit engagement team. Decisions that must, ultimately, be made in the context of a specific audit include:

- The assessment of the risks of material misstatements of financial statements, including the potential effects of fraud, bias and business risk.
- The identification, performance and assessment of audit procedures to address those risks.
- The evaluation of audit evidence to determine the quality and meaning of that evidence and to assess the need for additional evidence based on the process.
- The formation of an opinion on the financial statements and the decision whether or not to express that opinion.

Each of these judgments must be made by auditors throughout the audit process and before the date on which an audit opinion is issued, based on evidence that is reasonably available at that time. Ultimately, the auditor's opinion is based on informed judgments and not on conclusive evidence.

My comments are based on my earlier experience as an audit engagement partner supervising audits of both large and smaller public and non-public entities, a member of audit committees of public companies, a

member of the staff of the Public Company Accounting Oversight Board (PCAOB), and as a member of the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA).¹

Although the focus of this article is on audits of US public companies, many of the issues discussed are relevant to all audits and may have application to other regulatory environments.

Why the recent concern over auditor judgment? – Although judgment has always been a critical component of both the preparation of financial statements and of audits of those financial statements, the most recent expressions of concern regarding auditor judgment seem to have been a product of the Sarbanes–Oxley Act of 2002 (SOX) and the events that led to its passage. Specifically:

- The failure of Arthur Andersen, the increase in regulatory scrutiny and penalties resulting from SOX, and the major increase in class action lawsuits significantly increased the level of risk aversion exhibited by audit firms.
- The risk that the work of auditors of public companies would be inspected and evaluated after the completion of audits (detection risk) was increased by the creation of the PCAOB. The duty of the PCAOB to inspect registered audit firms on a routine basis created immediate concern as to the likelihood that audits would be reviewed and found deficient. In particular, auditors have been critical of the use of 'hindsight' in evaluating audit judgments whereas regulators have expressed concerns that 'professional judgment' is inappropriately asserted as a universal defense by auditors when the basis for those judgments is not evident.
- In a manner not seen before, auditing standards and the policies of the PCAOB became politicized through a combination of events.
 - Public companies became concerned as to the potential indirect effect of PCAOB inspections on their previously issued

financial statements. As a result, the subject of auditor judgment and the effect of PCAOB inspections on auditor behavior became the subject of preparer scrutiny. This was further compounded by business concerns over the effects of greater regulatory efforts on the attractiveness of the US capital markets. This was a specific concern addressed by the Securities Exchange Act's (SEC's) Committee on Improvements in Financial Reporting in 2008, and of the US Treasury Department's Advisory Committee on the Auditing Profession (TCAP) in 2009.

- The implementation of Section 404 of SOX, primarily through application by auditors of PCAOB Auditing Standard 2 (later superseded by Auditing Standard 5) politicized the development and implementation of auditing standards to a degree not experienced previously.
- By design, the PCAOB consists of non-practitioners and has a direct mandate to protect investors. The formation of the Standing Advisory Group of the PCAOB, consisting of representatives of investor groups, preparers, auditors and other interested parties, created a direct influence on auditing standards that non-auditor groups had not previously had.
- The promulgation of Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* and Auditing Standard 3, *Audit Documentation* by the PCAOB increased the scrutiny of documentation and pressure to demonstrate compliance with a process conforming to professional standards, and not just to a standard of sufficient competent evidential matter.
- In addition, there has been substantial criticism that the PCAOB's form of public reporting on inspections does not provide useful information on the quality of audits performed by the specific firms inspected to the public. This led to recommendations by the TCAP that the PCAOB

develop and consider releasing measures of audit quality. More recently, in 2008, the Financial Reporting Council in the United Kingdom published an audit quality framework that includes discussion about means of measuring audit quality. In addition, the PCAOB's emphasis on the linkage of incentives to audit quality increased the desire to measure audit quality.

In more recent times, other issues have emerged to increase the emphasis on auditor judgment. Specifically:

- The dialogue over the form and content of accounting principles in the future has led to a general notion that accounting principles will be more 'principles-based' than in the past. The PCAOB has expressed concern over how auditors will address the effects of additional 'discretion' in accounting principles.
- Accounting principles have moved toward greater use of estimates of the outcome of future events. Further, these estimates relate to events that are more inherently uncertain and require use of probability concepts in their application.

Finally, recent research indicates that investors may not be convinced that an audit provides the information that they need to make decisions. These criticisms include assertions that:

- The standard auditor's report does not, but should, provide information regarding the critical judgments used by the auditor in developing and supporting the audit opinion.
- The audited financial statements do not contain information about the critical estimates and other judgments made in preparing the financial statements. Although this could be dismissed as an accounting, rather than audit, issue, it could reflect a view that auditors are not requiring disclosures that might, arguably, be required by the current US Generally Accepted Accounting Principles (GAAP) model.

- The information provided by the auditor does not include information on the governance and controls of the company being reported on.

The necessity for preparers and auditors to exercise professional judgment is, if anything, even more important in light of these conditions. Despite the rumors, professional judgments remain the most essential element of the preparation and auditing of financial statements.

EFFECTS OF CHANGES IN THE REGULATION OF AUDITORS OF US PUBLIC COMPANIES

The passage of SOX in 2002 fundamentally changed the regulation of auditors of public companies in the United States, primarily through the establishment of the PCAOB. These changes and the indirect effect of heightened concern over auditor liability have also had substantial effects on the manner in which audits of public companies are performed.

The powers of the PCAOB

The PCAOB has the duty to register, inspect and discipline all firms that audit US public companies. The board itself is designed to be independent of the profession and to give substantial weight to the interests of shareholders and the public. This combination of power is substantially more rigorous than the former model of self-regulation by the profession combined with oversight by the activities of the US Securities and Exchange Commission (SEC) (principally through the SEC's enforcement activities) that had existed from the enactment of the Securities Exchange Act of 1934. The PCAOB operates under the direct oversight of the SEC. This oversight includes approval of audit standards.

Inspections of registered audit firms

SOX requires the PCAOB to conduct annual or tri-annual (for firms with less than 100 public

clients) inspections of firms that are registered with the PCAOB. These inspections include reviews of audit work papers for selected audits and other procedures intended to assess the quality controls in place at the audit firm. SOX provides that quality control deficiencies identified in inspections, if corrected within 12 months of the issuance of an inspection report, not be made public. This provision of the law has created a powerful incentive for audit firms to take whatever steps are necessary to obtain the PCAOB's agreement that the identified deficiencies have been corrected.

Form of reporting of inspection results

By law, the results of the inspections cannot be disclosed by the PCAOB. As a result, the reports of the results of inspections are carefully constructed to prevent the identification of specific registrants or the nature of the quality control deficiencies that require remediation.

Establishment of auditing standards

SOX authorized the PCAOB to designate an independent body to develop auditing standards and related professional practice standards for the performance of audits of public companies. The Board elected to designate itself as that the standard-setter and established the Office of the Chief Auditor to assist in that process. The Board established a Standing Advisory Board (SAG) that meets on regular basis to discuss matters related to auditing standards. The SAG comprises members from a variety of constituencies (investors, public interest representatives, regulators, auditors and analysts) with a minority of audit professionals.

The PCAOB initially adopted the AICPA's auditing standards, as they existed in 2003, as their interim standards. Subsequently, the Board has issued additional standards that supersede certain components of the interim standards. Some of these standards have had a substantial impact on the conduct of audits.

- The board ‘recalibrated’ the interim standards by issuing its Rule 3101 that defined the meaning of certain terms used in the interim auditing and related professional practice standards. This rule specifically increased the number of situations in which audit procedures are required. In addition, Auditing Standard 3 provided substantially more rigorous requirements for audit documentation. The combined effect of these actions was to increase the emphasis on documentation as a primary means of demonstrating compliance with professional standards.
- Section 404 of SOX requires that public companies provide an opinion on the effectiveness of their controls over financial reporting and that the auditor of the financial statements provide an opinion on the effectiveness of those controls as of the balance sheet date. To implement this requirement, the board adopted Auditing Standard 2.
- The Board recently issued Auditing Standard 7, which will substantially increase the effort involved in the engagement of quality reviews.

The auditing standards issued by the PCAOB have been notably more rules oriented, in contrast to the standards issued by the International Auditing and Assurance Standards Board.

Pressure to measure audit quality

Although the structure of SOX was clearly intended to allow the PCAOB to regulate the quality of audits without specifically reporting to the public, it has been criticized from the beginning for not reporting on the quality of individual registered audit firms. As a result, the TCAP specifically recommended that the board develop means of measuring audit quality and also consider making those measurements available to the public. This pressure has substantially raised the level of discussion regarding measurements of audit quality.

EVALUATING AUDITOR JUDGMENT AFTER ISSUANCE OF AN AUDIT OPINION

Judgments and judgment processes are improved when the outcome of earlier judgments is known accurately and in a timely manner. Judgments made, for example, in medicine, law or weather forecasting can be improved by the analysis of subsequent events that either confirm or disprove these judgments.

Unfortunately, the outcome of many audit judgments is never known or becomes known or suggested only because of subsequent discovery, by a preparer, of errors in previously issued financial statements or as a result of reviews of audits performed by inspectors, regulators, litigators or successor auditors. Even when these situations are identified, the information that can be derived is limited and often biased.

The specific situations in which reviews of audits are performed after the release of the auditor’s report are:

- Internal inspection programs of audit firms, peer reviews of audit firms required by professional rules and state regulatory requirements, and PCAOB inspections all involve an assessment of audit effectiveness based on a review of audit documentation. These programs involve reviews by competent professionals of the audit documentation and interviews with engagement personnel intended to assess either the overall quality of the audit being reviewed (internal inspections and peer reviews) or of components of the audit (PCAOB reviews).
- Restatements, litigation, enforcement actions, discovery of fraud or other subsequent events, including business failure may provide indications that a specific audit may not have been effective at the date of the auditor’s report.

Evaluating judgments based on later events

Hindsight does not necessarily provide evidence of the quality of a judgment made at the

time of release of an audit report. A number of decisions involving financial reporting involve estimates of future events. Estimates, even when made by persons with the relevant skills and experience and based on all reasonably available evidence at the time, will often prove to be different from the final outcome of the matter being estimated, because of later changes in conditions. These differences do not constitute errors in judgment.

For example, auditing standards require that an auditor consider the ability of the entity being audited to continue as a 'going concern' in the near future, generally one year. If that consideration indicates that there is substantial doubt regarding that ability to continue in operation, the auditor should report that conclusion. Experience and research show that many entities receive these going concern opinions but continue to operate as going concerns well after 1 year. This does not necessarily indicate an error in judgment because the entity has often taken steps to address the issues that created substantial doubt regarding its ability to continue in operation.

In addition, evaluations of audit judgments at a later date are more difficult to perform, because they must rely on documentation of audit work and the recollections of engagement team members at a later date. They are generally performed by persons who do not have the same level of knowledge of the specific audit engagement and that may differ in their views of materiality, their experience and their competency.

Information from inspections of audit engagements

Information generated from inspections is available to the firm subjected to the inspection and is an important part of an audit firm's monitoring process. However, this information is not generally available to the public, unless very severe deficiencies identified in these inspections require disciplinary action or, in the case of the PCAOB, public disclosure as required

by SOX. The PCAOB does provide summary reports under its Rule 4010 of annual inspection findings that are not specific to individual firms.

Information from alleged 'audit failures'

Restatements, litigation, enforcement actions, discovery of fraud or other subsequent events, including business failure may provide indications that a specific audit may not have been effective at the date of the auditor's report. When compared to the total number of audits performed annually, these events occur infrequently but are often highly public and tend to have significant adverse effects. They do not provide evidence as to the effectiveness of audits for which no such events have occurred.

Restatements can be the result of the discovery of an error by a preparer in the normal course of business, discovery of a fraud, an industry-wide reinterpretation of an accounting standard, a PCAOB review or a change in SEC policy regarding correction of errors. Some of these causes of restatement would indicate a potential audit quality issue whereas others do not. Information as to the actual causal factors may not be disclosed in a manner that allows an assessment of the causes of the errors. The investigation of these events often leads to an investigation of other matters, at a substantially more stringent level of inquiry (lower materiality), resulting in the discovery of additional errors.

Litigation related to audits tends to be associated with disproportionate and large dollar value drops in market values. The litigation process applies complete, and biased, hindsight to assessments of audit quality. In addition, when litigation is settled before a jury decision, one requirement of the settlement will often be to seal all the information related to the case.

Enforcement actions (SEC or PCAOB) tend to be selective and oriented towards situations involving losses or potential losses of market value that are significant to the market

as a whole or where there is identified bad behavior. It could also be assumed that the decision to initiate enforcement actions is based on an informed belief that the actions will be successful.

THE MOST IMPORTANT AUDITOR JUDGMENT – THE AUDIT REPORT

The most important judgment made by an auditor related to a specific audit is the decision to either release a report on the financial statements being audited or decline to do so. An audit is an iterative process that continues until sufficient evidence is obtained to form a professional opinion on the financial statements. Thus, the decision to report on the financial statements involves a judgment that the evidence developed in the audit process supports the auditor's report and a judgment that there is no evidence is reasonably available, which has not been examined and might change the auditor's opinion.

The principal assertions contained in the standard unmodified auditor's report in the United States are:

- an assertion that the audit was conducted in accordance with the applicable auditing standards and that the audit provides a reasonable basis for the opinions expressed;
- an opinion that the financial statements conform to the relevant financial reporting standards; and
- an opinion that the financial statements fairly present the financial condition, results of operations and the cash flows of the entity.

This means that an effective audit is one that provides a reasonable basis to develop an opinion as to whether all material errors are identified and properly addressed before the auditor's report is released. Auditing standards define audit risk as '... the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated'.

The nature of financial statement misstatements

Financial statements can be misstated by either errors in recorded amounts or inaccurate or omitted disclosures. In addition, an auditor must be concerned with misstatements and whether they result from inadvertent mistakes or fraud. As a result, the requirements of the accounting framework being used by the preparer of the financial statements are the primary determinants of what represents a misstatement. For example, when estimates of fair values are used in accounting for investments, the possibility that the ultimate amount realized differs from the amount recorded earlier would not necessarily indicate a misstatement. However, failure to disclose significant estimating uncertainty related to a particular estimate, generally by compliance with the requirements of the related accounting standard, would represent a misstatement.

Judgments regarding materiality

Although audit effectiveness is defined in terms of detecting and appropriately responding to all material errors, the auditor's view of materiality directly affects the amount of effort required to achieve the required level of effectiveness. Materiality is defined by FASB Statement of Financial Accounting Concepts No. 2 in terms of the effects of a matter on '... the judgment of a reasonable person relying on the information ...' AU 312.10 states that the auditor's consideration of materiality requires professional judgment and '... is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements'. It further states that judgments of materiality '... necessarily involve both quantitative and qualitative considerations'.

Quantitative calculations of materiality

Current and proposed auditing standards require materiality to be defined quantitatively in planning an audit. Although all these standards admonish the auditor to consider all of

the aspects of materiality in planning, experience has been that quantitative benchmarks are much more important in influencing the initial design of audit procedures, to evaluating the need for modification of those procedures in response to audit findings and for evaluating identified errors. Further, because most auditors' initial experience with materiality concepts involves calculating and using these single point quantitative measures, their training in these concepts may be delayed until later in their careers.

The application of the broad notion of materiality

It might be argued that the current quantitative model for audit planning materiality should be left undisturbed because it has been widely accepted. However, if the objective is to improve judgments, then the issue of improving the application of the total mix concept of materiality in planning an audit should be addressed.

- Auditors should be aware of publicly available information relating to a client and, particularly of analysts' reports. Planning documentation should include a discussion of the key variables discussed in these reports as being important for valuation. In cases in which the company's stock market valuation is primarily based on future expectations and not on historical performance (a 'story stock'), the plausibility of the story should be considered in decisions regarding acceptance or retention of the client and in evaluating disclosures and fairness of presentation. This review should be done by partners or managers and discussed in the risk meeting.
- Research may be able to help in increasing knowledge of how the total mix concept of materiality can be applied in practice before an audit is completed. In particular, does the assessment of materiality vary widely between audits?
- Variations between industries should be researched and key factors should be identified.

Most large firms have industry specialization programs that could be effective in developing concepts of materiality for specific industries.

- Developing concepts of disclosure error that could serve to improve the visibility of disclosures that are either missing or deficient.

Constraints on the ability to achieve absolute assurance

Audit effectiveness must meet or exceed a threshold level of reasonable, not absolute, assurance² in order to meet professional and legal requirements. If this minimum level of assurance is not achieved, the auditor should modify or withhold any opinion. An absolute level of assurance is not achievable because of several natural constraints.

- Preparers of financial statements have primary responsibility for the fairness of those financial statements. In accomplishing that task, they make judgments regarding the identification, interpretation and application of relevant accounting principles to transactions and events. The proper exercise of preparer judgment is a critical element of this risk. In addition, preparers are subject to time pressures created by the need to provide timely information to the market.
- Audits involve the use of selective testing. The nature of the audit procedures to be applied to items selected for testing, the number of items to be tested and the timing of those tests all influence the risk that significant information will not be obtained and evaluated by the auditor.
- The evaluation and interpretation of audit evidence involve judgments that may vary or may prove incorrect.
- Auditors must generally complete their work within a limited time period. Although an auditor should not issue an opinion before all procedures considered necessary are completed and their results are properly evaluated, time limitations create additional

pressure on the level of assurance that can be achieved.

- When preparers have purposefully misstated financial statements for the purpose of hiding or perpetrating fraud, an auditor may not detect the fraud because of concealment through collusion, the withholding or falsification of documents used in audit procedures or overriding of controls by management.

Auditing standards conclude that an auditor must place reliance on evidence that is persuasive, rather than convincing. All of these constraints are present in all audits but their relative impacts will vary widely from audit to audit and must be individually evaluated by an auditor.

Inter-relationship of audit effectiveness, materiality and reasonable assurance

In a manner similar to a confidence statement in statistics, audit effectiveness can only be described in terms of a specific view of materiality. A given level of effectiveness is more easily achieved when judgments about materiality are less stringent than those situations in which those judgments are more stringent. In addition, the level of assurance that is reasonable may vary between audits because of the limitations discussed above.

The net result of these relationships is that audit effectiveness cannot be measured against an absolute value but must be assessed in the context of a specific view of materiality and level of reasonable assurance.

THE EFFECTS OF ACCOUNTING PRINCIPLES ON RISK

As discussed above, the nature of accounting standards has a major effect on the risk of misstatement of financial statements. An auditor's ability to audit an estimate is constrained by the inherent imprecision of the estimate and by the population of reasonably available evidence.

Increased discretion in accounting principles

Recent changes in accounting principles have been partially a result of a desire for greater relevance and for a reduction in the complexity and volume of rules involved in applying accounting principles. This shift to a more principles-based approach to accounting standards has led to standards that increasingly rely on the preparer to exercise judgment in applying those principles to specific cases and not to rely on the rules. Correspondingly, auditors will be called upon to exercise more judgment in evaluating the risk that financial statements are misstated.

Substance over form

The nature and increased complexity of business operations has created much of the increased complexity in accounting principles. In particular, financial engineering can substantially reduce the auditor's ability to evaluate the substance of transactions aside from their legal structure. The form (legal rights and obligations) of a financial transaction may actually be the substance of the transaction. Further, the substance of a transaction may be dependent on counterparty or systemic risk characteristics that are not observable to the preparer of the financial statements or the auditor.

Increased imprecision due to estimates of fair value

The estimate of current market prices (fair value) for certain assets that do not have a current market has created a substantial increase in the imprecision of amounts recognized in financial statements and has increased the importance of disclosure of the nature of these estimates. These estimates substantially consist of the projection of future events that are often highly volatile.

These projections also require the development of probabilities of the possible outcomes of these events to be used in determining the amount to be recorded. Many models used in

estimating fair values are based on an assumption that probabilities are normally distributed. The result of an assumption of normality is to severely underweigh potential events that would have very large economic consequences but are believed to be remote in terms of their likelihood of occurrence (in the 'tails' of the distribution). Recent history involving mortgage-backed securities and their derivatives, shows that 'remote' events can become less remote as market concentration and the related systemic risk increase. In cases where active markets do not exist, it is often difficult to observe the effects of this systemic risk. Accounting standards-setters clearly recognize that disclosures are important in describing the potential variability of estimates of fair value but have generally concentrated on disclosure of the more likely range. However, the disclosure of unlikely events with potentially significant effects remains a very difficult issue that should be addressed, particularly where the preparer of the financial statements may not be aware that counter-party risk has been increased systemically.

Effects on control risk

Changes in the nature of accounting principles have also placed greater stress on the importance of controls over the preparation of financial statements. The preparer's systems and processes are based on professional judgments regarding the proper application of accounting principles, including the type and amount of evidence required to make that determination. Accounting principles that involve more discretion will place additional stress on these systems and procedures. For example, the application of fair value principles to investment securities requires a determination of whether an active market exists for the security. That determination may not have been a part of a preparer's systems and controls in the past. Now, preparers may be required to modify systems to monitor the status of markets or may use outside experts to perform that function.

THE STRUCTURE OF AN AUDIT FIRM AND QUALITY CONTROL

An audit firm is expected to have a system of quality control that provides reasonable assurance of compliance with professional standards in performing audits and a reasonable level of audit quality.

The decision to accept or retain a client

Given the consequences of association with a client that subsequently is revealed to have perpetrated a fraud, inadvertently issued materially misleading financial statements or fails to accomplish its business model, perhaps an auditor's most important judgment is the decision to accept an engagement to perform an audit. This decision requires a high degree of judgment and has direct effects on commercial risk to the firm, to individual members of the firm and the business model of the firm. It can also influence the market's perceptions of an audit firm.

Processes that obtain, develop and use resources

Many of an audit firm's processes relate to supporting audit quality by obtaining the right resources, primarily personnel. These processes include activities related to

- recruiting, education, performance measurement, compensation and discipline; and
- developing audit methodologies, technologies and processes that provide a basis for compliance with professional standards, identification and appropriate reactions to changes in conditions that may affect audit quality and the effective performance of audits.

Processes that monitor engagement quality

Much of the information required to directly assess the effectiveness and efficiency of an audit is contained in the audit working papers for that audit and is in unstructured text format. All audits involve highly subjective professional judgments that are based on both quantitative and qualitative considerations. As a result, the

audit firms monitor engagement quality by means of internal inspection programs that include reviews of selected audit engagements and by required levels of review and consultation before the release of audit reports.

The accurate and consistent capture, compilation and analysis of engagement-level information by an audit firm would require substantial and expensive changes in procedures and systems. In addition, methods for capturing qualitative considerations in a form that would allow analysis would require significant research and development cost.

Processes that are applied at the engagement level

Most audit firms' organizational structures recognize that individual audits are the focus of controls over audit quality by emphasizing oversight and monitoring activities that are primarily located at or near the engagement level. Both auditing and quality control standards place heavy reliance on supervision and review of the work performed by all members of the engagement team, consultation with qualified experts and specialists and concurring partner review. Auditing standards now place heavy emphasis on the completeness and quality of documentation and create a presumption that undocumented work was not performed.

Impact of PCAOB inspections on audit firm processes

In addition to reviews of selected audit engagements, PCAOB inspections include reviews of aspects of an audit firm's operations that are performed above the engagement level (functional reviews). Many of these functions were the subject of peer reviews and of the firms' internal inspection programs before PCAOB inspections. However, there are two areas that were not covered by earlier inspection activities that have had substantial impact on audit firm behavior. Specifically:

- The PCAOB reviews the methods used by a firm to communicate and enforce the 'tone at the top' as it relates to audit quality.

- The PCAOB reviews the processes used by a firm to monitor partner performance and to allocate partner earnings. The objective of this review is to determine how audit quality is assessed and factored into partner compensation. This is significant because, for the first time, an audit firm's business model is included as a consideration in assessing an audit firm's quality of practice. In addition, the early results of these reviews brought to light the difficulties involved in measuring audit quality in connection with performance evaluations.

Effects of clientele and external factors on the firm's business model

The business model adopted by different audit firms is directly influenced by the characteristics of their current clientele and the clientele they wish to attract or retain. The mix of risk represented by each firm's client list varies in terms of both the risks of association with the client and the client's risk of producing financial statements that contain material errors. In addition, the ability of an audit firm to attract new clientele is partly a function of relevant experience gained from its current clientele.

One driver of the consolidation and growth of large audit firms has been the consolidation of public companies into fewer, larger and more global entities. This trend placed greater emphasis on having in place effective global networks, personnel capabilities, technology and specialty skills as a prerequisite for being hired and retained by these large entities.

These business models also change over time as a result of changes in the firm's external environment. For example, because of the pressures on resources created by Section 404 of SOX, some firms adopted forms of dismissal for clients that did not meet certain criteria related to readiness for compliance with SOX. As the amount of 404 work has decreased, there are indications that these firms are again competing for clients.

Although large firms have generally resisted differentiation of public company audit and non-public work, this might change if the standards continue to diverge. In the United States, the differences in litigation exposure and regulatory oversight may cause this to change.

Impact of the business model on audit quality

Although the focus of auditor judgment continues to be on the activities of the engagement team and the various other aspects of monitoring of quality, the business model of a firm must also be considered as a major influence on the exercise of auditor judgment.

- Although audit quality may be the primary goal of an audit firm's quality controls, the fact that these firms must earn a return and allocate it to partners in a manner that compensates partners with the appropriate expertise, intelligence and motivation to remain with the firm and encourages partners without those qualities to either improve or leave the firm means that developing performance criteria and income allocation methods that properly emphasize quality requires careful study.
- The audit component of an accounting firm has a litigation risk profile (potential magnitude and causality) and imposes independent requirements that are substantially different from other areas of practice.
- An audit firm's ability to attract and retain the appropriate level of talent (experienced and inexperienced) is heavily influenced by the level and intensity of competition for these personnel with other audit firms, other firms that hire from the same sources and, in some cases, other areas of practice within its own entity.
- Competitive pressure on prices or reduction in the total level of available work creates incentive to reduce the level of audit effort in order to compete on the basis of audit cost. The pressure to earn a profit results in

pressure to meet the initial budget. To the extent this pressure is not controlled, it can produce a bias against modifying scopes to respond to adverse findings.

APPRENTICESHIP, PROFESSIONAL SKEPTICISM AND THE COMPETENCY OF AUDITORS

In addition to a knowledge of accounting, the necessary competencies of an auditor consist of an understanding of business and an understanding of materiality; an auditor must have the attitudes and attributes of independence, integrity and professional skepticism.

The ability to develop proper audit judgments is developed and maintained by the audit firms through an apprenticeship model, which is heavily dependent on the teaching of earlier experience. This model is an effective and efficient approach to develop inexperienced personnel but is susceptible to problems when conditions change. For example, the rapid computerization of business in the 1960s, increased complexity in financial products and the recent trend towards the use of fair values have all presented challenges for auditors that have, in general, been addressed by the use of specialists.

Although inexperienced auditors are typically hired based on the determination that they have had sufficient education and demonstrated ability in academics, they generally lack any real experience in making the judgments required to complete an audit properly. Audit firms compensate for this deficiency by a combination of policies and processes that include mentoring, formal training, and supervised on-the-job experience. New staff members are not assigned to tasks that require a high level of experience and judgment. However, over time, progression in an audit firm is based on demonstrated competency in auditing. Although all auditors must be skilled accountants, audit competencies extend beyond accounting knowledge and include knowledge of business, knowledge of evidence

and risk assessment, and an understanding of materiality.

A natural tendency as auditors gain experience is for them to rely heavily on their earlier experience in making judgments. This is a proper and useful approach but suffers from the risk that the auditor will encounter situations that are not comparable to earlier experience or that the auditor will not observe a change in conditions that affects audit risk. Although competent professionals take responsibility for their own continuing education, the processes and procedures of an audit firm must include provisions for keeping personnel informed of new developments, particularly changes in conditions that may affect audit judgments.

SUMMARY AND RECOMMENDATIONS

The judgments made by auditors in performing individual audits of financial statements are significantly influenced by factors that are external to those audits. This external environment includes the effects of the actions of regulatory bodies and the processes and policies and business model of the auditor's firm. General economic and industry conditions and the accounting principles used in preparing financial statements are also important components of the external environment. This environment has changed substantially and will continue to do so in the future.

- The quality of auditor judgments and the resulting quality of audits has become a topic of increased scrutiny by parties outside the auditing profession. These parties (investors, analysts, regulators and public interest groups) will continue to exercise greater influence on the activities of auditors. Auditing standards related to audits of public companies in the United States will continue to be rule-based standards enforced through inspections and enforcement activities. This regulatory approach will place greater emphasis on the ability of regulators to develop standards that can be demonstrated to be effective

and capable of reasonable implementation in practice.

- Business conditions affect audit firms and audit engagements through their effects on clients and on the business models of the audit firms. These conditions have shown a high degree of uncertainty and will continue to do so in the future. This will require that auditors become better at anticipating changes in the external environment and their effects on audit risk.
- Accounting principles will continue to evolve generally toward less specificity and greater use of estimates requiring predictions of future events that are fraught with difficulty. This trend will continue to increase the importance of judgments made by preparers of financial statements. The resulting increase in the inherent uncertainty in recorded amounts will increase the need for both meaningful disclosure requirements in accounting standards and for a better framework for identifying situations in which additional disclosure may be appropriate.

The pressure to measure and report audit quality will not decrease and should be addressed. Auditors should be actively involved, along with others, in the development of reasonable approaches to satisfy the desire for indicators of quality. Regulators should develop a useful definition of audit quality to provide a basis for evaluating quality in a regulatory framework. Research into the means used by audit committees may be useful in furthering this objective. Techniques should be developed, that allow the capture of qualitative data related to audit engagements in a manner that would prevent quantitative measurements overpowering qualitative considerations. Finally, any measures of audit quality must be developed with an understanding that audit quality is ultimately only meaningful in the context of a specific audit.

An audit firm's structure, process and procedures, and business model are partly determined by its external environment and the firm must

monitor and react to changes in that environment. In addition, an audit firm can influence or control many aspects of its internal processes that may allow improvements in the quality of auditor judgments and audit quality. Many audit firms are engaged in activities that are intended to improve these processes.

- There is an opportunity to improve the effectiveness of monitoring audit quality and of improving audit methodologies by capturing engagement level data in a manner that would allow analysis of audit characteristics and results. This will require research and significant investment.
- Audit firms should consider development of systematic processes to obtain and assess external information related to companies, industries and external conditions for their effects on audit risk.

The good news is that the audit process and auditor judgment are an important topic outside the profession. Although perhaps less comfortable to practicing auditors, I believe this outside interest will prove to be a useful incentive to continue to improve the exercise of auditor judgment and, thereby, the quality of audits of financial statements.

NOTES

- 1 These are my views and do not necessarily represent those of Grant Thornton LLP, the Auditing Standards Board of the AICPA or of any other organization with which I have been associated.
- 2 See the PCAOB staff briefing paper on Reasonable Assurance prepared for the 5–6 October 2005 PCAOB SAG meeting.