
A FRAMEWORK FOR AUDIT QUALITY: CRITICAL ANALYSIS

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ABSTRACT

Audit quality plays an essential role in maintaining an efficient market environment. External audits performed in accordance with high quality auditing standards provide a fundamental contribution in the implementation of accounting standards by reporting entities. This paper analyzes the critical view of previous literature on audit quality and deeply examines the standard setters proposal on audit quality in order to verify if they created a coherent approach that could be used in the generation of a unique Audit quality framework. A specific focus is on the PCAOB and IAASB projects on audit quality that try to identify the purpose, characteristics, and indicators of the audit quality, setting off two different perspectives in the audit quality debate. At the end of the review and of the analysis, we deem that regulators and academic researches should consider also the pivotal role of the stakeholders to link the audit quality not only to input, process or output issues, but also to those audit quality drivers outside the direct control of audit firms.

Keywords: Audit quality, Audit quality indicators, Auditing standards

1. INTRODUCTION AND RESEARCH QUESTION

The turbulent events of the global financial crisis have highlighted the critical importance of credible, high-quality financial reporting, and have demonstrated the importance of audit quality within it. The external audit plays a major role in guaranteeing the quality of financial reporting around the world, whether in the context of the capital markets, the public sector or the private or non-public sector. In addition, it constitutes an important part of the regulatory and supervisory infrastructure, and is consequently an activity of significant public interest, being a significant part of the financial environment because it aims to provide stakeholders with a true and fair view of the veracity of a company's annual reports.

Audit quality plays an essential role in maintaining an efficient market environment: external audits performed in accordance with high quality auditing standards can promote appropriate implementation of accounting standards by reporting entities and help ensure that their financial statements are reliable, transparent and useful to the market place, thus enhancing market confidence.

After two decades of research on audit quality, it can't be found a single definition of audit quality (De Angelo, 1981; Carcello et al., 1992; Chang et al. 2009), or a framework of its indicators (input based factors and output based factors).

Audit quality is a much discussed topic following the financial crisis and significant efforts have been made in recent years to make audit firms and their service more transparent and to provide tools with which to appraise auditors (IFAC 2009; IOSCO 2009; EC 2001; PCAOB 2011, 2013; IAASB 2014).

The International Auditing and Assurance Standards Board (2014) released its "Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality", describing "audit quality indicators," or those factors that lead to good audits.

Likewise, the Public Company Accounting Oversight Board (2013) released its Audit Quality Indicators Project in which they propose a set of qualitative indicators that must be discussed with the board's advisory groups, firms, other regulators, audit committees and academics in order to identify a good audit quality framework.

Moreover, Francis (2011) and Knechel et al. (2013) present in their studies a framework for audit quality came from the literature review on the audit quality. They reveal that the academic studies that focused on many input/output based factors have failed to find conclusive evidence of a direct positive relationship with better audit quality, probably because audit firms do not provide disclosure on these factors.

In this paper the standard setters proposal on audit quality are analysed in order to verify if they created a coherent approach that could be used in the generation of a unique Audit quality framework.

With a view to a qualitative analysis from an interpretative and critical perspective, this paper in paragraph 2 presents the main studies on audit quality in order to set out the critical issues on the subject, in paragraphs 3 examines the main characteristics of the most recent proposal frameworks, in paragraph 4 they fit in with the necessity to find a unique approach on which to increase the debate on the Audit quality framework that should be linked with a quality of the financial statement.

2. LITERATURE REVIEW ON AUDIT QUALITY

A topic of recurrent interest in research on accounting is audit quality, and numerous studies have tried to arrive at a working definition of the term.

This section of the paper examines those elements in the literature that provide a definition of audit quality and describe audit quality proxies (Arezo, 2011). For DeAngelo (1981), audit quality is “the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach”. In this definition, audit quality increasingly depends on the skill an auditor has in detecting misstatements in the accounting, and auditor independence as viewed by the market. DeAngelo (1981) speaks of “market-assessed” or perceived audit quality. She also demonstrates how auditor size may have a positive effect on audit quality. She further states that auditor size is determined by the number of clients and that as auditors earn client-specific quasi-rents, those with a greater number of clients run a higher risk if they fail to report any misstatements they discover in financial statements. In the wake of DeAngelo’s study, other research has examined the auditor size and audit quality correlation (Krishnan and Schauer, 2000; Al-Ajmi, 2009; Lawrence et al., 2011).

Palmrose (1988) considers audit quality in terms of levels of assurance. Starting from the premise that the audit is carried out to provide assurance regarding financial statements, audit quality is an indicator of the likelihood that financial statements are free of material misstatements. Effectively, this definition takes the results of the audit, and uses the reliability of the audited financial statements as a reflection of audit quality.

Others use the compliance of financial reporting with GAAP, quality control review, bankruptcy, desk review and SEC performance to assess audit quality. Krishnan and Schauer (2000), for example, examined the relationship between firm size and compliance with GAAP reporting requirements by nonprofit entities. They discovered that the greater the firm size, the greater the compliance.

Audit size, auditor tenure, industrial expertise, audit fees, economic dependence, reputation and costs of capital have all been used as a measure of audit quality. Ghosh and Mood (2005) claimed that auditor tenure might have a negative effect on audit quality, as long-serving auditors may compromise their independence to maintain the relationship with their clients, while Wooten (2003) finds that firms with several clients in the same industry have a greater insight into the specific audit risks particular industry may be subject to.

Another group of studies examines Output (e.g. audit opinion), Audit Process (e.g. audit environment) and Input (e.g. auditor perception and mandatory audit tendering).

Audit output has an influence on audit quality because stakeholders often consider it in their assessment of audit quality. The auditor’s report, for example, will probably be seen as having a positive influence on audit quality if it communicates the outcome of the audit with clarity. With an increase in tenure, the auditor’s judgment improves to give an appropriate audit opinion. Consequently, obligatory rotation will lead to a deterioration in audit quality through limiting tenure, and not the contrary (Carey and Simnett, 2006).

Maijor and Vanstraelen (2006) analyzed the consequences of the audit environment, the quality of the audit firms, and presence in international capital markets on earnings management. They identified two factors able to mitigate the national audit environment effect, i.e., Big Four audit firm quality and a company’s dependence on international capital markets. They observed that a stricter audit environment reduced the degree of earnings management, whatever the type of auditor (Big Four audit firm or non-Big Four audit firm), and there is nothing to show any influence due to the international Big Four in Europe.

There are a number of contributing factors to audit quality other than auditing standards. One major element is the personal characteristics of the auditor, such as skill and experience, ethics and mentality (Duff, 2004).

Another study investigates audit quality from two points of view: that of the Audit Firm and that of the Audit Team. For the first group, researchers consulted panels of experts to identify characteristics at firm level. Sun and Liu (2011) focused on whether the risk of client-specific litigation has an influence on the differences between Big N and non-Big N auditors from the point of view of audit quality. They found that the greater level of effectiveness displayed by Big N auditors over non-Big N auditors in imposing limits on earning management is more significant for high litigation risk clients than for low litigation risk clients, leading them to the conclusion that high litigation risk can make big auditors perform better. The second group of characteristics identified by the panel of experts relates specifically to the members of the audit team. Carcello et al. (1992) note that the characteristics of the audit team were generally seen as being more influential with regard to audit quality than the characteristics related to the audit firm itself.

Francis (2011) and Knechel et al. (2013) synthesized academic research related on the audit quality in order to develop a Framework of audit quality factors.

Francis argued that audit quality is affected by six factors: audit inputs, audit process, accounting firms, audit industry and audit markets, institution and economic consequences of audit outcomes.

Audit input	Audit processes	Accounting firms	Audit industry and audit market	Institutions	Economic consequences of audit outcomes
Audit test (Best practice)	Implementation of audit test by engagement team in order to meet the broad requirement of audit standards	Engagement team working in accounting firms	Accounting firms constitute an industry	Institutions affect auditing and incentive for quality (PCAOB)	Audit outcomes affect clients and users of audited accounting information (cost of capital, stockmarket value earnings surprise, analysts forecast)
Engagement team personnel (such as professional skepticism)		Accounting firms hire, train and compensate auditors	Industry structure affects market and economic behavior	Legal system	
		Audit reports are issued in name of accounting firms			

Knechel et al. (2013) identify a balanced scorecard for audit quality with four categories: input, process, outcomes, and context.

Input	Process	Outcomes	Context
Incentives and motivation (such as regulatory enforcement, potential litigation cost, potential reputation losses and so on)	Judgment in the audit process (auditor experience and expertise, knowledge, accountability, time of audit, and so on)	Adverse outcomes (accounting restatements, litigation against auditor, and so on)	Audit partner compensation (partner incentives)
Professional Skepticism (such as value, moral reasoning, professional identification,	Audit production (earnings manipulation, corporate governance, disclosure policies, audit	Financial reporting quality (earnings neutrality, earnings credibility and earnings	Abnormal audit firms

conservatism, audit tenure)	firm's political risk, and so on)	conservatism)	
Knowledge and expertise	Assessing risk	Audit reports	Non audit fees
Within firm pressure	Analytical procedures	Regulatory review of audit firms	Audit fee Premium –BIG n auditor and industry specialists
	Obtaining and evaluating audit evidence		Auditor tenure
	Auditor client negotiation		Market perceptions of audit quality
	Review of quality control		

3. STANDARD SETTERS PROPOSAL ON AUDIT QUALITY

The Public Company Accounting Oversight Board (2013) released its Audit Quality Indicators Project in which they propose a set of qualitative/quantitative indicators that must be discuss with the board's advisory groups, firms, other regulators, audit committees and academics in order to identify a good audit quality framework.

The Discussion paper identifies the following indicators to evaluate the quality of audit service:

- Operational inputs. These indicators regarding the people that work in audit firm: ratio of partners to staff, partner and staff utilization percentages / workloads, chargeable hours per professional, percentage of work outsourced to service center, industry expertise and proficiency, training hours per audit professional, and so on.
- Process: Number and substance of firm leadership communications on audit quality and investors' interests Metrics related to independence, testing, and compliance Number and nature of internal quality review findings; Compensation trends of prematurely rotated partners Leverage ratio of audit staff to partners Credentials of new hires and recruiting: academic achievement; best companies to work for rankings; compensation levels.
- Results: Frequency and market impact of financial statement restatements for errors Number of material weaknesses cited in conjunction with material errors Number of audit reports lacking a going concern opinion which had a subsequent bankruptcy Number and nature of PCAOB inspection findings, and so on.

Similarly, the International Auditing and Assurance Standards Board (PCAOB) (2014) released its "Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality," identified this factors describing "audit quality indicators," or those factors that lead to good audits.

The proposed framework identifies key elements contributing to audit quality:

- Inputs – the audit firm's culture (values, ethics and attitudes), the time, knowledge and skill brought to the audit and the effectiveness of the audit's processes and quality control procedures For these factors the IAASB distinguish:
 - Engagement Level (for example the engagement team is independent, The engagement team exhibits professional competence and due care, The engagement team exhibits professional skepticism, Partners and staff have the necessary competences, Partners and staff understand the entity's business., Partners and staff make reasonable judgments)
 - Firms level (Governance arrangements are in place that establish the appropriate "tone at the top", and which aim to safeguard the firm's independence, Necessary personal characteristics are promoted through appraisal and reward systems supporting audit quality Engagement teams are properly structured, Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or "on-the-job" training.)
 - National level (Regulators, national standards setters and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied. Robust arrangements exist for licensing audit firms/individual auditors, Education requirements are clearly defined and training is adequately resourced and effective)
- Process - quality audits involve auditors applying a rigorous audit process and quality control procedures that comply with laws, regulations and applicable standards. For these factors the IAASB distinguish:

- Engagement Level (The engagement team complies with auditing standards, relevant laws and regulations, and the audit firm's quality control procedures; The engagement team makes appropriate use of information technology.)
- Firm level (The methodology requires effective supervision and review of audit work; The audit methodology is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.)
- National level (Auditing and other standards are promulgated that make clear the underlying objectives as well as the specific requirements that apply, Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.)
- Outputs – recognizing that some stakeholders (such as regulators) have the ability to influence outputs while for others (such as investors) outputs (in the form of the auditor's report) are relatively standardized. For these factors the IAASB distinguish:
 - Engagement Level (**From the Auditor:** Auditor's Reports to Users of Audited Financial Statements, Auditor's Reports to Those Charged with Governance Auditor's Reports to Management, Auditor's Reports to Financial and Prudential Regulators ; **From the Entity:** The Audited Financial Statements , Reports from Those Charged with Governance, including Audit Committees).
 - Firm and national level (**From the Audit Firm:** Transparency Reports, Annual and Other Reports; **From Audit Regulators:** Providing an Aggregate View on the Results of Audit Firm Inspections).
- Interactions – the nature and quality of the various interactions between involved stakeholders e.g. auditors, management, those charged with governance and regulators during the audit process
- Context – the legislative and regulatory environment within which the audit operates. The impact of the financial reporting framework and corporate governance on financial reporting quality also give context to the audit.

The value and relevance of corporate reporting transparency has stimulated an important discussion on the increased complexity of audit quality, as demonstrated by the two Discussion papers summarised above.

However, a careful reading of the PCAOB and IAASB papers shows that the issue is difficult to solve.

The two papers examine the audit quality from two different perspectives.

The PCAOB chooses to concentrate the paper only on the audit quality indicators focused on operational inputs, process and results while the IAASB considers audit quality with a holistic approach that considers important also the context and interaction factors.

The PCAOB indicators could be very useful to evaluate the quality of the audit work when they are applied to factors on the direct control of the audit firms (such as the professional training) but most of them could be difficult to apply because they measure external drivers, outside the direct control of the auditor, such as the general legal and standards setting environment. At the same time, the IAASB approach that give more importance to context and interaction factors could provide over-generalised guidance, which does not allow for the definition of rules that can help to assure the audit quality.

4. CONCLUSIONS AND FURTHER RESEARCHES

The studies carried out on audit quality in the last two decades have created great interest in the role of audit on the corporate transparency and on the market efficiency.

However, despite the undoubted effects of audit on the transparency and the reliability of corporate reporting the audit quality lacks of an adequate regulation that have contributed to increasing the complexity and subjectivity of the matter.

The debate begun on the audit quality framework is a starting point for finding a solution to this constrain.

The PCAOB and IAASB projects, analysing above, try to identify the purpose, characteristics, and indicators of the audit quality, setting off two different perspectives that responding to the issues arising in the previous main studies.

In fact, if we look to the literature review the Francis (2011) audit quality framework presents similar aspect with the IAASB framework while Knechel et al. (2013) applies a similar approach of PCAOB.

Considering the results of the comparative and critical analysis, it is important to do some reflections about the audit quality. The different audit quality framework, both issued by standard setters or by academic studies), focusing on two particular aspect:

- the degree of compliance of a process or its outcome with a predetermined set of criteria
- the level of perceived value reported by the person who benefits from a process or its outcome.

These two particular aspect reflect the viewpoint regarding quality that differ regarding the diverse interest of multiple stakeholders.

To better understand what audit quality is and how audit quality could be regulate to assure the reliability of the corporate reporting, the regulators and the academic researches should consider the pivotal role of the stakeholders in this process in order to link the audit quality not only to input or process or output issues, but also to those audit quality drivers outside the direct control of audit firms that can be managed and influenced to have a positive effect on audit quality.

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