

Directors play key role in audit evolution

Merran Kelsall discusses the role directors can play in lifting the overall quality of financial statements.



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MUCH HAS BEEN WRITTEN ABOUT THE NEED FOR auditors to demonstrate more professional scepticism in challenging management about items such as accounting estimates, impairment models and goodwill valuations.

What about directors? Should they too not be sceptical? Signing off year-end accounts is absolutely the responsibility of directors. Advice can be taken from external experts and management, and comfort can be taken from the work of auditors, but in the final analysis, directors must take responsibility for the presentation and content of the statements.

Why are financial statements important? They are an historical record of company results for a period and the status of equity, assets and liabilities at year end. Investors may realistically make decisions on more timely and forward-looking information provided by management and which may not be subject to audit or assurance. However, the financial system and capital markets depend on trust in the system and in the integrity of players in the market. The role of audit as a fundamental plank in maintaining that trust and confidence should not be underestimated.

Recognising the importance of confidence in financial reporting, the International Auditing and Assurance Standards Board (IAASB) arguably took the bold step of going beyond its mandate to consider the full implications of a formal framework for audit quality. Earlier this year, after issuing two consultation papers and receiving international feedback, the IAASB released *A Framework for Audit Quality: Key Elements that Create an Environment for Audit*.

The key factors that stakeholder groups are likely to take into account in forming a view on the quality of an audit were used to develop the framework, which recognises that perspectives of audit quality vary among stakeholders. For example

- Client management might focus on such things as the efficiency of the audit process and the quality, timeliness and usefulness of communications.
- Audit committees might focus on the robustness of the audit, the independence of the auditor and whether communications between the auditor and the audit committee are effective.
- Regulators might focus on evidence of compliance with the auditing standards and the rigour demonstrated by the auditor in dealing with complex accounting issues.
- Investors might focus on firm reputation, perceptions of independence and the quality of the audit committee.

The framework sets out the key elements that contribute to quality audits: inputs, processes, outputs, interactions and contextual factors at the engagement, firm and national levels.

The framework recognises that the aim of an individual audit is for the auditor to form an opinion based on sufficient evidence as to whether the financial statements are free from material misstatement and then to report appropriately on the findings. While the primary responsibility for performing quality audits rests with auditors, the framework recognises that audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain.

The framework states: "The term audit quality encompasses the key elements that create an environment which maximises the likelihood that quality audits will be performed on a consistent basis." This statement recognises that various factors are important in thinking in a holistic or systemic manner about the environment in which audits are performed. In so doing, the framework considers the importance of the context in which the players are operating and the interaction among the

players themselves, which include directors, management, investors, regulators and standard setters, as well as auditors and their firms.

Directors, as key players in the financial reporting supply chain, have a vital role in maintaining confidence in the integrity and functioning of capital markets. Directors have a challenge to analyse critically their own performance and spheres of influence so that they can contribute to improvements in overall audit quality. They should consider whether:

- They have challenged both management and the auditors sufficiently to be confident that all material financial reporting risks have been considered.
- The financial statements properly account for and disclose significant transactions and events.
- They have been sufficiently sceptical and challenged auditors and management in relation to contentious items, such as impairment models.
- The audit fees are commensurate with the scale and complexity of the entity to enable a quality audit to be undertaken.
- External audit interacted appropriately with internal audit.

NEXT STEPS

The context in which an audit is undertaken is continually evolving to keep pace with changes in the business environment, perceptions of the scope of auditing, financial reporting standards, regulation and technology. An audit evolves over time. The pursuit of audit quality is therefore not a program with a definitive outcome. Rather, it is a process that ensures that, through continual improvements in its elements, its quality evolves with the environment in which it is performed. Directors have an important role to play in that evolution, thereby helping with underpinning confidence in capital markets. ☺