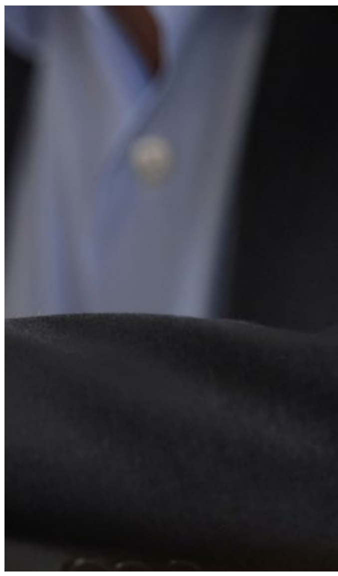
# Auditing in focus

**The expectation gap in audit, quality standards, independence, and the call for more assurance are all topics that characterize the work of auditors.**



The world's major accounting firms are often in the headlines. The public wonders where the auditors were when a company has to correct a mistake or suddenly collapses. Regulators scrutinize the cases, demanding far-reaching reforms, and reports of fines and sanctions are on the rise. What is going on with auditing?

Auditing has always been a complex and risky business. In Switzerland, auditing is a (secondary) corporate body, resulting in joint and several liability with the board of directors. However, the auditors are not on-site all year round. Due to the short deadlines for preparing financial statements, they work under high pressure, have to quickly comprehend complex issues, understand new business models, and make discretionary decisions. Accounting, they say, is an art and not a science, but international accounting standards have reached a volume and complexity that suggest the opposite and sometimes overburden financial departments and auditors alike. At the same time, however, companies also face ever greater challenges: the global wave of regulation goes far beyond accounting, increasing the demands placed on compliance departments in many respects, along with sometimes very unpleasant financial consequences in the event of non-compliance. Current examples can be found in data protection, the fight against corruption and money laundering, international tax law and the observance of human rights.
In addition, rapid technological change and other external developments, such as most recently the coronavirus, create disruption, calling into question the economic future of many companies. And last but not least, a worldwide increase in criminal activities is making the work of auditors more difficult – the risk of fraud and other legal offenses has increased continuously in recent years.



Public expectations that auditors will prevent any „accidents and crimes" with corresponding financial consequences are high and often go beyond their legally defined mandate. What does this expectation gap mean for auditing? Is it a losing battle? No, quite the opposite: These developments underline the high relevance of auditing, today more than ever. The audit profession can and will continue to make a very important contribution to the stability of capital markets. To do this, however, the auditors must take the concerns and demands of the public and regulators seriously and draw the right conclusions from them. After all, public confidence is a critical success factor for the industry.

### Dealing with the audit expectation gap

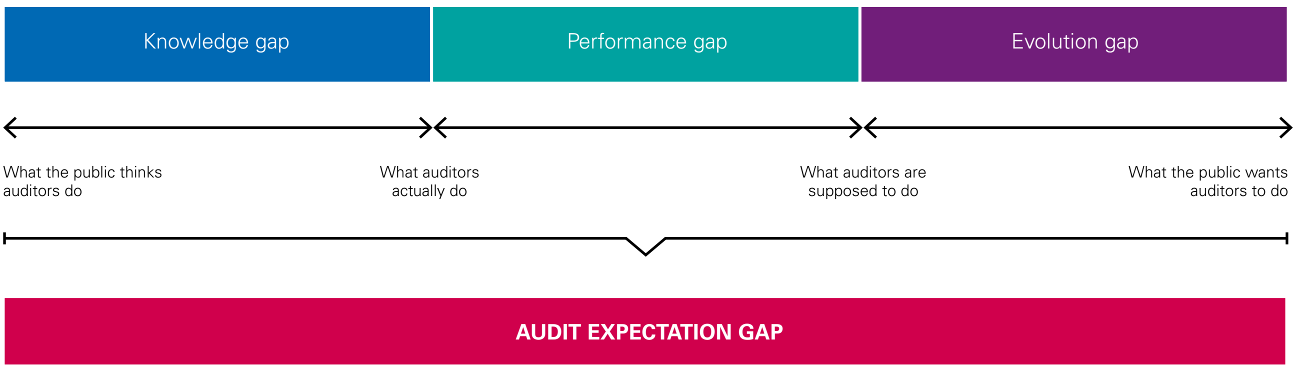
The Association of Chartered Certified Accountants (ACCA) defines the audit expectation gap in three ways: The first describes the gap between what the public, undoubtedly strongly influenced by the media, understands about the work of auditors and what auditors are actually responsible for (**knowledge gap**). The second deals with the gap that can arise between the formal requirements of the applicable auditing and professional ethics standards, and the actual work carried out by the auditors when an audit is not conducted properly (**performance gap**). Finally, the third describes the difference between the statutory tasks of auditors and the duties that the public would like auditors to carry out (**evolution gap**).

### Ensuring a high audit quality as the ultimate goal

The primary goal of the large auditing companies must be to close the **performance gap** as much as possible. This does not mean that a perfect audit will necessarily reveal all significant errors or shortcomings in financial reporting. But it does mean that the public can be confident that the auditing standards referred to in the audit report have been followed and that the audit has been conducted with the necessary independence and a reasonable degree of professional skepticism, i.e. that the audit opinion can be trusted. This undertaking is very demanding due to the high volume of regulations and the high complexity of our economic reality. It requires great effort in terms of:

- recruitment, training and development, and talent management;
- the tools and procedures that auditing firms make available to their auditors, for example in the areas of client and engagement acceptance, the audit process, access to specific expertise, consultation processes, and technological support in all these areas;
- the establishment of an internal quality management system[1] (ISQM-1) that monitors and ensures compliance with the rules and consistent audit quality; and
- not least, the creation or promotion of a culture that focuses on audit quality, and puts ethics and integrity before profit maximization.






Source: ACCA «Closing the expectation gap in audit», May 2019

[1] The industry is currently preparing for a new standard to introduce a comprehensive quality management system, the International Standard on Quality Management # 1 (ISQM-1), which is expected to be published by the International Auditing and Assurance Standards Board (IAASB) later this year. This requires the auditing companies to document the relevant quality management processes, to identify the associated risks, and to counter these risks by means of effective controls at the company level.

It should be noted that audit itself is affected by rapid technological change, which must be harnessed to close the performance gap (e.g. data analytics, use of bots, etc.).

However, the board of directors of the audited company also makes an important contribution to closing the performance gap by setting the tone at the top, defining the principles of financial management and the basic rules for cooperation with the auditors. Here, the more professional the organization of the company to be audited, the more open the auditor's access to management and the board of directors, and the greater the willingness to do something right and implement the auditor's recommendations, the higher the quality and benefit of the audit. The work of the auditors becomes particularly difficult whenever they encounter resistance, information is withheld, access to meetings of the board of directors or audit committee is restricted or there is a lack of willingness to provide transparent, fair financial reporting.

### Clarification and fair reporting on the work of auditors

With respect to the **knowledge gap**, this aspect must be dealt with by the industry as a whole. All efforts to educate the public about the role of auditing are to be welcomed. Outside of crises, which unfortunately cannot always be avoided, auditors must remain in contact with the media, report on the challenges facing the profession, and explain what efforts they are making in terms of continuous improvements, because in the event of a crisis, audit secrecy greatly limits their ability to comment on specific incidents. In such cases, the media are called on to report in a balanced manner on the duties of and possible omissions by the auditor; auditor bashing lacking in nuance in favor of short-term headlines is counterproductive, causes long-term damage to the profession, destroys trust, and makes it difficult to deal with the facts of the case in a meaningful way with the aim of learning from them. However, closer cooperation with policymakers is also appropriate, in particular with lawmakers. They sometimes impose obligations on auditors without determining the necessary conditions, properly defining the subject matter, or taking into account the role and responsibilities of other affected parties (companies and regulators).

### Answers to the call for more assurance

Finally, the **evolution gap** can be seen as an opportunity to further increase the relevance and contribution of auditing to public confidence in companies through clearly defined, additional assurance. This includes, for example:

- the assessment of alternative performance measures, i.e. key figures that the company publishes in addition to the audited financial statements to explain its performance;
- the review of sustainability reporting, which is becoming increasingly important in view of the current climate debate and legislative developments (such as the Responsible Business Initiative);
- the certification of certain processes (e.g. relating to data protection or anti-corruption systems) that are of importance to third parties that have business relationships with the company; or
- the assessment of forward-looking information, i.e. statements about the expected future financial development of the company, which investors intend to rely on in the context of a pending transaction.

Such additional tasks do not always have to be regulated by law. It may also simply be in the interest of the individual company to give its stakeholders additional security and thus strengthen its own attractiveness, for example, among investors, suppliers, and staff.





**The importance of independence**

The success of the audit is reflected in the public confidence in the auditing work. Auditors earn this trust by delivering high quality audits that ensure the timely detection of serious errors or going-concern risks to the greatest extent possible. A high audit quality in turn requires a healthy distance to the company and audit work that is free of potential conflicts of interest. Therefore, independence plays a critical role and accordingly receives great emphasis in the internal control system of an auditing company. Independence must be secured, both in fact and in appearance. A lack of independence, whether in fact or just in appearance, results in a loss of credibility and the trust of all stakeholders, regardless of how well the audit was conducted.

There are extensive independence rules at both the national and the international level, and compliance with these rules is ensured by a large number of processes and controls. These rules govern not only the compatibility of individual services with the auditing work, but also, for example, the fees for additional services in relation to the audit fee, or the avoidance of inappropriate financial and other business relationships between the audit firm, the audit team and the senior management of the audit firm on the one hand, and the audited company on the other. There are also requirements regarding the rotation of key audit partners or – as in the EU – the auditing firm responsible for the statutory audit after a certain number of years. In Switzerland, the lead auditor and – in the case of public interest entities – any other key audit partners are rotated after seven years. In Switzerland, rightfully no legal requirement governing the rotation of auditing firms exists, with the view being that it is and should be the primary task of the board of directors to evaluate the work of the auditor and to put the mandate out for tender at certain intervals.

**Is a complete separation of auditing and advisory services the solution?**

In certain countries and media, there are repeated discussions – usually in connection with corporate crises – about whether it makes sense to force the large audit firms to spin off their consulting business. The author of this article considers this to be a very risky approach that could cause lasting damage to the attractiveness of the profession and thus also do a disservice to audit quality. At first glance, this solution appears to improve the situation in that auditing firms would be relieved of a number of costly compliance processes for maintaining independence and could concentrate fully on audit work. However, this overlooks the fact that auditing firms rely on the support of a wide range of specialists (IT, tax, forensic and valuation experts, lawyers, actuaries, etc.) to carry out their work. Recruiting them exclusively for audit purposes and enabling them to pursue a long-term career would likely become much more difficult, while hiring such specialized service providers as subcontractors would significantly increase the coordination work involved in an audit and hence its cost. For example, the audit firm would have to make sure that each specialist has the necessary training, skills, and integrity, and is aware of and complies with the far-reaching personal independence rules.

The continuation of a multidisciplinary business model, one that allows the use of in-house specialists on audit engagements and the offering of a full range of services to advisory clients, is much more promising. Such a model enables the audit teams to benefit from the broad experience and high level of motivation of the required specialists. There are also a number of supplementary services that provide added value to audit clients, while giving the audit firm the opportunity to deepen its knowledge of the company to be audited and its business model. It is important for the board of directors and the auditors to develop a common understanding and principles that set the framework for such additional tasks and ensure that there is a healthy relationship between these tasks and the audit.

## Conclusion

The high public expectations must be taken into account on several levels. The top priority is to ensure a flawless quality of the audit. Global efforts to manage quality to a much greater extent from the center of the audit firm rather than just at engagement level (as is envisaged by ISQM-1) will further increase the reliability of audits and audit opinions. At the engagement level, an intensive and professional interaction between the audit firm and the board of directors is essential for a successful audit.

Moreover, the understanding of the scope and limits of an audit must be deepened in dialogue with the media and policymakers. The discussion on the independence of audit firms must be conducted in a balanced manner – dismantling auditing firms or their multidisciplinary business model, as is currently being called for by some, would be counterproductive.

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