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GLOBAL CHALLENGES INITIATIVE: PROVIDING DIRECTION

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Since its formation in 2004, the *Audit Quality Forum* has encouraged open and constructive debate about issues which are in the broadest sense related to audit quality. It develops viewpoints on international auditing and reporting issues, contributes to the work of governments, standard-setters and regulators and generates practical ideas for further enhancing confidence in audited financial information. Its membership is drawn from investors, business, auditors and regulatory bodies.

The programmes on *Shareholder Involvement, Fundamentals* and *Evolution* provide a platform for the current and future work of the Forum on *Global Challenges* related to providing direction and promoting dialogue on three themes: audit market needs, audit performance, and audited financial information.

This paper is aimed at providing direction on the theme of audit performance. People interested in giving feedback should send their comments to louise.sharp@icaew.com.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at auditqualityforum.com or telephone +44 (0)20 7920 8493.

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GLOBAL CHALLENGES INITIATIVE: PROVIDING DIRECTION

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EXECUTIVE SUMMARY

In recent years audit practitioners, standard-setters and regulators have taken significant steps to enhance confidence in the quality of financial statement audits, particularly in the light of problems encountered in major capital markets. As a result of the global financial crisis, questions continue to be asked about the future evolution of audit and further changes can be expected. Recent initiatives have been international in scope and have sought to promote consistency across countries in terms of what auditors should do and what financial statement users should expect from audit. Relevant developments include:

- strengthening and more widespread adoption of International Standards on Quality Control (ISQCs) and International Standards on Auditing (ISAs);
- updating and implementation of the EU Statutory Audit Directive;
- establishment of national independent audit oversight bodies; and
- agreements under which national regulators agree to rely on each others' work.

These developments, coupled with initiatives such as the International Federation of Accountants (IFAC) Member Body Compliance Program and the country action plans and recommendations arising out of the World Bank Reports on the Observance of Standards and Codes (ROSC) are important in enhancing audit quality. However, there are deeply embedded features of national environments that pose challenges for international consistency in audit quality. This paper explores the particular challenges posed by differences in the national environments in which financial statements are prepared and audited. Recognising and addressing these challenges is critical to the success of international efforts to promote consistency in audit quality.

Analysis of legal, political and economic differences is difficult and referring to cultural differences can prompt negative reactions because it suggests that consistent quality can only be achieved by eliminating those differences. This paper recognises that achieving audit quality in any national environment is challenging and that no country's culture guarantees either success or failure.

This paper's analysis of national differences is not intended to be definitive but it should instigate discussion and debate about whether and how differences are being addressed. It should be of practical interest to:

- policy-makers concerned with the future evolution of audit and its contribution to confidence in financial reporting and wider economic development issues;
- audit firms, whether members of international networks or not, concerned with managing their reputations for quality;
- international businesses, including their audit committees who attach importance to international consistency when selecting auditors;
- those involved in international investment and credit decisions;
- international standard-setters and national authorities charged with implementing international standards; and
- national audit regulators with responsibilities for obtaining assurance about audit quality in other countries.

Based on input from members of the *Audit Quality Forum*, discussions with individuals in audit firms, regulators, investors, businesses and other organisations, and on a review of relevant academic and other research, the paper identifies five features of national environments that affect audited financial statements:

- political, economic and business environment;
- legal framework;
- education;
- culture; and
- perceptions of audit.

Any analysis of the effect of such national differences on audit quality needs to consider what audit quality actually means. When people refer to audit quality they focus on the credibility of audited financial statements and ask whether the audit report accurately reflects whether financial statements are free from material misstatements. Although this is unobservable, one way of making the concept of audit quality real is to focus on the quality of inputs to the audit process and what auditors need to do to support an appropriate professional opinion on an individual set of financial statements.

Consistency is an important element of quality and standards set out expectations covering not just audit process and reporting but also other factors that are widely seen as drivers of audit quality such as audit firm culture and the skills and personal qualities of auditors.

This paper sees standards as providing a benchmark against which to identify the potential impact of national differences on audit quality. In order to identify challenges to achieving international consistency, the paper specifically focuses on how national differences can affect the application of standards, including the interaction of auditors with audited entities operating in different national environments. The standards considered are the ISQCs and ISAs issued by the International Auditing and Assurance Standards Board (IAASB). They already have wide international application and as ever more countries around the world are looking to apply IAASB standards, they are an appropriate point of reference.

In analysing the features of national environments that affect audited financial statements, the paper identifies the following specific sources of risk in applying ISQCs and ISAs:

- alignment with assumptions implicit in standards;
- quality of economic governance;
- nature of business relationships;
- strength of legal system;
- quality of record keeping;
- extent of management authority;
- expectations of secrecy; and
- professionalisation of auditing.

These features impact on how the IAASB standards are applied and expose some limitations in the standards themselves, particularly in relation to the interaction between auditors and audited entities and the ability of auditors to identify and address risks of material misstatement.

Auditors can legitimately be asked how they address the risks that arise from these sources and achieve international consistency in audit quality. The identified risks are expressed in technical terms as risks in applying ISAs and ISQC 1. However, this should not obscure their considerable consequences for those who are committed to promoting international consistency in audit quality. This paper suggests practical solutions to help deal with these challenges. We identify four areas for action that auditors, business, investors, standard-setters, regulators and governments and other organisations might take:

- Share experience to help to develop a consistent vision of audit quality, by building on existing practices and making use of new possibilities afforded by IT. This includes providing greater opportunities for international secondments, exchange and education programmes and discussion forums. These can take place within audit firms and audit firm networks and between national professional accountancy organisations, regulators, standard-setters, governments and national and international organisations. There is also scope at a national level to establish networks, for example, through professional accountancy organisations, to provide opportunities for people with different degrees of international experience to share problems and ideas.
- Acknowledge national differences within international standards. This means that standards would both: place more emphasis on how national differences (eg, as reflected in country indices) affect audit risk; and support auditors in exercising professional judgement to address misstatement risks in ways that suit the national environment in which those risks arise.

- Promote the role of audit in economic development. When auditors in a particular country face difficulties which cannot be solved by better sharing of experience or acknowledgement of national differences, it would indicate that there are wider issues relating to the political and business environment or the legal framework that need to be addressed. Indeed, the state of auditing in a country could potentially provide more objective insight into economic development issues than conventional country indices. Internationally applied auditing standards which buttress audit quality can play an important role in promoting economic development and institutional change by holding up a mirror to the quality of a country's financial reporting.
- Support research into national differences in audit. This recognises that academic and other research could make a vital contribution to learning in our three earlier areas for action by identifying effective ways of sharing international experience, critically analysing how international standards should acknowledge national differences, and exploring linkages between audit practice and wider issues of economic development.

1. INTRODUCTION

1.1 Background

Since the *Audit Quality Forum* was established, one of its key aims has been to promote confidence in financial reporting. The statutory audit reinforces confidence because auditors are expected to provide an objective opinion on the preparation and presentation of financial statements. While auditors need to be independent in the opinions they express, the work they do to form their opinions is highly dependent on, and rooted in, the real world. Different national environments are therefore likely to raise challenges for international consistency in audit quality.

In recent years audit practitioners, standard-setters and regulators have taken significant steps to enhance confidence in the quality of financial statement audits, particularly in the light of problems encountered in major capital markets. As a result of the global financial crisis, questions continue to be asked about the future evolution of audit and further changes can be expected. Recent initiatives have been international in scope and have sought to promote consistency across countries in terms of what auditors should do and what financial statement users should expect from audit. These initiatives include:

- strengthening and more widespread adoption of International Standards on Quality Control (ISQCs) and International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB);
- updating and implementation of the EU Statutory Audit Directive by the European Commission;
- establishment of national independent audit oversight bodies, with the US Public Company Accounting Oversight Board (PCAOB) being a leading example; and
- agreements under which national audit regulators agree to rely on each others' work.

We can expect these efforts to be reinforced in future years, for example through the activities of the International Forum of Independent Audit Regulators (IFIAR) and the continuing work of the International Federation of Accountants (IFAC) to support professional accountancy organisations' compliance with their IFAC membership obligations relating to international standards. These developments, coupled with initiatives such as the country action plans and recommendations arising out of the World Bank Reports on the Observance of Standards and Codes (ROSC), are important in enhancing audit quality.

However, there are deeply embedded features of national environments that pose challenges for international consistency in audit quality. Given that Francis (2009) identified differences in audit quality in different offices of firms in US states, it is easy to appreciate how differences in audit quality may be even greater between countries that have different legal and cultural environments and this is supported by Francis and Wong (2008). This *Audit Quality Forum* paper explores the particular challenges posed by differences in the national environments in which financial statements are prepared and audited. Recognising and addressing these challenges is critical to the success of international efforts to promote consistency in audit quality.

Analysis of legal, political and economic differences is difficult and referring to cultural differences can prompt negative reactions because it suggests that consistent quality can only be achieved by eliminating those differences. This paper recognises that achieving audit quality in any national environment is challenging and that no country's culture guarantees either success or failure.

1.2 Objectives

The objective of this paper is to raise international awareness of the challenges posed by differences in national environments for initiatives to promote international consistency in audit quality. It provides direction by:

- considering how national differences affect the application of standards, including the interaction of auditors with audited entities;
- highlighting key risks that audit firms, standard-setters, regulators, governments, academics and others need to consider;
- identifying potential practical solutions to these challenges which may help those involved in initiatives to enhance audit quality, as well as auditors, regulators and others; and
- helping to stimulate further study and research of these issues.

The paper's analysis of national differences is not intended to be definitive but it should instigate discussion and debate about whether and how differences are being addressed. It should be of practical interest to:

- policy-makers concerned with the future evolution of audit and its contribution to confidence in financial reporting and wider economic development issues;
- audit firms, whether members of international networks or not, concerned with managing their reputations for quality;
- international businesses, including their audit committees who attach importance to international consistency when selecting auditors;
- those involved in international investment and credit decisions;
- international standard-setters and national authorities charged with implementing international standards; and
- national audit regulators with responsibilities for obtaining assurance about audit quality in other countries.

1.3 Approach

This paper has been developed by ICAEW Audit and Assurance Faculty staff supporting the *Audit Quality Forum*.

Section 2 examines national differences and research on their effect on audited financial statements. On the basis that standards are generally seen as benchmarks of audit quality, Sections 3 and 4 examine audit quality and how national differences may give rise to risks in applying standards through their effect on audited entities and the interaction of auditors with audited entities as well as the limitations of the standards in helping auditors to address these risks. Section 5 considers the implications of our analysis for those involved in initiatives to enhance audit quality and audit firms, standard-setters, regulators, academic researchers, governments and intergovernmental organisations in terms of practical steps that they can take (and are already taking) to help to address these challenges and support audit quality.

The standards considered in the paper are the ISQCs and ISAs issued by the IAASB. These standards have wide international application.

In developing the paper we have sought to take account of:

- input from members of the *Audit Quality Forum* and its steering group;
- discussions with individuals in audit firms, regulators, academics, investors, businesses and other organisations with relevant experience to share;
- relevant academic and other research, highlighted in **Research findings** boxes, that looks at the impact of national differences on financial reporting and audit;
- sources of risk in applying international standards, highlighted in **Examples** boxes, as a result of national differences; and
- the need for a range of parties to take practical steps, highlighted in **Actions** boxes, to recognise and act on national differences and so address related risks to audit quality.

1.4 Issues

We acknowledge that our approach may give rise to a number of questions and concerns. For instance, people may question:

- the focus on audit quality rather than financial reporting quality;
- the focus on standards in enhancing audit quality;
- the analysis of national differences and how they may give rise to risks in applying the IAASB standards, rather than any other set of standards; and
- why there is no specific consideration of implicit assumptions in these standards.

The paper specifically looks at the challenges posed for international consistency in audit quality. However, we recognise that audit quality is interlinked with the quality of financial reporting and that many of the issues highlighted in Section 4 also have implications for financial reporting quality.

It is not the object of the paper to study the nature of audit quality in detail. But, as consistency is an important element of standards, the paper sees auditing standards as providing a suitable benchmark against which to identify the potential impact of national differences on audit quality. The application of standards is taken to be a necessary but not a sufficient condition for achieving audit quality.

As countries around the world are looking to apply IAASB standards in one form or another, they offer an appropriate reference point. The standards have not had a long history of use and the significant efforts that have gone into revising and strengthening them are in response to perceived problems in recent years with auditing in major capital markets. We are, therefore, still learning about how they may be adopted and adapted in different countries around the world. We could equally have conducted our analysis by reference to the US standards that are applied on a global basis to non-US corporations listed in the US as well as to non-US operations of US corporations. Indeed the national differences that we identify in this paper are likely to affect the application of any national set of standards insofar as those standards are applied to operations outside the country of origin.

In relation to implicit assumptions in standards, IAASB Board member Philip Cowperthwaite has recently made an original contribution through his paper 'Culture matters: how our culture affects the audit'. He explains that some countries might have difficulties with the implementation of international audit and assurance standards because of differences between their cultural assumptions and those embodied in the standards to be adopted. As a result, some practitioners may need help in interpreting ISAs and a useful first step would be for standard setting bodies to identify explicitly the cultural assumptions inherent in the standards they produce.

We recognise the sensitivities around this issue and while the paper has no intention of suggesting that any one national environment is better than another or of seeking to rank countries, if countries are moving to apply a set of international standards (with whatever implicit cultural assumptions may be attached to them), we believe the issues raised in this paper are relevant. We have therefore taken the view that certain features of the reporting environment (for example, lack of an effective legal framework) may undermine confidence in the information in financial statements. Notwithstanding this, we also recognise that implementing certain aspects of the standards in some national environments might not only prove challenging, but could potentially have an adverse effect on businesses, for example, requiring formal documentation in situations where business relationships have been built on trust.

2. RECOGNISING NATIONAL DIFFERENCES

2.1 Limits to harmonisation

Great progress has been achieved in recent years in producing a set of high-quality international standards covering audit performance and regulators have made continuing efforts to harmonise oversight of auditing and enforcement of standards. Nevertheless, there are limits to what these endeavours can achieve on their own. Parallels can be drawn with the development, adoption, implementation and enforcement of International Financial Reporting Standards (IFRS). The success of IFRS should be judged in the context of what it is realistic to expect of international harmonisation of standards rather than an ideal of absolute consistency in financial reporting quality.

Research findings 2.1: IFRS and accounting convergence

Based on his 2005 PD Leake lecture at ICAEW, Ball (2006) reviews research on the international implementation of IFRS and concludes that it will not eliminate national differences in financial reporting practice and quality since the incentives of preparers and enforcers, including auditors, remain primarily local.

Similarly, Leuz (2010), in a paper for the ICAEW 2009 Information for Better Markets Conference, concludes: 'the role of accounting standards is much more limited in bringing about global reporting convergence than often thought. Moving to a single set of accounting standards is not enough to produce comparability of reporting and disclosure practices, even if standards were strictly enforced in all countries. […] true convergence in reporting practices seems far away and would require a much broader convergence of countries' institutional frameworks, which is unrealistic in the near future (and probably not even desirable).'

International indices providing country rankings in areas such as the ease of doing business show how certain national characteristics vary enormously between countries. Such characteristics all affect the context in which audits are carried out and how auditing standards are applied. Appendix 2 provides some examples of country indices.

In this section, we consider the following features of national environments and their effect on audited financial statements:

- political, economic and business environment;
- legal framework;
- education;
- culture; and
- perceptions of audit.

These are illustrated with examples of academic and other research. We focus on the effect on audited financial statements, recognising that audit quality and financial reporting quality are interlinked. While it is tempting to focus on poor quality, it is also important to recognise that auditing facilitates learning through the interaction of auditors and audited entities and ultimately high-quality auditing can drive up the quality of financial reporting.

2.2 Political, economic and business environment

Features of the political, economic and business environment can affect the quality of audited financial statements and pose challenges for the audit. These national differences include the level of business ethics, the accountability and transparency of governments, the sophistication of capital markets, the number and rights of foreign investors and the quality of governance in all aspects of economic activity.

The business environment affects the motivations of preparers of information. Businesses that are part of larger groups might see a range of disconnected external reporting requirements and regard them as not adding value to the business with the result that preparers may have less incentive to provide reliable information. Moreover, if the concepts of accountability and transparency are not well established in national institutions then this has implications for financial reporting and the audit. Likewise, lack of enforcement mechanisms or clear legal responsibilities aimed at preparers of information affect motivation.

Research findings 2.2: Incentives and the reporting environment

- Ball, Robin, Wu (2003) looked at the interaction between accounting standards and incentives and argued that it is misleading just to classify countries by standards, ignoring incentives.
- Gul (2006) tested the hypothesis that there will be a greater increase in audit effort and audit fees for Malaysian businesses with political connections, as a result of the Asian financial crisis, than for non-politically connected businesses because these businesses have a higher risk of financial misstatements. Results supported the hypothesis.
- Faccio, Masulis and McConnell (2006) provided evidence that in some countries, political connections influence the allocation of capital through the mechanism of financial assistance when connected companies confront economic distress.
- Samsonova (2008 and 2009) highlighted the local institutional factors that have affected developments in auditing in Russia including: the effect of the revision regime (Soviet system of financial control over state-owned enterprises) on the audit profession; the effect of limited professional investments and the weakness of the capital market on the demand for audited financial statements; and the steadily growing emphasis on public trust in auditing.
- Chaney, Faccio and Parsley (2010) conclude that the quality of earnings reported by politically connected firms is significantly poorer than that of similar non-connected companies. Their results suggest that, because of a lesser need to respond to market pressures to increase the quality of information, connected companies can afford disclosing lower quality accounting information. This conclusion is based on an analysis of accounting data from more than 7,000 firms in 21 countries.
- Abdullatif and Al-Khadash (2010) surveyed the views of Jordanian auditors about how an international approach, with emphasis on the currently popular business risk approach is applied in practice by Jordanian audit firms and how appropriate and practical the application of such an international approach to auditing is in different contexts. Audit clients in Jordan face too many business risks, especially because of poor control systems, poor corporate governance structures and unclear or non-existent corporate strategies and objectives. These risks have to be addressed by the business risk approach under very low audit fees. Such factors have led to the business risk approach not being applied in the way that the large international audit firms intended.

2.3 Legal framework

Laws play an important part in the business environment because they help govern the behaviour of business and help protect other parties such as investors and creditors. A country's legal framework can provide rules or principles for how business should be practised and place responsibilities on business people. An effective legal framework may also help to resolve disputes as well as addressing issues such as property rights.

Where laws are non-existent or weak or vary significantly between countries then this has a potential impact on the application of international accounting and auditing standards and the quality of audited financial statements. In some instances, businesses and individuals may need to rely on other mechanisms and the audit might need to be responsive to the different means by which objectives are achieved.

These issues are illustrated in the *Audit Quality Forum* publication *Fundamentals – Third parties* which outlined the need for legal and regulatory as well as ethical incentives in countries if auditors are to obtain relevant and reliable information from third parties. It highlights the difficulties of achieving audit quality without a supportive legal framework. A further publication in the same series, *Fundamentals – Making global auditing standards local*, emphasised the need for ISAs to be legal framework-neutral so that they can be supplemented by national material that ensures that auditors respond to the regulatory and legislative needs of individual jurisdictions. This point was emphasised in relation to corporate governance frameworks and requirements for audit committees in the subsequent *Audit Quality Forum* publication, *Evolution – the impact of audit committees on auditing*.

Countries may be bound by constitutional and administrative laws which significantly limit their ability to give domestic legal force to international standards issued by non-governmental international organisations. Specific issues may arise for countries with a tradition of reliance on laws and regulations in that there may be a need for new statutory measures to amend or adopt a standard. This can be time-consuming and costly and in turn has an impact on compliance, monitoring and enforcement efforts. Likewise, if external quality assurance systems (operated either by governments, regulators or professional accountancy organisations) are not enforced then this will have implications for audit quality.

The paper *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank's Accounting and Auditing ROSC Program* (2004) by Hegarty, Gielen and Barros highlights some of these issues. It explains that for international standards to be effective, they require the force of law or regulatory backing. Unfortunately, it found that the necessary legal, institutional and policy conditions are often undeveloped or absent in many countries.

It is important for people to have the ability to enforce their rights (whether in law or otherwise) and a way of doing this is through litigation which provides a means of recourse. However, this can become counterproductive. In an environment where everything is subject to the threat of litigation and legal liability is a great source of risk, it is very difficult to achieve full transparency and audit quality can be adversely affected. For example, greater litigation may result in defensive auditing and a tendency to treat standards as rigid rules instead of using judgement in their application. Also, greater litigation may act as a disincentive for, or impediment to, evolution and innovation in standards and practice.

Research findings 2.3: Impact of legal frameworks

- Salter and Doupnik (1992) reported empirical work that indicates that the nature of the legal system strongly influences accounting practice.
- La Porta et al (1997 and 1998) found that common law countries have stronger investor protection laws and more developed financial markets than civil law countries.
- Jaggi and Low (2000) looked at the impact of legal systems on financial disclosures by businesses. The results indicate that businesses in common law countries had higher disclosures than businesses in code law countries.
- Francis, Khurana and Pereira (2003) found that national accounting standards are more timely and transparent in common law countries, which is consistent with a greater role played by the public disclosure of accrual-based accounting information under corporate governance regimes in these countries.
- Bushman and Piotroski (2006) found that a country's legal system, securities laws and political economy create incentives that influence the behaviour of corporate executives, investors, regulators and other market participants and such incentives ultimately shape the properties of reported accounting numbers.

2.4 Education

At a national level, education is necessary for ensuring effective public administration and efficient economic activity. More specifically, in the business environment, it is important to have financially literate people in finance roles who have the relevant skills and experience to oversee the financial operations of organisations and who understand and can apply relevant accounting standards and law.

Some countries do not have appropriate education systems for these purposes and the level of financial literacy is low. Resulting poor quality financial reporting affects the ability of auditors to perform an audit. Even where the quality of the underlying financial reporting systems is good, auditors too must possess the relevant skills and experience to perform audits with appropriate professional scepticism and judgement.

Levels of education, skills and experience are affected not only by countries' education systems but by other factors, such as their degree of global connectivity, including the extent of cross-border communications, relationships and mobility. Opportunities to experience other countries and work and train in them might be affected by many considerations including language barriers and ease of physical entry and exit.

Research findings 2.4: Importance of education

The role of education is highlighted in *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank's Accounting and Auditing ROSC Program* (2004). It suggests that lack of human and financial resources is an impediment to the implementation of international standards:

'The application of international standards requires certain minimum levels of capacity (i.e., appropriately qualified individuals), which depends on the availability of opportunities for relevant and adequate education, training and experience…Systems, methodologies, application guidance, curricula, teaching and training materials, examination and certification procedures, and much else must be adapted to support the new obligations. Differences in language can limit the application of resources developed elsewhere, as well as the transfer of knowledge and experience from one country to another.'

2.5 Culture

Any discussion of the impact of national culture on accounting and auditing has to acknowledge Hofstede's seminal 1980 work, *Culture's consequences: International differences in work-related values*. Between 1967 and 1973 employees in IBM were asked to complete an attitude survey in order to provide a management tool for organisation development. This survey process resulted in 117,000 responses from 88,000 employees in 66 countries. Geert Hofstede, the head of the international team conducting the survey, used the results of this data gathering to develop cultural indices which provided four dimensions of national culture for each one of the countries surveyed.

More recently, Schwartz (1994) and the GLOBE study by House et al (2004) have provided an update on Hofstede's work as well as more rigorous methodologies.

Hofstede defined culture as the 'collective programming of the mind which distinguishes the members of one human group from another'. The four main dimensions of national culture identified were:

- Individualism versus collectivism – a society's preference for a loose knit social fabric or a more interdependent tightly knit social fabric.
- Strong versus weak uncertainty avoidance – the degree to which individuals feel uncomfortable with uncertainty and ambiguity.
- Large versus small power distance – the extent to which hierarchy and unequal power distribution in institutions and organisations are accepted.
- Masculinity versus femininity – the extent to which gender roles are differentiated within a society and the extent to which traditional masculine values of performance and visible achievement are emphasised relative to traditional feminine values of relationships, caring and nurturing.

Cultural differences can be observed between different countries through the way in which business is conducted and what might be acceptable in given circumstances and what is not. Different cultural orientations are observed in business etiquette, manners, protocols, customs, negotiating tactics, communication, dress and views on gifts. For example, in some countries business is carried out formally through legally binding contracts whereas in others an informal handshake might be acceptable. Cultural differences are also evidenced through professional judgements and preferences for transparency and information sharing or secrecy and confidentiality.

The accounting and auditing academic community picked up on Hofstede's work and has frequently used his classification and quantification of cultural differences in research. Furthermore, Hofstede's research underpins Cowperthwaite's analysis of cultural assumptions inherent in the IAASB's standards.

There are a number of criticisms of Hofstede. For example, McSweeney (2002) considers the adequacy of his research methodology and highlights a number of methodological flaws and a limited characterisation of culture in his work. Baskerville (2003) challenges the way Hofstede equates nations with cultures and highlights difficulties in understanding culture by means of numerical indices. She also describes possible alternative explanations of national differences in accounting systems.

There are many arguments about what culture is, but the concept of 'national culture' is useful in helping to identify specific features of national environments that might pose risks to international consistency in audit quality. However, we recognise that to rely solely on the concept of national culture is too simplistic. Different cultures co-exist within countries and culture is affected by and entwined with other social and economic characteristics of a national reporting environment such as those already referred to in Section 2 of this paper.

Examples of academic research on the effect of culture on accounting and audit is summarised below.

Research findings 2.5: Impact of culture

Gray (1988) explored the extent to which international differences in accounting may be explained and predicted by differences in cultural factors. He argued that shared cultural values within a country lead to shared accounting values which in turn influence the nature of a nation's accounting system. He links four accounting values and systems with Hofstede's cultural dimensions: professionalism versus statutory control (ie, professional judgement versus prescription): uniformity versus flexibility (uniform accounting practices between companies or flexibility in accordance with the perceived circumstances of a company); conservatism versus optimism (caution versus risk taking); and secrecy versus transparency (confidentiality and restriction of information versus transparent public accountability). The first two values relate to authority and enforcement of accounting practice and the second two relate to the measurement and disclosure of accounting information.

There have been empirical tests of the resulting framework:

- Gray and Vint (1995) looked at the attitudes of local partners of an international accounting firm to understand secrecy with respect to disclosure practices. Correlations were found that supported Gray's original hypotheses with respect to secrecy that it was significantly related to uncertainty avoidance and individualism.
- Salter and Niswander (1995) found that while Gray's model has significant explanatory power in terms of differential financial reporting practices, it is relatively weak in explaining professional and regulatory structures from a cultural base.
- Zarzeski (1996) studied 2,256 corporate annual reports from France, Germany, Hong Kong, Japan, Norway, the UK and the US and found that the secretive nature of a culture relates to the level of accounting disclosure practices.
- Wingate (1997) and Jaggi and Low (2000) found no significant relationship between culture and accounting disclosure.
- Hope (2003) found that culture was significant after controlling for legal factors, using a larger sample of countries, and provided a critique of Jaggi and Low.
- Mohamed Zain and Mohammad (2006) found that cultural factors in Malaysia, such as modesty, secrecy and religion are a major hindrance to corporate social responsibility disclosure.
- Tsakumis (2007) looked at the influence of culture on accountants' application of financial reporting rules in Greece and the US.
- Askary, Pounder and Yazdifar (2008) investigated the effects of cultural values on accounting uniformity and consistency in Arab countries. They found support for the Hofstede-Gray hypothesis of accounting uniformity in Arab countries. The study indicated that in Arabic nations with a Muslim majority, cultural factors affect accounting development generally and accounting uniformity in particular.

Research findings 2.5: Impact of culture (continued)

The following are examples of research on national differences in perceptions of auditor independence and auditors' ability to make judgements and resolve client conflicts:

- Patel and Psaros (2000) studied differences among final year undergraduate accounting students in the UK, Australia, India and Malaysia with respect to perceptions of external auditors' independence.
- Patel, Harrison and McKinnon (2002) examined cultural influences on professional judgements of Australian, Indian and Chinese Malaysian accountants in relation to auditor-client conflict resolution.
- Lin and Fraser (2008) looked at perceptions of auditors' ability to resist client pressure in China and the UK. They drew on cultural differences to explain differences in auditors' perceptions in their respective countries.

2.6 Perceptions of audit

A particular feature of the reporting environment that may affect the quality of audited financial statements and pose challenges for audit quality is the perceived value of audit in different countries. It is important to understand the national institutional history of the audit as this might go some way to explaining how the audit is positioned and whether there is pressure and demand for it.

The length of time over which accounting and auditing regulations and systems have developed is likely to have a significant effect on how auditors are expected to perform their audits. In some countries, the independent role of the auditor and the nature of the audit are clearly established whereas in other countries the auditor might traditionally have had a much closer relationship with management. For example, countries with greater orientation towards external shareholders and creditors (ie, those with an 'outsider' capital model) are likely to have established a significant and independent role for external audit. Those countries with 'insider' capital models might place less emphasis on the audit and perceive it as part of the internal governance structure of businesses.

The origins of the audit and its development vary across countries. For example, in some countries the audit has its origins in serving government needs rather than those of owners, investors and creditors. Different views on the nature and objectives of the audit and what is meant, for example, by auditor independence and objectivity affect the ability to achieve consistent audit quality.

The role of audit also changes over time. It might be challenging for auditors to adjust to new objectives and it takes time for education systems and training organisations to reflect in full such changes in their syllabuses.

It is also important to consider the motivations of auditors which may be affected by factors such as:

- the degree of regulation and disciplinary rigour over auditors;
- the status and perception of the auditing profession; and
- whether those being audited think auditors are their equals or not.

In relation to the last point, some people warn that if the audit becomes increasingly regimented and tick box in nature, with more emphasis on inspection rather than adding value, there is a danger that high-quality people will be deterred from joining or staying in the auditing profession.

Auditors' own backgrounds may also affect how they implement auditing standards and communicate with clients. Auditors may question whether they can rely on audit work performed elsewhere if they believe that there is a risk that the messages and instructions they send may be misinterpreted by those receiving them.

In summary, if the audit is seen as having limited value and there are only weak incentives for auditors to do a good job, then achieving audit quality will prove challenging.

Research findings 2.6: Different perceptions of audit

There is research on the impact of historical and international influences on the level of conformity with ISAs. Mennicken (2008) analysed the use and circulation of international auditing standards within a large post-Soviet Russian audit firm in 2002 as it faced up to the challenges of international harmonisation. The paper highlights how ideals of international comparability may be challenged by global divisions of audit labour, problems and practices of power and exclusion, struggles for intra-professional distinction and discrepancies between local accounting and accountability cultures. The paper draws attention to the fragile nature of processes of translation and standardisation.

Other relevant work includes the following:

- DeFond, Wong, Shuhua (1999) identified a 'flight from audit quality' in China where larger accounting firms experienced a decline in market share as a result of adopting standards to increase auditor independence. They conjecture that this resulted from the absence of market-based incentives for Chinese managers to demand independent auditors.
- Samsonova (2009) studied the evolution of a legislative framework for auditing in Russia and analysed how transnational communications have influenced the development of Russian audit legislation.

3. QUALITY AND STANDARDS

3.1 Achieving audit quality

Any analysis of the effect of national differences on audit quality needs to consider what audit quality means to people and, although the paper is not a detailed study of the nature of audit quality or how to measure it, this section highlights some of the practical issues in seeking to understand what is meant by audit quality.

When people refer to audit quality they focus on the credibility of audited financial statements within the reporting regime in which they have been prepared. Does the audit report accurately reflect whether financial statements are free from material misstatements? In academic research, for example Elifsen and Willekens (2008), audit quality is often related to the competence and independence of auditors in being able to detect material misstatements and being prepared to issue appropriate audit reports to reflect their findings. In more formal terms, a commonly quoted definition of audit quality from DeAngelo (1981) is the 'Market-assessed joint probability that a given auditor both discover (a) a breach in the client's accounting system and (b) report the breach.'

However, at his inaugural lecture at Maastricht University in September 2009, Knechel highlighted particular problems with this; firstly that DeAngelo is trying to define the unobservable and secondly, this definition contradicts auditing theory by seeing audit quality as, in essence, unbounded with more assurance always considered better than less.

Neither a user of audited financial statements nor an academic researcher can tell whether a specific audit report accurately reflects the presence or absence of material misstatements. Even when misstatements that were not reported by an auditor subsequently come to light, that does not represent conclusive evidence of a failure in audit quality, since audits are not intended to provide absolute assurance.

While there is a widespread desire to try to develop universal measures of audit quality, this is extremely challenging. The approach taken in this paper focuses on the quality of inputs to the audit process. However, we acknowledge that audit quality is generally seen as an abstract concept, which could just as easily be about the quality of outputs or the quality of both outputs and inputs. Alongside this, while inputs are relatively easy to measure, there may not necessarily be a correlation between the quality of inputs and output quality. A good audit process can result in a bad outcome, just as a good outcome can result from a bad audit process.

ICAEW's 2002 *Audit Quality* publication explained that '…at its heart, [audit quality] is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgements.' One way of making the concept real is to try to establish clear expectations of what auditors need to do to support an appropriate professional opinion on an individual set of financial statements.

The *Audit Quality Framework* published by the UK Financial Reporting Council (FRC) in 2008 helps with this by identifying the following key drivers of audit quality:

- the culture within an audit firm;
- the skills and personal qualities of audit partners and staff;
- the effectiveness of the audit process;
- the reliability and usefulness of audit reporting; and
- factors outside the control of auditors.

Ultimately, the level of audit quality depends on the perceptions of users of audited financial statements and is evidenced by the level of trust and respect that users have for auditors and auditing practice. For users to have trust, they also need to see credible inspection and enforcement mechanisms for holding auditors to account.

Consistency is an important element of quality. The mantra of 'an audit is an audit' is widely used to emphasise the importance of consistency in ensuring that audits of small and medium enterprises are not seen to be of inferior quality simply on the basis of size. Likewise, the mantra may also be used to emphasise that the quality of an audit should not be judged on the basis of the country where it is performed.

3.2 Role of international standards

Significant efforts have gone into developing internationally recognised standards that contribute to audit quality and explain what auditors need to do to achieve it. Standards set out expectations covering many aspects of the drivers of audit quality: audit firm culture, skills and personal qualities, audit process, and audit reporting.

This paper sees IAASB standards as providing a widely accepted benchmark against which to identify the potential impact of national differences on audit quality. They have wide international application and as ever more countries around the world are looking to apply IAASB standards, they are an appropriate point of reference.

In March 2009, the IAASB completed its Clarity Project to review and update its International Standards on Quality Control and Auditing. As a result, the standards now clearly establish the objectives of the auditor and distinguish paragraphs containing requirements (1, 2, 3, etc) from paragraphs containing application and other explanatory material (A1, A2, A3, etc). Relevant standards are summarised in Sections 3.3 to 3.5 below with additional material included in Appendix 1 to provide a context for subsequent discussion.

Alongside the IAASB standards are the ethical requirements of *The Code of Ethics for Professional Accountants* (the IESBA Code) issued by the International Ethics Standards Board for Accountants (IESBA). While this paper makes reference to aspects of the IESBA Code to set the context in which IAASB standards may be implemented, the auditor independence requirements in the IESBA Code are not covered in detail.

3.3 International Standards on Quality Control

Auditors are assumed to have a certain range of skills when applying auditing standards; indeed, auditing standards start from this basic premise. However, the levels of education in some places are such that additional training might be required to enable audit firms to find people with the right skills to do the work. These challenges, while not specifically addressed in auditing standards, are closely related to some of the elements of the IAASB's ISQC1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* (ISQC1).

Paragraph 11 of ISQC1 states that the objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

- the firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- reports issued by the firm or engagement partners are appropriate in the circumstances.

Paragraph 16 specifies that the elements of a system of quality control include:

- leadership responsibilities for quality within the firm;
- relevant ethical requirements;
- acceptance and continuance of client relationships and specific engagements;
- human resources;
- engagement performance; and
- monitoring.

Paragraph 18 of ISQC 1 goes on to require the firm to establish policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements.

3.4 International Standards on Auditing

The IAASB's terms of reference state that ISAs are developed to enhance the quality and consistency of audit practice throughout the world (www.iaasb.org). ISAs require auditors to obtain reasonable assurance about whether financial statements as a whole are free from material misstatement, whether due to fraud or error and this forms the basis of the auditor's opinion.

A fundamental characteristic of ISAs is their risk-based approach to auditing. Particularly relevant here is ISA 315, which sets out requirements for identifying and assessing risks of material misstatements through understanding the entity and its environment. Such an approach is very different to how some audits might have been performed in the past in some countries. It is not about ticking boxes and carrying out a list of procedures. It requires real judgement and will mean that different work will be performed for different types of businesses in different environments. This philosophy might not, therefore, be easy to follow or be liked by all.

Auditors need to be aware of the risks arising from different environments. However, as we outline later, there are features of national environments which are not specifically addressed in ISAs and which affect how ISAs are applied and how auditors interact with audited entities.

As the UK Auditing Practices Board explains in a statement on the scope of a financial statement audit (www.frc.org.uk/apb):

> 'An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's and the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.'

The statement goes on to explain that some ISAs address the core aspects of the audit process such as:

- planning;
- understanding the company and its environment (including internal controls);
- assessing the risks of material misstatement; and
- responding to assessed risks.

Other ISAs establish requirements in specific areas where it is important that the views of auditors and users on the nature and extent of work to be performed are aligned. These specific areas include:

- going concern;
- the auditor's responsibility to consider fraud in an audit; and
- consideration of laws and regulations.

3.5 ISAs particularly affected by national differences

The following ISAs address core aspects of the audit process and we see them as particularly relevant when considering the impact of national differences:

- *ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* – covers issues in relation to professional scepticism and judgement.
- *ISA 315 Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment* – sets out requirements for risk assessment procedures.
- *ISA 330 The Auditor's Responses to Assessed Risk* – covers auditors' responses to assessed risks, including tests of control.
- *ISA 500 Audit Evidence* – requires auditors to design and perform audit procedures to obtain sufficient appropriate audit evidence.

Further information on the requirements of these ISAs is included in Appendix 1. National differences might also impact significantly on the application of standards that deal with specific areas or issues, such as:

- ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements;*
- ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements;*
- ISA 260 *Communication with those Charged with Governance;*
- ISA 501 *Audit Evidence – Specific Considerations for Selected Items;*
- ISA 505 *External Confirmations;*
- ISA 520 *Analytical Procedures;*
- ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures;*
- ISA 550 *Related Parties;*
- ISA 560 *Subsequent Events;*
- ISA 570 *Going Concern;* and
- ISA 580 *Written Representations.*

Specific references in a number of the standards to financial reporting frameworks might also be relevant.

3.6 National risks

Drawing on our analysis in Section 2 of national differences and relevant research, we identify eight principal sources of risk in applying ISQCs and ISAs which are analysed in Section 4:

- alignment with assumptions implicit in standards;
- quality of economic governance;
- nature of business relationships;
- strength of legal system;
- quality of record keeping;
- extent of management authority;
- expectations of secrecy; and
- professionalisation of auditing.

Auditors can legitimately be asked how they address the risks that arise from these sources and achieve international consistency in audit quality.

4. APPLYING STANDARDS INTERNATIONALLY

4.1 Alignment with assumptions implicit in standards

A country's values and norms may not be aligned with those that are implicit in international standards. In terms of ISAs, we have already highlighted their risk-based philosophy and explained that this might be markedly different to how auditing has historically been performed in some countries. Likewise, while this paper does not specifically address implicit cultural biases in standards, we note Cowperthwaite's contribution to this issue and how, as a result, some countries might have difficulties with their implementation.

Differences in the cultural characteristics of auditors may affect auditors' application of ISAs to multinational groups. As noted in Mennicken (2008): 'Although the adoption of ISAs is often motivated by attempts to imagine and create auditing as a uniform, internationally homogeneous whole, differences between the local and non-local, between the big international and the smaller indigenous audit firms, can never be completely erased'.

There may also be differences between local assumptions and those embodied in the accounting standards applied at a consolidated level. This could affect the application of accounting principles and the ability of people in finance roles to use professional judgement which in turn may lead to differences in financial reporting practices and the incorrect accounting treatment and classification of transactions. For example, if IFRS is to be applied, this may be at odds with, or not sufficiently supported by, local laws and regulatory frameworks or a multinational group may have locally employed staff without the level of knowledge or experience needed for group reporting purposes as well as for local filing requirements.

Examples 4.1: International alignment risks

- In some countries there may be an expectation that certain procedures are performed regardless of whether or not specific risks have been identified or whether suitable controls are in place.
- Risk identification and assessment (ISA 315) – in some countries, entities may be used to record transactions according to their form rather than their substance in terms of effect or outcome. This creates risks of incorrect recognition, measurement and classification.
- Accounting estimates (ISA 540) – selecting suitable accounting policies and determining accounting estimates involve judgement and a clear understanding of the relevant standards and how they should be applied.
- Related parties (ISA 550) – paragraphs A11-13 explain that local frameworks might not establish requirements for related party transactions and so an entity might not have information systems in place for management to be aware of the existence of all related parties.

4.2 Quality of economic governance

To provide a basis for the identification and assessment of the risks of material misstatement at the financial statement and assertion levels, ISA 315 on identifying and assessing risks requires auditors to obtain an understanding of the entity and its environment. According to paragraph A19, this includes the legal and political environment. Key features of a country's legal, political and business environment, such as access to justice and security of property rights, affect the quality of economic governance in the broadest sense (not just corporate governance) and the quality of audit.

Another key feature may be the incentives for preparing accurate financial information. In some countries financial statements might not be on the public record or they may be prepared primarily for a very specific purpose, for example tax assessment. Directors' legal duties may be limited and there may be a lack of accountability to the entity (and other stakeholders) and poor or non-existent corporate governance practices. All these factors can affect the value and quality of the information provided in the financial statements and, as a result, the importance and focus of an audit.

It is important to understand reasons for having an audit in a particular country, where the audit sits in the legal framework and the incentives for encouraging high-quality auditing. A limited demand for audit or a perception that the audit is of limited value will affect the ability to achieve high quality. Limited outsider ownership or institutional shareholdings, the state of national capital markets and a lack of professional investors all affect the demand for, and the value of, audit. Where there are higher levels of foreign investment in countries there tend to be higher levels of disclosure of information because providing transparent and reliable information is seen as important. However, in multinational audited entities, there may be a feeling that audit work on national entities is disconnected from local filing requirements and so auditors may experience difficulties in getting engagement.

Governance aspects of the business environment should therefore affect the auditor's risk assessment process and the auditor's ability to obtain sufficient appropriate audit evidence, for example in relation to the:

- assessment of the entity's control environment;
- risks of fraudulent financial reporting;
- quality of financial information and records, including the completeness of transactions and how audited entities account for transactions; and
- adequacy of disclosures.

Specific examples of how features of the reporting environment might affect the application of standards other than ISA 315 are summarised below.

Examples 4.2: Economic governance risks

- Fraud (ISA 240) – this standard explains the responsibilities of management and those charged with governance with regard to fraud prevention and detection. Paragraph 4 explains the importance of management, with the oversight of those charged with governance, placing a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by active oversight by those charged with governance. The standard is based on a presumption that fraudulent activity should not be normal. For example, paragraph 22 requires auditors to evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures may indicate risks of material misstatement due to fraud. ISA 240 also refers to significant transactions outside the normal course of business. Corruption may, however, be pervasive in the environment in which a business operates and while a strict application of the ISAs might suggest that the auditors should withdraw from the engagement this might not always be possible. Some of the sources in Transparency International's corruption indices use criteria such as adequate laws requiring financial disclosure, ineffective audits or that the external auditor must be independent and equipped with strong diagnostic skills to assess the levels of corruption in a country.
- Laws and regulations (ISA 250) – this standard only looks at non-compliance with laws and regulations rather than what to do in circumstances where there are no specific laws and regulations in place. The standard deals with non-compliance as a one-off or unusual transaction rather than contemplating circumstances where non-compliance is commonplace and expected. The standard highlights withdrawal from engagement as a last resort in such circumstances without considering whether this is possible in relation to systemic problems.

Examples 4.2: Economic governance risks (continued)

- In addition, though recognising that written representations do not provide sufficient appropriate audit evidence on their own, ISA 250 requires auditors to request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. In certain countries the reliance that can be placed on such management representations must, however, be doubtful.
- Accounting estimates (ISA 540) – scope for management bias and its impact on the reliability of management representations may impact on the ability to obtain sufficient appropriate audit evidence about accounting estimates. Paragraph A46 of ISA 200 explains that the preparation of financial statements involves judgement by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgements that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, ISAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

4.3 Nature of business relationships

In some countries, complex business structures and trading relationships are very common. These relationships rely heavily on trust rather than formal contracts and employing or trading with family members and other connected parties may be the norm rather than the exception. These features of the reporting environment may affect the quality of accounting records as considered under ISA 315 and also affect the application of other standards.

Examples 4.3: Business relationship risks

- Fraud (ISA 240) – complex relationships may be a fraud risk factor.
- Laws and regulations (ISA 250) – complex relationships might give rise to concerns about an entity's compliance with relevant laws and regulations.
- Related parties (ISA 550) – the hiring of relatives is commonplace in collectivist cultures. If in some cultures related party transactions are the norm and not the exception then it might be difficult to apply ISA 550 and it could impact on how auditors obtain sufficient appropriate audit evidence. For example, if auditors need external confirmations but these would be from related parties, there may be issues with their reliability. Appendix 1 of ISA 240 does recognise that there might be significant related party transactions when significant operations are located abroad in jurisdictions where different business environments and cultures exist.
- Furthermore, in relation to ISA 550, in some cultures, business relationships are built on notions of trust and honour. These characteristics of relationships might not fit easily with the definition of related parties in international standards and the assessment of whether they should be treated as related parties or not might prove difficult.

4.4 Strength of legal system

The audit risk assessment process may be affected by the nature of national legal systems. If property ownership rights are not clearly established or enforced in the laws of a country and if the government or other bodies have the power or authority to seize property, then this can prove particularly challenging for auditors in making judgements about asset recognition and confirming ownership rights and obligations relating to assets and liabilities.

Legal protection issues such as the extent of recourse provided to investors or creditors who have been harmed as part of the country's legal and regulatory system may indirectly impact the audit. In business environments where investors have limited powers of recourse, it may lead to the creation of a dominant position for management to exercise influence, abuse power, override controls and distort the assessment of liabilities.

Examples 4.4: Legal system risks

- Audit evidence (ISA 500) – paragraphs A14 to A16 look at inspection as a form of audit evidence but recognise that while inspecting assets and some documents may provide evidence of the existence of assets, they may not necessarily provide audit evidence about an entity's rights and obligations or the valuation of assets. If ownership rights are not clearly established then it is unlikely that any form of external confirmation will be available. Auditors might therefore struggle to obtain sufficient appropriate audit evidence in this respect.
- Laws and regulations (ISA 250) – paragraph 16 requires auditors to obtain written management representations of all known instances of non-compliance or suspected non-compliance but if management are in a position to avoid the consequences of non-compliance, they may not disclose this information.
- Audit evidence for selected items (ISA 501) – in relation to the completeness of litigation and claims involving the entity, auditors must make enquiries of management and review minutes and legal expense accounts. Paragraph 12 requires a written representation from management that all known actual or possible litigation and claims that may affect the financial statements have been disclosed to the auditors and disclosed or accounted for in the financial statements. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor is required to seek direct communication with the entity's external legal counsel. All these requirements presume a stable and well-developed legal framework.
- Accounting estimates (ISA 540) – if investor protection rights are weak relative to the pressure to meet market expectations then there may be greater incentive for management to hide or manipulate information and accounting estimates is an area where there may be scope to do this.

4.5 Quality of record keeping

Auditors might not have reliable accounting records to use for audit purposes for a number of reasons relating to the national reporting environment, for example:

- a lack of financial expertise and suitably experienced and qualified staff in the audited entity; or
- a tradition of mechanistic bookkeeping where transactions are recorded according to form rather than substance.

The cultural characteristics and complexity of business structures and relationships might also affect the completeness and detail of accounting records in audited entities. In some countries, business relationships may be conducted on a less formal basis than others. Terms of agreements may be vague or not followed and what ultimately determines the commercial outcome of an arrangement might be the relationship of trust between the parties and not what is written on paper. Trading with family members may be common and some audited entities may rely on this. Agreements may only be made orally.

A lack of formal documentation poses problems for auditors in terms of risk assessment and obtaining sufficient appropriate audit evidence.

Examples 4.5: Record-keeping risks

- Risk identification and assessment (ISA 315) – required procedures include observation and inspection of documents such as business plans and strategies, internal control manuals and other records. Paragraph A107 of ISA 315 highlights that where auditors have concerns about the quality of records, they may judge that sufficient appropriate audit evidence will not be available.
- Audit evidence (ISA 500) – paragraph A2 clarifies that inquiry alone is not sufficient appropriate audit evidence and there is a need, for example, to inspect documents. Paragraph A31 reinforces the idea that documentary evidence is more reliable than oral evidence. Consequently, where there is little or no formal documentation or poor quality accounting records, it will be difficult to rely on controls or to perform the analytical procedures and substantive tests of detail required under ISA 330 on responding to assessed risks.
- Analytical procedures (ISA 520) – the standard requires auditors to evaluate the reliability of data which means taking account of the source, comparability, nature and relevance of information and controls over its preparation.
- Related parties (ISA 550) – paragraph 15 requires auditors to remain alert during the audit when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditors. However, identification and disclosure of related parties and related party transactions may be particularly challenging where records are poor or incomplete and where controls over related party relationships and transactions are deficient or non-existent. Paragraph A18 identifies a number of reasons for this, such as management attaching low importance to identifying and disclosing related party relationships and transactions. This is more likely in environments where trading with family members and other connected parties is common.

4.6 Extent of management authority

The acceptability of communication between people of different levels of authority varies greatly between countries. There are different views of what might be deemed acceptable. Auditors face a challenge in knowing how to react and deal with this inequality particularly in situations where cultural assumptions may preclude the audit team from interacting directly with senior management. The audit team and, in some circumstances, the engagement partner may be unable to ask sensitive questions of management or request supporting evidence. Differences in levels of respect have implications for auditors' assessment of management integrity and the trust they place in information provided and judgements made by management.

In addition, there may be cultural characteristics which determine the acceptability of challenging management. For example, at one extreme it might be perfectly acceptable and, in fact, commonplace for audited entities to book audit adjustments to the financial information they have prepared. At the other extreme, any audit adjustments might imply weakness in the financial reporting function of the audited entity and could be used as evidence that someone is not competent to do their job.

These issues may be of far greater significance for auditor effectiveness than the threats to independence set out in the IESBA Code. They have implications for obtaining sufficient and appropriate audit evidence, particularly in areas where auditors need to make inquiries of management, question accounting policies or ask for management representations. Consequently, there is a risk that disagreements on the adequacy of disclosures in financial statements or the accounting treatment of transactions are not properly resolved because auditors are not able to challenge management. Auditors will experience difficulties in complying with specific requirements of ISAs where auditors are required to make inquiries of management and such issues arise.

Examples 4.6: Management authority risks

- Fraud (ISA 240) – paragraph 17 requires auditors to make inquiries about management of the risk that financial statements may be materially misstated due to fraud, management's process for identifying and responding to risks of fraud, management communications to those charged with governance regarding processes for identifying and responding to risks of fraud, and management's communication to employees regarding views on business practices and ethical behaviour. Moreover, paragraph 18 requires auditors to make inquiries of management and others in the entity to determine whether they have knowledge of any actual, suspected or alleged fraud. In some countries this is a particularly sensitive area and one where auditors might find it difficult to know how to approach management.
- Laws and regulations (ISA 250) – paragraph 14 requires auditors to make inquiries of management as to whether the entity is in compliance with laws and regulations and paragraph 19 requires auditors, if they suspect non-compliance, to discuss the matter with management and those charged with governance.
- Communication with those charged with governance (ISA 260) – paragraph 16(a) requires auditors to communicate their views about significant qualitative aspects of accounting practices, including accounting policies, accounting estimates and financial statement disclosures and ISA 265 requires auditors to communicate deficiencies in internal controls to those charged with governance.
- Accounting estimates (ISA 540) – auditors make inquiries of management to understand how management identify transactions and conditions that may give rise to accounting estimates that are recognised or disclosed in financial statements as well as how management make accounting estimates and the data they use. This can be a judgemental and sensitive area and auditors may experience difficulties in getting information or challenging judgements as a result of features of the reporting environment.
- Subsequent events (ISA 560) – auditors are required to make inquiries of management related to events after the balance sheet date.
- Going concern (ISA 570) – auditors must discuss management's assessment of going concern with management and if there is no assessment they discuss the basis for the intended use of the going concern assumption.
- Written representations (ISA 580) – this standard and others contain requirements for written representations from management which may be difficult to obtain.

4.7 Expectations of secrecy

The secretiveness of cultures where information is closely guarded and seen as confidential can affect the auditor's assessment under ISA 315 of the risk of material misstatement. Unwillingness of management (or lack of incentives) to provide transparent financial information in financial statements increases risk in a number of areas and may affect the audit process. In addition, auditors may have difficulties obtaining sufficient and appropriate audit evidence that is required by ISA 500 because management may collude to hide information from auditors and override controls.

A secretive culture may generate concerns about the adequacy of disclosures in financial statements. Paragraph 24 of ISA 330 on responding to assessed risks requires auditors to perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. Auditors might be fully aware of a particular issue and what the appropriate disclosures should be but may find the audited entity unwilling to make them as they consider the information to be confidential.

In a different vein, the secretiveness of some cultures may make it difficult for some audit firms to form or join international networks or to experience other cultures and share information and experience. This lack of global connectivity can hinder the development of skills such as the ability to challenge and think of alternative solutions to problems and to make professional judgements.

Examples 4.7: Secrecy risks

- Accounting estimates (ISA 540) – management may not be prepared to make suitable disclosures or adjustments as they may wish to keep information confidential.
- Related parties (ISA 550) – auditors might struggle to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements. Paragraph 13 requires auditors to make inquiries of management regarding the identity of related parties, nature of relationships, whether the entity has entered into any transactions and if so, their type and purpose, as well as controls in place. But as this may reveal sensitive information, management may be unwilling to share information and the controls in place might be non-existent or deficient.
- Written representations (ISA 580) – auditors may assess management representations as providing low value audit evidence. A number of other ISAs require written representations such as ISA 240 on fraud, ISA 250 on laws and regulations, ISA 501 on audit evidence, ISA 550 on related parties, ISA 560 on subsequent events and ISA 570 on going concern.

4.8 Professionalisation of auditing

Because of the need to apply professional scepticism and judgement on audits, Cowperthwaite (2010) argued that auditing is more of an art than a science and as art is always the product of an individual artist so the audit process too will be affected by the individual qualities of auditors.

Recruiting auditors with the necessary financial expertise might be difficult in countries with poor education systems and where there are limited cross-border activities, communications and opportunities to gain relevant experience and financial literacy skills. If there are only limited facilities to train, to share knowledge and experience and to develop these necessary skills then this is likely to affect the quality of audits performed. Even in the absence of those problems, a poor perception of the auditing profession may mean that a career in auditing does not attract enough high-quality candidates. This might be especially so if there is a perception that auditing is just about ticking boxes and complying with regulation and not about performing a valuable activity.

In some countries, auditors may be less comfortable about making judgements and being sceptical, particularly where there is a rules-based culture and process has always been more important than outcome and reliability more important than relevance. Using Hofstede's cultural dimensions, auditors in high uncertainty avoidance countries where rules are prevalent may be less confident about making judgements based on principles than auditors in low uncertainty avoidance countries. This could have a significant effect on the level of work deemed necessary by auditors.

Auditors' own cultural background will affect their views on the acceptability of transactions and whether they are at arm's length and give rise to national risks to international consistency in audit quality. Likewise, there may be differences in approach to auditor independence based on established cultural assumptions about what is deemed acceptable and the purpose of the audit. Indeed, in very small countries, it may be extremely difficult for auditors to be able to demonstrate to others that they are sufficiently independent to apply the level of objectivity that is required.

There may be cultural barriers to communications, for example, the acceptability of an audit team member approaching the engagement partner with an issue or concern. In recognition of the importance of communication in the audit team, a number of ISAs (eg, ISA 240 on fraud and ISA 315 on identifying and assessing risks) include specific requirements for discussions among the engagement team. However, if audit team members are not encouraged to raise issues or if culturally this is seen as unacceptable then it would be difficult for audit firms to comply with all the requirements in ISAs and ISQC 1.

Examples 4.8: Professionalisation risks

- Because the subject matter of ISQC 1 is the quality control systems of audit firms, it imposes professional requirements which will be more difficult to satisfy in certain countries. These requirements cover the following matters:
  - paragraph 20 – establish policies and procedures designed to provide reasonable assurance that audit firms (and their personnel) comply with relevant ethical requirements.
  - paragraph 29 – establish policies and procedures to provide reasonable assurance that audit firms have sufficient personnel with the competence, capabilities and commitment to ethical principles necessary to perform engagements in accordance with professional standards and applicable legal and regulatory requirements. Paragraph A24 explains that the relevant policies and procedures cover recruitment, capabilities and competence and paragraph A25 explains that competence can be developed through a variety of methods, including professional education, continuing professional development, training, work experience, coaching by more experienced staff and independence education.
  - paragraph 32 – establish policies and procedures for engagement performance and responsibilities in respect of review and supervision.
  - paragraph 34 – establish policies and procedures designed to provide reasonable assurance that appropriate consultation takes place on difficult and contentious matters. Paragraph A37 explains that appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognised as a strength.
- Paragraph A2 of ISQC 1 explains that encouraging firm personnel to communicate their views or concerns on quality control matters recognises the importance of obtaining feedback on the firm's system of quality control. However, there may be cultural barriers to such communication.
- In addition, some requirements of ISA 200 on the overall objectives of an audit might be difficult to satisfy in some countries because of the state of development of the auditing profession. For example, paragraph A23 of ISA 200 refers to the application of professional judgement in ISAs to:
  - materiality and audit risk;
  - nature, timing and extent of audit procedures;
  - evaluating the sufficiency and appropriateness of audit evidence;
  - evaluation of management judgements; and
  - drawing conclusions based on evidence obtained.
- Similarly, the IESBA Code makes demands based on assumptions about the professionalisation of auditing which might not be realistic in some countries. For example:
  - section 100.7 requires use of professional judgement in making determinations about whether appropriate safeguards are available to eliminate threats to compliance with the fundamental principles;
  - section 100.2 requires a professional accountant to use professional judgement in applying the conceptual framework; and
  - section 130.5 requires a professional accountant to take reasonable steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision.

4.9 Wider implications of national risks

The national risks analysed above are expressed in technical terms as risks in applying ISAs and ISQC 1. However, this should not obscure their considerable consequences for those who are committed to promoting international consistency in audit quality, including audit firm networks, standard-setters and regulators. They are also critical to initiatives such as IFAC's compliance program and the country action plans and recommendations arising out of the World Bank ROSC work. Section 5 suggests practical solutions, by way of areas for action that auditors, businesses, investors, standard-setters, regulators, governments and other organisations might take to address these challenges.

5. RESPONDING TO RISKS ARISING FROM NATIONAL DIFFERENCES

5.1 Share experience

Sharing practical experience and understanding of national differences across audit firms and networks, professional accountancy organisations, standard-setters, regulators, governments and national and international organisations can help to build a consistent vision of audit quality. A clear understanding of what is meant by audit quality allows people to recognise that there may be different ways to achieve this underlying objective in different countries. Enhancing experience and understanding of national differences should ultimately help with initiatives aimed at promoting international consistency in audit quality.

Audit firm risk assessment processes, methodologies and audit approaches can all help to deal with the risks identified in Section 4. However, some auditors may not even be aware of the risks and challenges raised by national differences and how they impact on the audit or they may lack the resources, communication channels and necessary experience to deal with them.

To enhance audit quality, it is therefore vital to share experience about how auditors assess and deal with country risks, build on existing practices and make use of new possibilities afforded by IT. For example, international secondments for audit staff and exposure to other national environments through exchange and education programmes are vital mechanisms for all sizes of firm in enhancing communication and understanding and developing the skills needed to achieve consistency and audit quality.

There are examples in countries of locally run networking organisations which bring together audit firms of all sizes to discuss relevant auditing issues. There is scope to build on these communication mechanisms at a national level, for example, through professional accountancy organisations, to provide opportunities for people with different degrees of international experience to share problems and ideas.

Such examples of sharing experience and practice extend beyond audit firms and audit firm networks and can take place between national professional accountancy organisations, regulators, standard-setters, governments and national and global organisations. For example, sharing experience is vital for national regulators to ensure that they are all working towards the same objectives. IFIAR was established in 2006 and according to the IFIAR Charter, its primary purpose is to enable independent audit regulators to share among each other their knowledge and experiences with a focus on inspections of auditors and audit firms. When ensuring that regulators are working to the same goal, it will be important to take account of national differences.

Actions 5.1: Share experience of national differences

- Share practical experience to help to develop a consistent vision of audit quality.
- Build on existing mechanisms for sharing practical experience by:
  - providing greater opportunities for international secondments, exchange and education programmes and discussion forums to benefit auditors in both perceived advanced and developing countries, national professional accountancy organisations, regulators and national and global organisations; and
  - setting up local network organisations eg, through professional accountancy organisations, to share practice and experience.
- Sharing practice and experience, eg, through IFIAR, is also vital for national regulators to ensure that they are all working towards the same objectives.

5.2 Acknowledge national differences

Building on the shared experiences of national differences in Section 5.1, auditors and standard-setters need to be responsive to the audit risks that arise as a result of national differences, reflecting on how these differences are currently addressed in international standards and in practice and how they can make improvements. National regulators should also find it useful to consider how they respond to risks in relation to national differences that arise in their areas of responsibility.

We suggest that more information is made available about the consideration of national risk factors by audit firms (eg, when looking to take new firms into their networks), and standard-setters and regulators (both national and international organisations). Appendix 2 provides some examples of country indices that may be helpful in identifying national risks. It is, however, important to understand that such indices are not themselves measures of audit quality. They point instead to potential country risks that a quality audit needs to address.

International standards could place more emphasis on how national differences, such as those reflected in country indices, affect audit risk. The application and other explanatory material in ISAs could usefully be extended to raise awareness of the risks and challenges that some features of national environments may pose for auditors. The existing standards do not specifically recognise some of the features of national environments identified in this paper. Moreover, in some cases, standards do not reflect the complexity of national environments and business relationships and structures. For example, there are frequent references to 'unusual transactions' but in certain environments the assumption that such transactions are unusual will be incorrect.

While there is scope for changes, such as those outlined below, to enhance the application and other explanatory material in ISAs to reflect features of national environments, we recognise that it is important for ISAs to remain principles-based. Greater prescription may prevent auditors in many countries from applying international standards effectively. As Mennicken (2008) notes: '…the ambiguity of the standards is both their strength and their weakness. To be connectable to a variety of different situations, worlds, dreams and ideals, ISAs necessarily have to maintain a level of abstraction that can only be made concrete by users themselves.'

Having identified and assessed specific risks related to national differences, such as complex business structures and relationships, a lack of personnel with appropriate accounting and financial reporting skills and cultural issues around seniority and challenging management, auditors also need to adapt their audit approaches to deal with them. For example, auditors may step up internal procedures for engagement acceptance and continuance, supervision and review responsibilities and expert involvement and, within this context:

- accept the substance of relationships based on inquiry with management and third parties rather than reliance on formal documentation;
- spend more time checking individual transactions and carrying out more substantive work to ensure that transactions have been correctly classified, including increasing sample sizes to address the risk of bookkeeping errors;
- obtain more corroborating information to increase the assurance auditors obtain from sources independent of the entity, recognising the potential need to go beyond conventional third party confirmations about account balances and terms of agreements where third parties have weak incentives to provide reliable audit evidence; and
- understand management behaviour and accepted communication methods and consider taking a less direct and more circumspect approach to challenging management.

Notwithstanding the need for auditors to be responsive to specific circumstances such as those highlighted above, auditors must also ensure that they are fully aware of, and continue to address the expectations and needs of external investors, parent company management and their auditors.

While national audit firms that belong to international networks can clearly make use of the opportunities those networks provide to share experience and raise awareness of national differences, there may be potential pitfalls if networks do not supplement global methodologies and approaches with country-specific material that helps auditors address national risks. Indeed, international networks might need to assess whether the use of a global audit methodology is actually the most effective approach in specific circumstances or whether they ultimately need to devote more time to reviewing the work of local firms and the judgements made.

Standards should support auditors in exercising professional judgement to address misstatement risks in ways that suit the national environment in which those risks arise. When setting standards, standard-setters therefore need to ensure that there is sufficient flexibility for auditors to decide what the most appropriate audit approach is for dealing with identified risk factors. The overriding objective should always be to obtain assurance rather than to complete particular procedures.

Ultimately, auditors need to be alive to the environment in which they are operating. In seeking to enhance standards it is important to emphasise this and for standard-setters to understand how their standards are being applied in practice. In his inaugural speech at Maastricht University in 2009, Knechel concluded 'In the end, the best source of audit quality may be the judgement and expertise of an experienced auditor in dealing with an uncertain and idiosyncratic environment of each individual client'.

Sharing experience and practice and being more responsive to audit risks arising from national differences are important steps for audit firms and standard-setters but such actions are also of value to international businesses. Ultimately they might help investors to understand and assess the risks posed by national differences to international businesses.

Actions 5.2: Acknowledge national differences within international standards

- Place greater emphasis in standards on how national differences (eg, as reflected in country indices) affect audit risk. This could involve amending the application and other explanatory material in ISAs to reflect the following issues:
  - ISA 315 on risk identification and assessment requires auditors to obtain an understanding of industry, regulatory and other external factors that affect the audited entity. These factors might include the legal, political and regulatory environment but the standard does not refer to broader issues such as culture, behaviour or levels of corruption associated with countries.
  - ISA 330 on responding to assessed risks could provide examples of the types of procedures that might be applied to help mitigate additional sources of risk that could be identified in ISA 315.
  - ISA 250 on laws and regulations addresses non-compliance with laws and regulations and suggests that auditors seek legal advice in situations where there is non-compliance. However, it does not address circumstances where laws and regulations are unclear or not enforced or where there are no laws and regulations in areas where they would be expected.
  - ISA 240 on fraud, ISA 250 on laws and regulations and ISA 550 on related parties all refer to unusual transactions but do not take account of the complexity of some national environments where such transactions, far from being unusual, may be prevalent or pervasive.
- Standards should support auditors in exercising professional judgement to address misstatement risks in ways that suit the national environment in which those risks arise.

5.3 Promote the role of audit

Recent years have seen a new emphasis on the importance and interdependence of institutions in economic development, as exemplified by North in his influential book, *Understanding the Process of Economic Change*. In this context, institutions comprise practices, such as auditing, rather than organisations. Therefore, implementing international auditing and quality control standards where there are limited institutional infrastructures in a country to complement and support them will be extremely challenging.

When auditors in a particular country face difficulties in issuing clean audit reports and this cannot be solved by better sharing of experience or acknowledgement of national differences, it would indicate that there are wider issues relating to the political and business environment or the legal framework that need to be addressed eg, if the country is to attract international investment. However, different institutional models might work for different countries and achieve the same objective and so, provided that audit is seen to be important, it is inappropriate to be dogmatic about the form that institutional reform should take.

Analysing ISA implementation and the challenges for achieving international consistency in audit quality raises many issues that have wide relevance to businesses, governments, inter-governmental organisations and international development agencies. Prompting debate in these areas might help to encourage a more critical analysis of the issues and, where relevant, pressure for these issues to be pushed up the reform agenda. Indeed, the state of auditing in a country could potentially provide more objective insight into economic development issues than conventional country indices. Likewise, initiatives undertaken by professional accountancy organisations to share experiences and support educational programmes in countries may help to foster change.

In the final analysis, internationally applied auditing standards which buttress audit quality can play an important role in promoting economic development and institutional change by holding up a mirror to the quality of a country's financial reporting. Audit firms as well as auditing standard-setters and regulators therefore play a vital role by supporting such standards.

Actions 5.3: Promote the role of audit in economic development

Global implementation of IAASB standards will help focus attention on national differences and support economic development and encourage change because the standards may:

- Instil a greater sense of responsibility in management for the quality of information in financial statements.
- Improve the spirit of learning and financial literacy, by strengthening educational systems and providing:
  - incentives to train as accountants or in finance roles;
  - encouragement to develop critical thinking skills;
  - opportunities to gain financial experience through on the job training; and
  - training courses in bookkeeping and accounting standards.
- Focus attention on ways to attract talented candidates to accounting and auditing by building professional accountancy organisations and improving public perceptions of the value of high-quality audited financial information.
- Highlight a need for strong quality assurance systems with appropriate sanctions.
- Require the implementation and enforcement of appropriate laws that protect property rights and the rights of investors and creditors.
- Prompt measures to uphold integrity and accountability in public and private life.

5.4 Support research

This paper seeks to identify and raise awareness of the risks to international consistency in audit quality that arise from national differences. It draws on a wide range of academic research. However, there is very little academic research which bears directly on the issue of how national differences contribute to differences in audit quality. In supporting research into national differences in audit, we recognise that academic and other research could make a vital contribution to learning in our first three areas for action by identifying effective ways of sharing international experience, critically analysing how international standards should acknowledge national differences and exploring linkages between audit practice and wider issues of economic development.

The widespread international adoption and implementation of IFRS have recently led to a huge expansion of academic research into international comparisons of financial reporting quality. This is because the common platform of IFRS facilitates such comparisons. We hope to see a similar phenomenon in the field of auditing research. As more countries adopt and implement IAASB standards, and thereby establish a common quality benchmark, there will be more scope for both qualitative and quantitative research to analyse the extent to which national differences affect audit quality. Implementation of IAASB standards should provide new and more comparable information on matters such as audit report qualifications and modifications, published results of audit quality assurance regimes, audit costs, and auditors' and financial statement preparers' experience of the audit process.

Performing qualitative research in this area may prove quite daunting. Humphrey (2008) highlighted some of the challenges to performing research that gets closer to audit practice. Not only are there difficulties in gaining access to audit firms due to client confidentiality, but there is also a reluctance across parts of the academic discipline of auditing to undertake research of a more qualitative nature. Qualitative research that provides an understanding of audit practice is, however, important. Such research should ultimately be useful to auditors, investors, businesses, standard-setters and regulators.

Actions 5.4: Support research into national differences

- Academic and other research could make a vital contribution to international consistency in audit quality by:
  - identifying effective ways of sharing international experience;
  - critically analysing how international standards should acknowledge national differences; and
  - exploring linkages between audit practice and wider issues of economic development.
- Research could provide vital insights into:
  - the measures being taken by audit firms and networks to address risks arising from national differences;
  - the effectiveness of international secondments, global audit methodologies and other techniques to promote international consistency;
  - the impact of IAASB standards on actual and perceived audit quality and the quality of audited financial information across different countries;
  - the importance of various features of national environments in explaining differences in the impact of IAASB standards;
  - the effect of IAASB standards in helping to change features of national environments and narrow national differences;
  - the costs of implementing IAASB standards relative to the perceived benefits;
  - the limits of global standards as a necessary but not a sufficient condition for international consistency in audit quality;
  - cultural influences on standard-setting practices and procedures; and
  - auditing traditions, for example, how auditing as practised in different forms in different countries has developed.

APPENDIX 1 – SUMMARY OF SELECTED ISAS

ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

Paragraph 15 of ISA 200 explains that the audit should be planned and performed with professional scepticism which paragraph 13(l) defines as an 'attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'. Paragraph A19 goes on to explain that professional scepticism is important to help reduce the risks of:

- overlooking unusual circumstances;
- over generalizing when drawing conclusions from audit observations; and
- using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Examples of professional scepticism include questioning contradictory audit evidence, considering the sufficiency and appropriateness of audit evidence and assessing the honesty and integrity of an audited entity's management.

Paragraph 16 requires auditors to exercise professional judgement in planning and performing an audit. Professional judgement is needed to interpret ethical requirements and auditing standards and to make informed decisions by applying relevant knowledge and experience to the particular facts and circumstances of the engagement.

ISA 315 Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment

Paragraph 5 of ISA 315 requires auditors to perform risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement at the financial statement and assertion levels. This risk assessment determines the nature, timing and extent of further audit procedures. Risk assessment procedures specified in paragraph 6 include:

- making inquiries of management and of others within the entity who in the auditor's judgement may have information that is likely to assist in identifying risks of material misstatement due to fraud or error;
- performing analytical procedures; and
- observation and inspection.

Appendix 2 of ISA 315 sets out conditions and events that may indicate risks of material misstatements.

ISA 330 The Auditor's Responses to Assessed Risk

ISA 330 covers auditors' responses to assessed risks, including tests of control. According to paragraph 3, the objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks. Paragraph A62 explains that auditors' judgement as to what is sufficient appropriate audit evidence may be influenced by factors such as:

- the significance of the potential misstatement in the assertion and the likelihood of it having a material effect on the financial statements;
- the effectiveness of management responses and the controls to address risks;
- the source and reliability of available information; and
- understanding of the entity and its environment.

Irrespective of the assessed risks of material misstatement, paragraph 18 requires auditors to design and perform substantive procedures for each material class of transactions, account balances and disclosure.

ISA 500 Audit evidence

ISA 500 requires auditors to design and perform audit procedures to obtain sufficient appropriate audit evidence. Paragraph 5 c explains that audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. Paragraph A2 of ISA 500 explains that the audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry.

APPENDIX 2 – COUNTRY INDICES

The following country indices may be helpful in identifying national risks in relation to international consistency in audit quality:

- The World Bank's Doing Business Reports measure the ease of doing business in countries, based on criteria that include the ease with which property can be registered, protection of investors, transparency of transactions, extent of directors' liability and enforcement of contracts (www.doingbusiness.org).
- The Worldwide Governance Indicators (WGI) Project reports aggregate and individual governance indicators for 213 economies over the period 1996 – 2009 for six dimensions of governance (http://info.worldbank.org/governance/wgi/index.asp).
- The Legatum Prosperity Index assesses countries on, among other things, whether they have democratic institutions and on the governance and accountability of governments (www.li.com/prosperityindex.aspx).
- The Corruption Perceptions Index of Transparency International (www.transparency.org/policy_research) and the Global Integrity Index (http://report.globalintegrity.org) assess countries using criteria such as access to laws and institutions that are required to control corruption, anti-corruption mechanisms, the legal framework and practical implementation and government accountability.
- The Accounting Development Index (ADI) Research Initiative acknowledges the pivotal role accountancy plays in capital market development and the overall economic growth of a country and is working to provide for the first time, a simple, comprehensive quantitative summary about a country's accountancy environment and its adoption and implementation of accounting and auditing standards. The initiative is the result of a partnership between USAID, UNCTAD, Leiden University and Royal NIVRA and a pilot report was published in 2009 (http://www.minbuza.nl/dsresource?objectid=buzabeheer:80877&type=org).

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ICAEW
Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA UK

T +44 (0)20 7920 8493
F +44 (0)20 7920 8780
E aqf@icaew.com

TECPLN9100