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**Chapter 2. Thinking differently:  
making audit innovation the new  
practice standard**

From the book *Revisionens roll i  
bolagsstyrningen* (The role of audit-  
ing in corporate governance).

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# REVISIONENS ROLL | BOLAGSSTYRNINGEN

*The role of auditing in corporate governance* is the result of an SNS research project focusing on some crucial challenges that the auditing profession is currently facing.

Due to its supporting and controlling role, auditing constitutes a fundamental part of corporate governance and the audit does, in a broader sense, fulfil an important function in many parts of society. Currently, regulatory initiatives from the EU, international harmonization and the implementation of International Financial Reporting Standards (IFRS) contribute to the transformation of the auditing practice.

In the book, three leading accounting and auditing researchers investigate the challenges that auditing is facing, especially the role of auditing in corporate governance. They build their arguments on international research and current Swedish cases. The following issues are investigated:

- Which innovations are needed to enhance auditing quality?
- Which are the driving forces developing the auditing profession today?
- How can the auditor reporting be improved?
- How do principle-based accounting standards affect auditing?
- How has the introduction of audit committees influenced the auditor's position and work?

The authors conclude that the auditing profession needs to regain the initiative, lead innovation within auditing, and focus on quality competition.

Except for the enclosed chapter, the book is written in Swedish.

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"Thinking differently: making audit innovation the new practice standard", chapter 2 in *Revisionens roll i bolagsstyrningen* [in English *The role of auditing in corporate governance*]

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## **2. Thinking differently: making audit innovation the new practice standard?**

The auditing profession around the world is currently facing unprecedented criticism. It is accused of failing to protect investors, creditors and other users of financial statements when there is a business failure or large fraud. Legal actions have been brought which have resulted in auditors having to pay significant damages or, agree to expensive out-of-court settlements. Quite apart from the economic impact of these cases and the high cost of professional liability insurance, is their impact on the reputation of our profession for strict standards, high integrity and moral courage. We have defended ourselves by claiming that we are too often innocent victims or scapegoats and that, knowingly or unknowingly, people have come to expect too much of the auditor. I suggest that a significant defence that an auditor can make is that he/she has adhered to auditing standards established in an international forum, by leaders in the profession, which have received international acceptance.

The purpose of this chapter is to raise questions and stimulate debate about the development of international auditing practice and its implications for the auditing profession. Why this focus? On one level it is possible, in today's auditing world, to believe that everything is getting, or already is, sorted out following the disruptions of the global financial crisis. We now have fully clarified International Standards on Auditing (ISAs), with many countries having formally adopted the standards. The International Organisation of Securities Commissions (IOSCO) has also given its own form of endorsement of ISAs for cross-border investment activity and the EU looks close to approving ISAs for application in all member states, having spent a considerable amount of time reviewing the case for formal endorsement.

ISAs have long been recognized by the Financial Stability Forum (now Board) as one of its 12 standards and codes for financial stability, while the World Bank has actively promoted ISAs in its formal Reports on Standards and Codes (ROSCs), reports which since the late 1990s have reviewed financial governance and accountability in (primarily) developing nations. We routinely talk of an international regulatory architecture in which bodies, such as the IAASB, are a significant component and we can see how a broad mix of these regulatory bodies relate to each other through a complex range of interlocking or embedded relationships and shared commitments to enhance global financial transparency, governance and accountability (see Humphrey and Loft 2009; Humphrey et al 2009). Such bodies increasingly serve to drive forward agendas concerning notions of audit quality, as recently demonstrated by the IAASB in its exposure release on an audit quality framework (see IAASB 2013).

This said, there is also a niggling sense of disquiet that things are not as orderly or as developed as they seem; that something is missing in the response to crisis and the type of criticisms evident in the quotation at the start of this chapter. What are the roots of this disquiet? And is it of sufficient significance to reflect critically on the international development of the auditing function? Persuasive grounds for answering in the affirmative include the fact that the above quote is not a formal reflection on the global financial crisis that started in 2007/2008, nor a 2002, post-Enron commentary. It is part of a report presented to the XIII World Congress of Accountants in Tokyo, Japan, in October 1987 by Justin Fryer, the, then, chair of the International Auditing Practices Committee (IAPC), the body that subsequently became the IAASB.

Adherence to international standards on auditing may still be a significant defence for the auditing profession when questioned about auditor performance but, it is evident that the development of such standards has not stopped the recurrence of major corporate scandals and financial crises – nor has it stopped the persistent, “standard”, questions that such events raise about levels of audit quality. This chapter builds a case for thinking differently about auditing and the pursuit of standardisation, asking whether it is possible for innovation to become the new practice standard.

## Living with an expectations gap

Auditing as a discipline has lived for many years with notions of an audit expectations gap, of a sense that auditors are not working, or at least not seen or recognized to be working, to the standards expected by its key stakeholders. This is often classified by the profession as an education gap, with an accompanying claim that the reputation of the profession would be far more positive if stakeholders properly understood what it is that auditors do. The professional literature is replete with such comments, but the sheer longevity of the expectations gap suggests that it is something more than just an education gap. The recent global financial crisis is, in fact, the latest in a long, recurring, set of expressions of concern with the quality of auditing practice. If, as the UK Treasury Select Committee notably asked, auditors had been doing their job and, still, so many banks collapsed soon after having received a clean audit report, what does this say of the function of auditing and the overall "quality" of that function? The profession has produced various responses, explaining, for example, that auditors do not have the benefit of hindsight and that, given the information available at the time of issuing an audit opinion, a qualified opinion on the grounds of going concern would have been challenged by the banks receiving the reports. However, it is difficult for such responses to dispel the argument that the audit expectations gap is about the performance of auditing and not just about auditing education.

## A question of standards

It is puzzling that debates over auditing expectations and performance occur continually even though we have, apparently, robust and internationally accepted auditing standards. Further, the intensity of these debates does not seem to be influenced by the nature of the standard setting regime. For instance, it could be expected that auditors are more likely to be critical of standards imposed through more external or "independent" standard setting regimes than through "self-regulatory" regimes. However, the history of the audit expectations gap suggests that professional criticism of the nature and impact of standards was more visible when the regimes were more controlled and directly influenced by the auditing profession. The recent EU Green Paper reform debate

certainly did not see the auditing profession arguing against ISAs – quite the opposite; the profession argued in favour of the EU endorsing and supporting these standards as quickly and seriously as possible.

It is particularly interesting and revealing in this regard to look at how auditing textbooks refer to auditing standards. References to standards are worded in a very matter of fact fashion, listing the current, ruling standards. The texts spend little time discussing the concept of "standards" and their apparent centrality to notions of, and the provision of, audit quality. In a UK context, for example, if one goes back to auditing textbooks from the early 1980s (when the first set of UK-based standards had just been issued) one could have expected such textbooks to explain why there was a need for standards and how auditing had managed to function for so long without them. But such a discussion usually did not take place. Auditing standards were simply in existence and auditors had to comply with them.

Furthermore, in subsequent editions of such textbooks, when auditing standards had become more prolific and national standards had been replaced by international auditing standards (ISAs), it is difficult to find any real discussion of the differential significance of standards and the way in which standards used to be referred to as stipulating minimum practice standards at levels that were very likely to be substantially lower than the current standards being applied by the larger firms. From being ahead of standards and reference to standards as codifications of practices already in existence, we have now moved to a situation in which compliance with ISAs has become an essential descriptive characteristic of an auditing firm's approach. Rather than making reference to branded, firm-specific audit methodologies, audit firms now uniformly characterize their audit approaches as being compliant with ISAs.

Further, a profession that speaks of the importance of respecting the value of individual professional judgment, also seems to have chosen to accept (and accepted without any discussion in leading auditing texts and professional journals) the notion that "an audit is an audit". Such phraseology does look more in place with a mass-manufacturing car plant, where each car coming off the production line is identical (although even here any one brand of car can have multiple variants depending on whether it is the basic model or a top-of-the range

model). Claims that “an audit is an audit” may well be helpful for standard setters, but they essentially imply that all auditors apparently know, recognize and think the same as to what is an audit. Inconveniently, users continue to have different expectations about the role and achievements of auditing!

### **The value-proposition of audit**

The benefit of such discussions is that they invite a broader-based reflection on the audit’s value-proposition. This is often specified by the profession through phrases such as the audit “enables people to do business with confidence”, or it is “the source of transparency, or the ‘oil’ that enables financial markets to function smoothly”. The problem for the profession is two-fold. First, the acclamations as to the value of audit are ones that most frequently and visibly come from the profession and not from those for whom the audit is supposedly being provided. It is usually the auditors telling us about the value of the audit and not users and stakeholders telling the auditors about the value experienced.

Further, when things go wrong and companies collapse, it is the audit profession telling stakeholders that they do not properly understand the audit function and what auditors are doing. Secondly, the value proposition of audit is framed nowadays centrally around the information that is being audited/assured – with the resulting risk being that if the pertinence and relevance of such information declines, so, automatically does the value of the assurance function associated with/applied to it. This is something that has been increasingly raised as a concern by those critical of the way in which financial reporting rules and requirements have developed. This criticism has included arguments emphasizing the dangers of overly complex and long corporate financial reports and has noted reductions in readership levels and degrees of relevance, with evident implications for the derived value of the audit of such statements.

### **How innovative is audit practice?**

In a world increasingly populated by independent standards and regulation, it is important to contemplate where audit innovation stands. To what degree is innovation critical to audit quality? In what innovative

ways is the audit developing in light of the global financial crisis, or has it developed in response to other crises and questions directed at the auditing profession? In a recent joint paper, we asked:

(How) has the technology and practice of auditing developed in recent years and to what extent is it comparable to technological advancements in areas like mobile telecommunications, medicine, computing and motor manufacturing? What is the equivalent advancement in the field of auditing to the smart phone, ipad, laser surgery or the hybrid/electric car? A common form of response to this question is for audit practitioners to point to information technology developments that have taken place in the audit arena. How working papers and audit files are all now electronically set up, developed and maintained. How it is now so much easier for files to be updated by individual audit team members and how any member of the team can immediately access the up-to-date version of the file. But what do all of these changes say about the level of innovation in audit as a professional knowledge base? (Humphrey et al 2013, p. 178.)

An illuminating way of considering the significance and status of audit innovation is to note that in two recent major public policy documents on audit quality produced by the lead international standard setting body (see IAASB 2011; 2013), the word innovation does not appear once. But the word quality appears a total of 86 in one document and 332 times in the other. The IAASB is not alone in this regard. For instance, a recent policy document by the Chartered Professional Accountants (CPA Canada) and the Canadian Public Accountability Board (CPA Canada/CPAB 2013) entitled "Enhancing Audit Quality: Canadian Perspectives" made no mention of innovation, while referring to quality 137 times.

Innovation in auditing is an issue I have raised on a regular basis with senior audit practitioners over recent years and their response has, on several occasions, been quite blunt. While some have referred to the above mentioned IT developments in the maintenance of audit files, a significant number responded to the request to identify a recent major innovation in auditing by stating simply that there has been, in fact, *no significant innovation* in auditing practice over the last decade or so!

When pursued further, it is evident that this is quite a controversial debating point and one that divides auditors and their regulators. Auditors claim that audit quality is now framed very much by a control orientation focused on the maintenance of, or compliance with, specified standards. It is not constructed around notions of practice innova-

tion. Auditors make reference to senior technical partners who, in the past, would have been described as scholars, but are now referred to as technicians, expert in the mass of detail embedded in auditing standards. Younger audit partners are seen as much less likely to contemplate, when facing a problematic auditing issue, reverting to "first principles" and logically deriving the appropriate action – instead, they ask their technical advisers for detailed information on "what the standard says"?

In spite of the formal promotion at public policy and standard setting levels of the importance of focusing on principles more than on than rules (and the representation of rule-dominated standards as professionally less robust than principles-based standards), the emphasis in executing an audit is acknowledged by a good number of auditors as increasingly one of following rules, check lists and other such compliance requirements. Principles-based standards and tick box-based operational auditing may be a contradiction in terms, but this is a contradiction that appears to capture many of the perceived daily realities of audit practice. Documentation is increasingly said to dominate over judgement. Routines dominate over inspiration, insight and innovation.

Such concerns and criticisms are challenged by the profession's regulators who label as "mischief making" the notion that auditors now do one audit for themselves and one audit for the regulators. They would also point out that the firms, themselves, and not the regulators, encourage the emphasis on rules and check-lists and that audit inspections would be a lot more conducive if audit staff did precisely what their firm's quality control systems require. Indeed, I have come across arguments within the regulatory and standard setting community that the big multinational audit firms have tried hard to ensure that international auditing standards mirror/encapsulate the firms' preferred risk management and control frameworks.

### **Contemplating auditing innovation**

Calling for innovation in auditing should not be a wildly extraordinary idea. After all, there are many industries where a lack of innovation means a rapid demise, if not certain death of that industry.<sup>8</sup> Pharmaceu-

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<sup>8</sup> I would like to thank my colleague, Kostas Stathopolous, for demonstrating this point through his corporate governance and executive remuneration research.

tical or electronic companies who fail to innovate, do not survive. But in the auditing profession, a lack of innovation is seemingly able to go hand-in-hand with major commercial success and longevity.

When the first set of formal auditing standards and guidelines were being developed in the UK (in the mid-1970s), it was usual for the standards to be referred to as "minimum" benchmarks, specifying a level of audit quality which could be aspirational for certain smaller firms, but a standard that was likely to have already been surpassed in the larger firms. These latter firms were ahead of the standards, instead of following in their footsteps. This sentiment, as Humphrey and his co-authors (2013, p. 166) note, was well captured by Stoy Hayward & Co's *Audit Guide* (1983) which stressed that "although our audits must be up to standard, they must not be standard" (p. iv). Nowadays, most firms characterize their audit approach as being fully compliant with ISAs but say very little as to whether they are delivering a level of quality exceeding that specified by ISAs. Likewise, they have tended to say little as to what the delivered level of quality means in practical terms and what the audit firm has done that specifically sets them apart from their close competitors.

Such observations are certainly suggestive of a shifting sense of what professionalism means in the context of auditing, not only in terms of changing "external" influences on the nature of audit work, but also as regards the key values represented by the responses to the crisis facing audit professionals. As Humphrey and his co-authors (2013) noted:

When we talk of professionalism in auditing, we routinely evoke images of independence and freedom of thought, of individuals committed to truth and justice, of reasonableness and a rationality of evidence-based judgement and an overriding commitment to and belief in transparency. However, it may be that the auditing profession, at least in recent years but arguably for many years, has adopted a very much more pragmatic and business-oriented perspective on "professionalism"; one that prioritises commercial survival over a strong and undying adherence to a "professional" code of practice (p. 180).

It was emphasized earlier that history is something that we can, and should, learn from – but with regards to the auditing expectations gap, there seems to be limited learning on the part of the profession. This is not a "time-lag" gap reflecting a shifting set of social expectations of

auditors and a profession committed to closing the gap – rather, this is a gap that persistently concerns the same issues – whether it be worries over auditor independence, the capacity of auditors to detect fraud and to produce informed and meaningful audit reports, etc.

From such a standpoint, audit looks more like a function with perennial difficulties – a function persistently trying to “improve” at the operational level – but which, for many years, has provided a regular and significant source of income (and an invaluable field-site for training young professionals in the art of audit practice) to professional firms, the largest of which are among the world’s most successful businesses. In medicine, it is possible to speak of the failure to combat certain diseases but, in general terms, the history of medicine is written as a history of success, a history of cures and breakthroughs. Similarly, in the history of transport or telecommunications, while there may be notable failures, there are invariably more striking successes.

How is the history of auditing usually retold? Internationally speaking, audit history is delineated through reference to initiatives stimulated through crises and failures, whether it be specific scandals, such as McKesson Robbins, GEC-AEI, BCCI, Enron, Parmalat, Lehman Brothers, HQ Bank etc. or notable official investigations and legislative changes, such as the Metcalf or Cohen Commissions, the Audit-Effectiveness Panel, Sarbanes-Oxley or European company directives. Periods of development are labelled according to whether they are pre- or post-crisis or pre- or post- a particularly notorious financial scandal or corporate collapse. Just think how many times reference is made to something being pre- or post-Enron. Why not describe auditing development more through references to successes rather than to failures?

Interestingly, when there is mention of success in auditing, it is often about the success of processes – such as the international endorsement of International Standards on Auditing (ISAs) or newly codified (1990s) or newly clarified (2000s) standards. As Humphrey and his colleagues (2013, p. 166) suggest, can it be that we focus more on the quality of auditing standards, than on the value of differing levels and notions of audit quality? This, in turn, raises the question as to why, rather than talking about the misplaced nature of the audit expectations gap, there is no dominant discursive emphasis on learning to appreciate overall improvements in the quality of auditing practice and on identifying

what has driven any such improvements?

It has long been said that a good way of identifying the critical core of an organisation and its purpose is to seek to study its priorities in the face of a manifest disaster. For instance, in a prison, if this question is posed to prison officers and they reply that a manifest disaster is a prisoner escaping, this does tend to undermine all the talk of the operational importance of prisoner rehabilitation and suggests that incarceration and restraint lie at the essential core of imprisonment. Ask the same question to an audit partner, and a popular response (in terms of what will count most against you in the promotion stakes) is the loss of an audit client. Likewise, talk to auditors about work processes and priorities and it is striking how infrequently they will make reference to the concept of auditor independence – especially in comparison with the risk of not keeping the client, or customer, satisfied.

### **Confronting the underlying constraints of the practice environment**

My own lecturing experience on training programmes for auditors has also tended to reinforce the sentiment that there is something not quite right with the way in which the concept of professionalism is being constructed in practice. Academically speaking, auditing is a fascinating and exciting interdisciplinary subject, full of politics, intrigue and challenge. Yet in practice, so much training seems to be rules-based, requiring practitioners to work through all of the latest revisions to individual auditing standards and their firm's specified working procedures (paragraph by paragraph). It has always struck me as worrying, for instance, that training programmes place so much emphasis on the detailed specification of standards but do not discuss the nature of the membership of standard setting bodies, the way in which standards are set and what factors are most influential in such processes. Ironically, while typical characterisations in the profession describe auditing as "dull" and "boring", this is not the impression that I have often received when talking to senior auditors who are prepared to confide in me some of the more intricate details of their work as lead audit partners. Such conversations are not characterized by reference to specific rules; rather, they are filled with illustrations of the strength of character and wide

range of skill sets that have to be drawn upon to withstand challenges from senior company management and to ensure that the final audited accounts are presented in an accurate and insightful manner.

Such reflections invite many questions for the auditing profession. What are the consequences of practice now being much more defined by standards; standards which were at one stage the basic minimum but now delineate the broad remit of practice? To what extent is success and getting promoted within the firm dependent on being compliant, on meeting specified business targets, observing cultural requirements and not talking out of turn? To what extent are audit firm partners unduly constrained by what they can say due to concerns over legal liability? To what degree, in turn, are professional institutes constrained by having to give appropriate recognition to the views of the large firms (whose professional subscription payments provide those institutes with a very valuable revenue stream and whose partners staff, to a large degree, many of its technical and policy committees/boards)? Is the audit function in any danger of struggling in today's fast moving, technological and business environment to attract the most "creative", "brightest" and "best" individuals? Indeed, are the stereotypical images of a function, which in one context are felt to preserve its stability and viability, threatening the auditing profession's longer-term sustainability? Is a profession that allows regulators to dominate in danger of no longer being a profession, or at least a highly regarded profession?

I have discussed such issues with senior audit partners in some of the large firms and it is clear that they are capable of thinking of a whole host of advances that could be applied to audit practice. However, when asked if these would be things that they would be willing to share, in the spirit of a broad-based practice enhancement, they quickly respond that there is little economic incentive for them to do so. "Why should we give such potential competitive advantages away to others?" "What is the sense in us doing this?" Alternatively, they comment that the problem with such possible developments is determining whether there is a viable market demand. Various possible advances in practice may seem stimulating on the drawing-board but are they commercially viable? Sticking with the statutory audit function, with its ready market (albeit diminishing as audit exemption thresholds increase and the limitations and constraints on the audit are acknowledged) always seems to be the

safer play. If anything, contemplation of innovation has tended to take place more visibly in the construction of alternatives or additions to the statutory financial audit – in the creation of new “assurance services”. These services are, by definition, less tightly regulated and, therefore, more certain of providing auditors with abnormally high economic returns and the possibility to lay claim to a distinctive level of expertise.

Such commercial imperatives also come through very evidently when educational issues are raised with practising auditors. The successful recruitment of trainees is discussed in terms of how quickly they make it through the qualification process – with a growing emphasis on knowing the universities attended by those students that progress the quickest through the various organizational ranks to become partners. The profession prides itself on the difficult nature of the path to partnership, with the image that only the “best” make it. But is a training process where only a very small percentage of recruits make it to the top positions the best one for the longer term sustainability of the profession? Is it possible to see in younger generations of audit partners a more compliance, rules-oriented approach to work and a narrower outlook on educational and professional development processes? Do the elder generations appear more radical and broad-minded, more capable of thinking imaginatively and out of their normal frame of reference? Does the practice environment encourage auditors to think in silos and seldom to think across silos or beyond the context of the present and reflect on the developments of the past? When did the profession last move in ways that were not politically comfortable? When did the profession take an initiative that was in the public interest but directly against, at least in the short term, the interests of its members? And, when it did, what was the reaction of its members?

Arguably, a strong profession is one that encourages and promotes a diversity of thought, not one that constrains thought in a safe harbour of accepted “normality”? The latest advances in cancer treatments are deriving from detailed genetic analyses, which are finding that certain drugs work well on certain genetic make-ups and cautions against advocating blanket treatments on the basis of evidence from singular genetic forms. Following this, it is hard to accept the claim that a sustainable profession is one that recruits from the same “gene pool”. Doesn’t a sustainable profession have to be one that knows why individuals, who

ticked so many boxes at the initial recruitment stage, subsequently fail to make it to the top of the profession? Shouldn't the profession be one that stops living with a lack of innovation, to become one that actively promotes innovation and knows what practice innovations work and deserve to be applied on a wider scale?

Isn't it a sign of strength if a profession can accommodate a diversity of views and recognize that different sets of obligations on different parts of the profession necessitate the pursuit of differing objectives? The views of professional bodies should legitimately be expected to differ from those of the firms. Likewise, the views of the larger firms should be expected to be different from those of smaller firms. Surely what matters more than uniformity and standardization is that the quality of practice in different institutional contexts is readily visible and that interested parties know that different perspectives are not being expressed to hide a significantly different quality of practice (or to preserve unjustified claims about the quality of such practice).

### **A tipping point?**

It can be argued that auditing is a function which will only ever attract attention in cases of "failure" – it is a "bad news" dominated function in the sense that good news (i.e., a clean audit opinion) is not news. Or that psychologically, people are expecting to be reassured through the audit and when this reassurance is not forthcoming, then a reaction is generated. Good audit quality is largely presumed; it is only when the audit fails that we want to know what happened. Alternatively, it could be argued that initiatives are on-going in terms of the commitment to promote audit quality and to advance auditing practice. For example, people could point to the work of bodies, such as the Centre for Audit Quality in the USA and the Audit Quality Forum and the Audit Futures initiative in the UK – or to the thought leadership initiatives of professional bodies, institutes and standard setting boards that have all emphasised the importance of audit firms implementing the highest possible quality control standards and governance codes.

It could also be said that the audit profession has had a lot of experience in dealing with the ups and downs of the business environment in which audit is situated and is sufficiently smart enough to know that,

while uncomfortable and far from being perfect, the profession's chosen form of strategic response and crisis management is optimal, in the sense that they are able not only to survive but to profit, in some cases, very substantially, from the environment in which they operate. While it may take a lot of effort to maintain an uneasy status quo (Fogarty et al 1991), maybe this is the rational response considering the nature of the function being provided?

To what extent is it possible to premise a counter view? Namely, that the audit profession has reached a tipping point, whereby the ruling strategy for so many years is now not only sup-optimal but also not fitting of a profession claiming to be a fundamental lynchpin providing the confidence in financial information that business and society need to conduct their affairs in an orderly and effective manner? What are the key signs of such a tipping point? The first is that regulatory authorities are now very firmly committed to audit reform, despite the fact that a number of their favoured reform proposals do have a questionable, or unproven, evidence basis. With regulators tending in their investigations to focus on situations where audits have not worked or, at least, have not complied with recommended processes, there has been a very limited promotion of audit successes and positive audit achievements. This presents us with the scenario that if regulation is the visible response to a history of (suspected) audit failings, a resulting consequence is to reinforce or emphasise such notions of failure.

The recent EU Green Paper proposals and the approach taken by the European Commission is a pertinent illustration of the shifting impetus associated with practice development (for more detailed discussion, see Humphrey et al 2011). The Green Paper clearly privileged reform of independence rules and regulations and the development of enhanced levels of competition in the audit market. However, this preference was based on a belief that was not well grounded (and not empirically demonstrated) in what specifically went wrong (if it did) with the audit. Neither was this preference based on evidence that the proposed reforms would serve to rectify any such problems and failings.

Quite evident in the Green Paper was a lack of reference to (and, by implication, lack of respect for) professional judgement. Instead, the Paper presumed that reforming regulations and adjusting (or seeking to adjust) levels of market competition, would serve to enhance or deliver

higher levels of professional judgement. But, again, this is a vague belief rather than a proven empirical proposition. The obvious alternative to trusting markets or regulations is to place trust in the professional – however, this is the essential problem for the profession in responding to such regulatory investigations. Trust has been undermined in audit professionals.

The worrying thing for the profession is that this loss of trust has been happening under an active regulatory environment. With increasingly demanding regulatory interventions and associated extensive sets of rules and regulations always likely not to be complied with by a subset of the profession, trust levels could decline even further – with such breaches exposing the profession to further criticism and the prospect of even more regulation. A regulated profession at some point stops being a profession and becomes an activity, defined by little more than its rate of compliance with a specified set of routines.

Or maybe the world of auditing is, ultimately, rather more stable and less dramatic in terms of future possible scenarios? Maybe we are better placed by expecting to muddle through in ways which make no major break with the past. Looking through the literature, one can certainly find pertinent examples from many years ago where the profession's leading, and most dynamic, representatives were still battling against regulatory efforts seeking to improve auditor independence and to constrain the services provided by auditors. For instance, there are Sir Henry Benson's very striking comments against banning auditors from providing non-audit services as far back as the early 1970s:

The provision of management consultancy and other advisory services by the accountancy profession is probably more developed in the UK than in any other EEC country. This development has come about through a growing demand on the part of the business community for independent assessments and advice which accountants by virtue of their training and expertise are particularly qualified to provide. It is the view of the accountancy bodies in the UK that it would be damaging to the profession, its clients and the community generally if restriction were to be placed on the services which the profession can offer its clients.

The services provided by practising accountants in the field of management consultancy and taxation are advisory services. In carrying them out accountants do not usurp the executive functions of the management of client companies.

Those responsibilities remain with the directors and the management of the companies concerned. The auditor does not impair his objectivity by offering advisory services for the reason that he avoids involvement in, and does not assume responsibility for, the executive operation of the business.

It is axiomatic that auditors should be independent and ensure that their objectivity is unimpaired. Objectivity is an essential quality of the qualified accountant; his training is designed to develop it, and he guards it scrupulously. The provision of other accounting services is not, in principle, a factor in determining whether he has objectivity or not.

There is, nevertheless, a body of opinion in the Commission which believes that auditing should not be combined with consultancy services. It is argued that the interests of shareholders and other third parties can only be fully protected if there is an absolute divorce between these two functions. While the accountancy bodies in the member countries are in complete sympathy with the general aim of the Commission to maintain the independence and objectivity of the auditor, we question the reasoning on which the Commission's arguments are founded. In our view (and in the view of many of the other accountancy bodies in the EEC) the premises are erroneous (*The Accountant*, 14 December 1972, p. 758).

At first sight, such a view has some very direct parallels to the debates triggered by the EU's recent Green Paper on auditing reform. However, there is a difference of spirit in Benson's comments that is worth highlighting. Benson emphasizes objectivity over independence, essentially arguing that a profession can be trusted when providing a range of valued services if it acts with balance and integrity. It could imply that, in the face of threatened regulation, the profession should be talking more of the importance of objectivity and competent, business informed judgement, than of the significance of "independent" assurance and assessment. Arguably, auditing has a role to play in enhancing confidence in corporate financial statements and the underlying strengths of reporting businesses not solely because of the notion of auditor independence, but also because of the pertinence and overall insightfulness of auditor judgement.

How has the profession apparently developed into a position in which its professionalism and quality of judgement is inherently, if not, routinely questioned? Maybe the post-Enron world left it with no alternative? Maybe independent regulation became inevitable in light of such massive corporate failures at the turn of the 21st century,

coming as they did so soon after the Asian crisis. The questions raised as to the global consistency of auditing practices within multinational audit firms and the effectiveness of self-regulatory regimes in enhancing overall global auditing standards perhaps automatically led to independent regulation. Still, such events, in themselves, do not determine the particular shape and focal point of a regulatory regime, which leaves open the question as to whether the profession has, itself, in one way or another, allowed such a regulatory regime to gain a secure foothold. Proposed regulations may be resisted strongly by the profession but once put into effect, they quickly become accepted forms of practice.

This invites questions as to whether the profession and its response to criticism have ended up with the regulatory regime it deserves. Is it in this position because of the way it chooses to organise and promote itself, wherein the ruling concept governing audit practice is more of a commercial than a professional imperative; one dominated by notions of corporate control, economic pragmatism and business survival?

### **The possibilities of promoting audit from the "inside looking out"**

Claims and counter-claims about the contribution of the auditing function often serve to raise the question as to what the profession can do to rebuild trust. With various investigations and "thought leadership" publications on audit quality by professional accounting bodies, and with current attempts by standard setters, such as the IAASB, to expand the audit reporting format to provide more information on the work of auditors, it could be assumed that matters are suitably in hand and that the chances of a constructive future for the auditing function are high. From such a perspective, calls for innovation in auditing could be seen as underplaying the scale of reform that is currently underway. It could also be suggested that the profession does not need to pursue innovation just for the sake of it; it has to be purposeful and demonstrably linked to improved levels of audit quality.

However, while, ultimately, it is quality that counts, the spirit with which change is embraced is fundamental. Here, the reform agendas give the impression of being somewhat enforced on the profession and/or the domain of professional practice. This raises questions as to the

capacity of the profession to gain a more distinctive voice and not leave the development of audit quality in the hands of significant others?

As a society, we are investing a lot of resources in audit (and the monitoring of audit) but we still do not have a sufficiently strong appreciation of what auditors are doing and achieving in the name of audit. If there are concerns about the continuing rise of regulatory reforms "from the outside looking in", we need to start to promote understanding and reform from the "inside looking out"! We also need to think much more seriously about the intellectual (and not just ethical or commercial) values governing the auditing profession. We need to ensure that professionally qualified auditors, both in their initial and continuing professional education have a good appreciation of the history of auditing and the economic, political, social and cultural contexts in which practice has developed.

From such a standpoint, it can be argued that the profession can make more visible the achievements of audit practice, demonstrating more effectively the good work that auditors say they are doing and the impact that they are having. Likewise, it should be capable of better managing the constraints of client confidentiality and the worries of the threat of legal precedent. The profession also has the capacity to shake off the shackles of boredom, routine and standardised techniques to show, instead, real artistry and the power of the challenge provided by auditors. For a so-called public interested function, the profession surely has the ability to ensure that we know much more about its "public spirited" contribution.

Recent audit reporting reforms may well help here in giving auditors the formal capacity to say more about the nature of the audit process, the issues that gave them most concern and their key findings. However, it has to be recognised that the debate over the relative merits of short and longer form reporting is not a new one and there are arguments that would suggest that the primary purpose of the audit report is to send clear signals as to the quality and reliability of the audited financial statements rather than a vehicle for signalling audit quality. The mindset through which both the profession and users of audit reports approach such a reform is going to be critical.

In this respect, it is welcoming to note that the IAASB (2013), in its recently released exposure draft for a newly proposed standard advocat-

ing a longer form of audit reporting (ISA 701), has placed considerable emphasis on the importance of audit firms "field testing" the application of the proposed standard. It has also stressed the importance of firms feeding back to the IAASB their findings and experiences of such field testing and experimentation so that the final ISA 701 can be "both robust and workable in practice" (IAASB 2013, paragraph 19).

In terms of the pursuit of audit innovation and enhanced levels of audit quality, however, it also has to be recognised that audit regulators are going to be significantly influenced and governed by considerations of compliance with standards/regulations. For example, in its first ever global survey of inspection findings (covering 22 national audit inspection bodies), the International Forum of Independent Audit Regulators (IFIAR) concluded that more needed to be done to improve the consistency of auditor performance. Its findings confirmed that audit firms need to improve their quality control and oversight systems (not least because many findings were found to recur year after year), with a lack of professional scepticism being seen to be a significant performance issue as well as a possible causal factor underlying many inspection findings.

An important feature to note with respect to IFIAR's report is the adopted definition of an inspection "finding". This is defined as:

a significant matter where the auditor did not perform sufficient work to meet the applicable auditing standards and other related requirements. A finding should not be interpreted to imply that the financial statements were necessarily materially misstated (IFIAR 2012, p. 6).

IFIAR also chose to emphasise that the data presented in its report should be seen as indicative rather than definitive, noting that while some inspected engagements had more than one "finding", many had none at all. IFIAR's report amounted to a survey of inspection findings and, significantly, "did not seek information regarding instances where auditors had met the required professional standards" (ibid. 2012, p. 5), leaving IFIAR to emphasise that the survey was "not a balanced scorecard" (p. 5).

The challenge for the profession is quite clear – when IFIAR calls for greater consistency in auditor performance, it is not a call that the profession can ignore, especially when IFIAR says that its survey results will be of use to other regulators, standard setters and policy makers.

But, at the same time, there is an issue of balance to deal with – and if IFIAR and other such regulatory bodies are not going to address this, then it is clear where the responsibility for action lies. Put simply, the profession has in its own hands to do more to show where auditing works, where audit practice is innovative, not just describing how practice is in compliance with standards, but, instead, where it is better than "standard". But can the profession seize the agenda?

In assessing the profession's position in this regard, a further pertinent matter to consider is the nature of strategic developments in the arena of audit quality being pursued in the US by the Public Company Accounting Oversight Board (PCAOB), especially as PCAOB reforms can have a significant propensity to travel in terms of informing international regulatory debate. Building on the recommendations of the 2008 report by the US Department of the Treasury's Advisory Committee on the Auditing Profession (ACAP), the PCAOB has established, as a priority project for 2013, a plan to develop audit quality indicators (AQIs) and to track such measures with respect to domestic global network firms over time (see PCAOB 2013).

Essentially, the approach drafted in the paper prepared by the staff of the Office of Research and Analysis (OFA) (and for which much of the groundwork is acknowledged as already being underway in terms of tracking and analysing certain metrics) is to provide a "balanced scorecard" of a portfolio of 10–20 measures covering the quality of audit inputs, processes and results, with the portfolio of measures being tested for their relevance and robustness (in terms of observed correlations between input and process measures and audit results). Indicative operational input measures include: the ratio of partners to staff; average years of experience; levels of industry expertise; percentage of work outsourced to service centres; chargeable hours and training hours per professional; and excessive turnover levels of audit personnel.

In terms of process measures, the OFA staff paper anticipates the PCAOB monitoring indicators such as: the number and substance of firm leadership communications on audit quality and investors' interests; the results of anonymous staff surveys of an audit firm's "tone at the top", hiring, training, supervision and remuneration policies; compliance rates with independence rules and standards; the content of firms' marketing materials and the extent to which they are consistent with

a commitment to audit quality and independence; average compensation rates for audit partners and managers and compensation trends for partners prematurely rotated off/replaced on an audit assignment; test scores for newly implemented competency assessments and the emphasis placed on technical competence and fortitude in partner and manager evaluation and compensation processes; the number and size of auditor resignations; the percentage of clients assessed as high risk; the ratio of audit staff to partners; and the level of firm investment in infrastructure supporting quality auditing.

With respect to "results", the OFA staff paper identified metrics such as: the frequency and market impact of restatements; the number of audit reports that appropriately and/or inappropriately included a going concern opinion; the quality of audit reporting on internal controls associated with financial reporting systems; results of surveys of audit committees regarding the quality of auditor communications; trends in litigation cases against audit firms and trends in practice protection costs; the number and nature of (and trends in) internal quality reviews, PCAOB inspection findings and enforcement actions; and trends in and impact of reported frauds.

The AQI project was set in train by ACAP because it found that "audit firms provide limited information on audit quality to the public, particularly to audit committees and investors" (PCAOB 2013, p. 26). ACAP also believed that requiring audit firms to provide such AQI's would not only serve to improve audit quality but also stimulate competition amongst audit firms and enhance PCAOB oversight of such firms (ibid. 2013, p. 27).

The chairman of the PCAOB, James Doty, recently spoke at an ICAS' memorial speech of the audit market as "flirting with stagnation", as it was being regarded as an obligatory compliance function, best obtained at the lowest cost and viewed as "largely irrelevant to the investment process because of a lack of information and difficulty in discerning the difference between one audit and another" (see *Accountancy Age* 2013). In another speech to the Harvard Law School Forum on Corporate Governance and Financial Regulation, in May 2013, Doty observed that "significant factors have combined to deter the profession from innovating the audit to meet public demand" (pp. 2–3). Among key causal factors he included the way the statutory audit franchise had

shielded the profession from the risks of obsolescence and not given them a natural incentive to evolve their work. He lamented the restricted way in which the profession views the audit function, citing the work and views of University of Chicago economist, Luigi Zingales, who had said recently: "I don't know exactly what accountants are supposed to do, because every time I talk to an accountant, they're not supposed to do what I expect them to do."

Underpinning Doty's sense of a global concern with the audit function is:

the fact that regulators around the world have found that "auditors are too often accepting or attempting to validate management evidence and representations without sufficient challenge and independent corroboration". In particular, regulators have called for improvements in key areas – the sufficiency and appropriateness of audit evidence, auditors' professional scepticism, and auditors use of other auditors and experts (*Accountancy Age* 2003, p. 3).

Doty went on to list a range of initiatives that the PCAOB was pursuing, concluding that:

We may never have needed the external audit more. Yet the audit has, in the minds of some, become a commodity to be obtained from the lowest cost provider. We need the audit profession to compete on quality more than price. We need a profession that is revered for insight and clarity, not box-checking (ibid. p. 5).

With PCAOB Board member, Lewis H. Ferguson, having recently been elected as the chair of IFIAR for 2013–2015 and the PCAOB now firmly committed to playing a leadership role in IFIAR (see PCAOB 2013), the work of the PCAOB can be expected to be of a continuing significant international influence. Indeed, IFIAR's current strategic work plan includes "an examination of measures of audit quality and studying how the governance structures and business models of large auditing networks contribute to, or detract from, audit quality" (see IFIAR 2012).

Such declarations, strategies and commitments pose an immediate question as to how well placed the auditing profession is in terms of responding to such challenges. In this regard, it can be noted that there are some profession-led initiatives placing the subject of innovation

as their central or core *raison d'être*. For instance, the Audit Futures initiative has recognised that our:

society and the audit profession are both at a crossroads and we want to take this opportunity to develop a vision of audit that best serves society. Our approach is from the shared understanding that no single individual or organisation has the answers to the complex problems we are facing today. It is essential that before we think about answers, we find the right questions. We need to build our shared vision of the future and to acknowledge that there is no one right solution but several feasible pathways that could take us there. The first phase of Audit Futures is about convening a diverse multi-stakeholder community, building our collective intelligence, refining our vision for audit of the 21st century, and defining the pathways we can take to deliver these goals (Audit Futures 2013).

In a similar fashion, the CPA Canada/CPAB (2013) report identified that a "significant opportunity for the future of the audit is to develop a comprehensive plan to stimulate and integrate global thinking and practice to demonstrate and enhance the value of the audit" (p. 37), acknowledging that crucial factors needing to be factored into any such plans include (a) gaining a better understanding of what constitutes audit quality and (b) the role that the culture of an audit firm plays in enhancing audit quality (*ibid.*).

These matters were also addressed, albeit from a different perspective, in a recent Institute of Chartered Accountants in England and Wales' (ICAEW 2013) report on reliability and the role of the auditor. The report saw real dangers if the only public response to the perceived failure of reputational intermediaries such as auditors was to subject them to increased regulation and to look to build trust in emerging intermediaries such as public oversight bodies – "this can lead to a vicious spiral in which successive crises lead to a succession of failed reputational intermediaries, ever tighter regulation and the long-term erosion of public trust" (p. 21). To avoid such a "destructive" cycle, the report concluded by recommending that the role of a reputational intermediary:

must surely be seen as an evolving one: a role that requires a commitment to reliability, constant learning, engagement and a willingness to respond to public perceptions and adapt to change. Failures will continue to happen – reputational intermediaries are powerless to stop this – but it is how they are seen to anticipate and respond to failures that will determine whether they can secure long-term trust. Is such a vision realistic? (*Ibid.*)

This closing question as to the realistic nature of such a vision was left unanswered by the ICAEW but it is a critical question to address, and probably, from the perspective of the auditing profession, one that is not easy at present to answer in the affirmative given the mindsets that appear to dominate the practice environment in which audit work is undertaken. A powerful illustration of this is provided by Bedard et al (2010) in considering how the global network firms assess and manage audit quality within their practices. An extract from their paper is purposeful in demonstrating how the dominant cultural emphasis is one of inspection and control/compliance orientation:

Changes in the professional auditing environment in the past decade have caused audit firms to consider how to improve their practices in order to reduce the number of audit failures; improve internal consistency with existing firm and professional policies and procedures regarding GAAS and GAAP; and reduce and avoid negative results in the PCAOB inspection process. /.../ All of the global network firms have expanded the quantity and quality of their internal inspections since the Sarbanes-Oxley Act was passed in 2002. These inspections number in the hundreds of engagements annually *and exceed the number of PCAOB inspections within each firm by a multiple of four or five*. Most firms follow the practice of reviewing each partner periodically, with more frequent inspections occurring if a risk-based analysis of the engagement, engagement personnel, client or industry warrant particular scrutiny, or if concerns or problems had been raised or uncovered as a result of prior inspections (Bedard et al 2010, p. C16, emphasis added).

In such a practice environment, audit quality is defined by notions of inspection, monitoring and compliance. A broader rhetoric of audit quality may well be characterised by talk of principles and the strength of independent, professional judgement, but the realities of practice are dominated by a concern with compliance with standards and/or standard procedures. Further, this is a practice environment in which there does not appear to be a ready or distinct divide between firms and regulators in their commitments to a compliance culture, with regulators (as we have seen above, in a US context) encouraging firms to compete on quality not box ticking and audit firms' own inspections out-numbering external inspections (PCAOB) by a multiple of four or five.

While recognising the existence of potentially competing and conflicting rhetorics and change-drivers, the audit practice environment,

overall, does seem to be considerably removed from a working environment readily conducive to practice innovation and creativity of thought. The dominant focus is arguably one intent on avoiding deficient performance or justifying existing performance. Audits in compliance with standards or audits that set new standards of excellence are not ones that are of central concern; audit quality improvement looks to rest more in making deficient audits "standard", not making standard audits "better". This is a state of affairs that could be classified as the "innovation imbalance" in the audit quality balanced scorecard – and is one that needs rectifying.

Additionally, while the above referenced audit quality frameworks and thought pieces speak of the need or desire to "improve" audit quality and highlight ways to do this, the persuasiveness of their appeal is significantly reduced when it is recognised that the recommended areas of improvement in audit quality dimensions prove to be pretty static – covering similar sets of past issues, such as the need to close the expectations gap, to strengthen the tone at the top in audit firms, to make central to the firms' culture commitment to quality, independent auditing.

Improvement in this sense is not innovation, it is almost bordering on a sense of "catch-up", of rectifying the (same) errors of the past. Such a tendency is also evident in the way in which such policy documents place emphasis on the role of inspections and inspection findings in stimulating audit quality improvements. Firms are told to study such processes and reports closely and to learn from them – suggesting that the primary driving force behind what counts as practice development are the regulators, rather than the profession itself.

### **Thinking differently about audit – making innovation the audit practice standard**

It is of residing concern that after a considerable amount of activity in developing new governance codes for audit firms and enhancing communications between auditors, audit committees and prudential regulators in the five or so years following the outbreak of the global financial crisis, we have gained no substantially greater knowledge or insight into the practical quality and value of the work of auditors from what the profession has told us.

Of critical importance here is the need to change (or bolster existing efforts to change) ruling attitudes within the profession regarding the pursuit of quality enhancement in auditing; to enable a more visible and broad-based commitment to creative action on the part of the profession. This could be expected to incorporate deliberations regarding new constructions of audit and new audit approaches; audit "prototypes" (or "concept cars" as one of the big firms described a prior attempt) which the statutory audit function could subsequently adopt or incorporate. Creative action, though, does not have to be restricted to normative contemplations of future "ideal" audit forms, but can also involve more constructive and critical reflection on current audit achievements – as recently illustrated by Smith-Lacroix and his co-authors (2012) in their work considering the practical experiences of contemporary auditors and the extent to which the auditor's jurisdiction is being eroded in an increasingly market values-oriented financial reporting regime.

There is scope to talk more publicly about what auditors do and how they have performed on recent audit assignments – better explaining what auditors have done in the cases of companies affected significantly by the recent financial crisis, or talking more explicitly about where audits have worked best. There is room for enhancing insight into the type of audit activities, decision making and achievements that routinely remains invisible to stakeholders and users. A working mantra could be to declare that if audit quality is invisible it is so because the profession wants this to be the case. There is always a likelihood of encountering concern as to how the provision of visible examples of high or superior quality audit work could provide lawyers, and others wishing to take action against the profession, with valuable benchmarks with which to contrast the profession's performance when audits fail.

There may also be arguments that client confidentiality requirements inevitably constrain what auditors can reveal about the audit work they undertake. However, confidentiality can be preserved by sophisticatedly presented anonymous cases of audit practice, and the way in which international audit reporting standards are developing is certainly pushing in the direction of making audit judgements more visible. Indeed, if the profession believes in its own standards of practice, it is not difficult to suggest that it should be setting performance levels reflecting the heights of professional attainment – not the, metaphorical, "bargain basement".

While it may be an aid to standard setters and regulators in terms of the development of standards and determining the scope and focus of regulatory inspections, terms such as "an audit is an audit" are inherently anti-innovative. They represent audit in an unduly uniform and ultimately static view, which is strange given that it is a function with a longstanding expectations gap and a history of struggles to "improve" understanding of the audit and standards of auditor performance. Likewise, if we are serious about the importance of audit quality, we have to stop operationalising the concept in restrictive ways, wherein the pursuit of enhanced audit quality is dominated not by making quality audits better but by avoiding "deficient" levels of quality. So in thinking what a profession has to do in order to move, in the words of Öhman and his co-authors (2006), from "doing things right" to "doing the right things", we have to contemplate audit in a more open, less standardised fashion. Instead of saying an audit is (just) an audit, that one audit should be the same as any other, we must think differently about auditing.

In a world where innovation has not been strong or dominant, one anticipated response from the profession to such calls could be a request for greater detail as to what is meant by the term innovation and for the provision of more specific examples of what innovation should look like in auditing. This, however, would fundamentally be missing the point of a call for innovation. Innovations are unexpected, they have the capacity to surprise, to break new ground, to stimulate new thinking, processes and products; collectively, innovation can serve to make our lives better and more fulfilled. Innovation is something that an auditing profession, heralded for recruiting the brightest and the best, should be doing as a matter of course – attracting the nation's talented individuals and empowering them to innovate, not constraining them through ever extensive (internal and external) monitoring and inspection regimes.

Likewise, the capacity of innovation to make life better for individuals and society at large (OECD 2010) is certainly something that a profession committed to serving the public interest should be embracing. Formal definitions of innovation, such as that provided by the OECD, recognise four types of innovation – product innovation, process innovation, marketing innovation and organizational innovation. What would an audit look like that was fundamentally different (and more effective) than the audits that we have come to know as an

audit? What processes and procedures would auditors undertake to deliver such audits in smarter, sharper and more distinctive ways? How could we promote the audit function in novel, new ways, which do not rely on clichéd appeals to audit as being "boring" or, at best, "strangely" interesting? How could we restructure audit firms in ways that challenge existing hierarchies and modes of behaviour and empower people employed in such firms to contemplate the previously "unthinkable"?

All of these are fascinating questions and, while they may not be accompanied by ready prepared answers, they are connected by one overriding message. In a world so committed to standards and standardisation, the auditing profession could do a whole lot worse than to make innovation the new (audit) practice standard!

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