Audit quality practices and the quality of financial reporting

Pr.Dr. Djemaa Haouam

Djemaa.haouam@univ-annaba.dz

Abstract:

A primary goal of both financial reporting research and audit research is to understand the determinants of quality, and researchers in both areas have identified a wide set of variables that enhance or impair quality.

This study examines the impact of audit quality practices on the quality of financial reporting through a literature review and some studies using a descriptive and analytical method trying to find if there is a relation between audit quality practices and financial reporting quality.

The study found that there is a relationship between the measures of audit quality (auditor independence, technical training and proficiency and engagement performance) and financial reporting (measured in terms of reliability and relevance of financial report).

Key words: Audit Quality, Financial Reporting ,reliability, relevance

I. Introduction

The audit provides assurance to the owners and management of companies and to investors and stakeholders. Audit, along with financial reporting, corporate governance and regulation, supports confidence in capital markets.

Following the collapse of Enron and other high profile corporate scandals, the responsibility and quality of audit came under intense scrutiny on an international scale. Government, regulators and other stakeholders asked many hard questions about audit and the auditing profession. The very public debate that ensued on the role and quality of audit brought the auditing profession centre stage and resulted in significant changes in how auditors are regulated and the way in which auditors communicate and interact with regulators and other stakeholders.

Audit is a cornerstone of confidence in capital markets and making audit services of the highest quality is of crucial importance for all participants in the capital markets and especially important to the auditing profession.

Audit quality practices are procedures established by auditors to ensure that financial reports communicate relevant and reliable information to members of an organization and the public. These practices vary from one audit organization to another depending on their sizes, nature of activities and applicable legislations.

1.1. Research Problem:

What impact Audit quality measures have on financial reporting quality ?

1.2.Objective of the study :

The aim of this study is :

- Measuring Audit Quality .

-Measuring the quality of financial reports prepared by companies by assessing the availability of information characteristics in the preparation of financial reports.

-Identify the impact of audit quality measures on financial reporting through the framework of audit quality

1.3.Importance of the study:

This study seeks to provide a theoretical Contribution to the field of audit quality , Financial Reporting Quality through the use of audit quality indicators (auditor independence, technical training and proficiency and engagement performance) and financial reporting (measured in terms of reliability and relevance of financial reporting).

1.4- Study methodology :

In order to answer the following question “ Audit quality and its impact on financial reporting quality” we used the analytical descriptive approach to study the theoretical and practical studies in the subject with an extrapolation of the main results and presentation of them in order to increase the quality of the financial reports.

1.5. Hypothesis study:

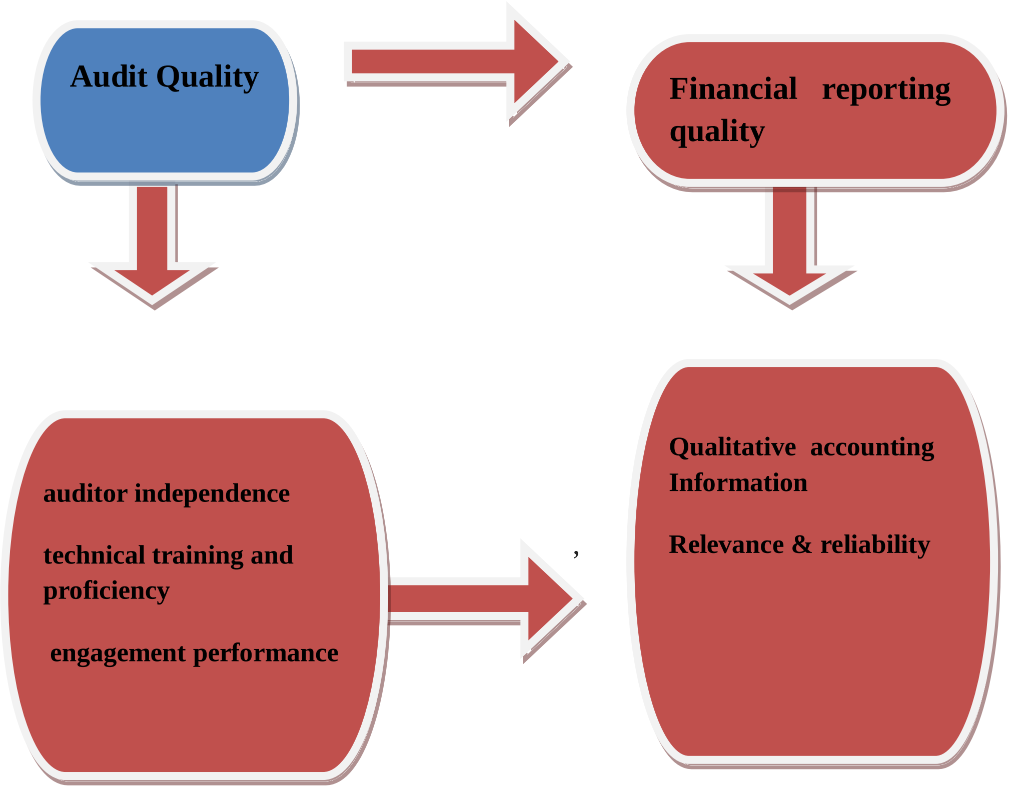
Based on the problem and objectives of the study we can formulate the following hypotheses :

H1- Quality of Accounting Information can be measured

H2- Audit quality has an impact on financial reporting quality

1.6 -Study variables:

Figure 1: Study variables



1.7. Study Axes :

In order to answer the problematic question we are going to divide this study into three axes as follow:

First, Audit quality framework (concept and indicators IIASB)

Secondly, Financial reporting quality

Finally; Audit quality impact on Financial reporting quality

II.Literature review and framework for audit quality:

Auditors play a key role in contributing to the credibility of the financial statements on which they are reporting. High-quality audits support financial stability. As the global auditing standard-setter, the IAASB has a public interest responsibility to develop standards and guidance for auditors to facilitate high-quality audits being achieved – which in turn builds public trust and confidence in financial statements and financial reporting more broadly.

Global financial stability is supported through high-quality reporting. Audits can help foster trust in the quality of reporting. This highlights the importance of audit quality—a topic of relevance to all stakeholders in the financial reporting supply chain.

The IAASB developed a Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality, which describes in a holistic manner the different elements that create the environment for audit quality at the engagement, firm, and national levels, as well as relevant interactions and contextual factors.

The objectives of the Framework for Audit Quality include:

- Raising awareness of the key elements of audit quality;
- Encouraging key stakeholders to explore ways to improve audit quality; and
- Facilitating greater dialogue between key stakeholders on the topic **quality**

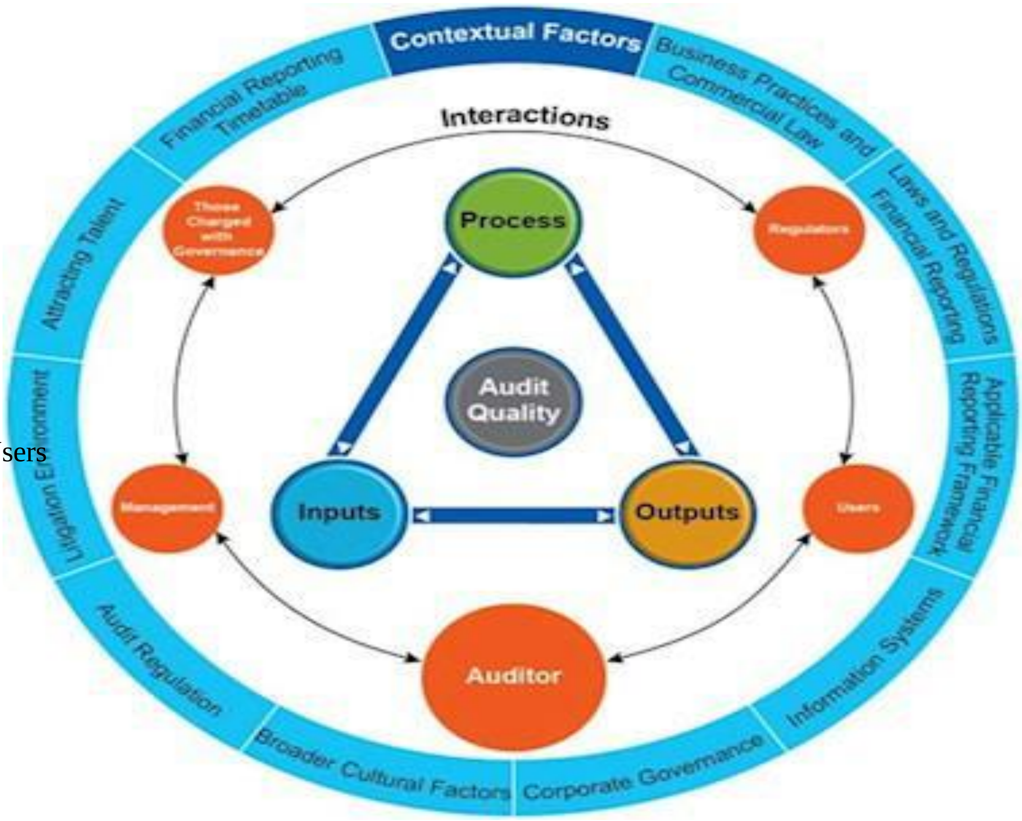
The Framework describes the **inputs, processes and outputs** factors that contribute to audit quality at the engagement, audit firm and national levels, for financial statement audits. The

Framework also demonstrates the importance appropriate interactions among stakeholders and the importance of various **contextual factors**

The Framework applies to audits of all entities regardless of their size, nature and complexity. It also applies to all audit firms regardless of size. The Framework is non-authoritative. It is not a substitute for standards of quality control, nor does it establish additional standards or provide procedural requirements for the performance of audit engagements.

Figure 1: The Framework can be presented as follows:

Users



Source : IAASB CAG Agenda (March 2011), IAASB CAG PAPER

Inputs

Quality audits involve auditors:

- Exhibiting appropriate values, ethics and attitudes,
- Being sufficiently knowledgeable, skilled and experienced and having sufficient time allocated to them to perform the audit work

Outputs

Quality audits result in outputs that are useful and timely. They are described in relation to the entire financial reporting supply chain and include outputs from the auditor, the audit firm, the entity and the audit regulators. Outputs include reports and information that are formally prepared and presented by one party to another, as well as outputs that arise from the auditing process that are generally not visible to those outside the organisation being audited.

Process

Quality audits involve auditors applying a rigorous audit process and quality control procedures that comply with laws, regulations and applicable standards.

Interactions

Each stakeholder plays an important role supporting high-quality financial reporting and the way in which they interact may affect audit quality. Increased interaction is promoted.

Contextual Factors

Collectively, the contextual factors have the potential to impact the nature and quality of financial reporting and, directly or indirectly, audit quality. Such factors include amongst others, laws and regulations and corporate governance.

2.1.Concepts of Audit quality:

There have been a number of attempts to define "audit quality" in the past. However, none has resulted in a definition that has achieved universal recognition and acceptance. Audit quality is, in essence, a complex and multi-faceted concept.

Literature documents differences in opinion as to what constitutes appropriate definition of audit quality. Saleh and Azary (2008:65 -77) defines audit quality as" how well an audit detects and reports material misstatements, reduces information asymmetry between management and stockholders and thus assist protect the interest of stockholders". While Palmrose (1988), defines audit quality as " the probability that financial statements contain no material misstatements". Also, Davidson and Neu (1993: 479 - 488) define audit quality as" a function of the auditor's ability to detect and eliminate material misstatements and manipulations in reported net income". While De Angelo (1981) reports audit quality as" the market assessed joint probability that a given auditor will both discover a breach in the client's accounting system and report the breach" .

These definitions, emphasis compliance with relevant audit procedures and standards . Users of financial statements demand nothing less than a report that conveys relevant and reliable information for decision making. This is made possible by auditors through the provision of quality services.

2.2.Audit Quality measures:

Scholars have put forward varying measures of audit quality, none of which is conclusive. Giroux and Jones (2011) identified five theoretical constructs to evaluate audit quality: auditor type, audit experience (industry and specialization), audit fee, demographics and local government type. according to a current study audit quality can be measured using in terms of auditor independence, technical training and proficiency and engagement performance[1]

2.21.Auditor independence

The international audit and assurance Standard Board (IAASB), a sub-committee of the international federation of Accountant (IFAC) defined audit as an independent examination of, and expression of opinion on the financial statements of a business enterprise by an appointed auditor in accordance with his terms of appointment and in compliance with the relevant statutory and performance requirement. The audit report is the end product of every audit assignment that the auditor issues to its client company expressing his opinion on the true and fair view regarding an enterprise financial statement.

According to the Consultative Council of Accountancy Bodies (CCAB), independence is an attitude of mind characterized by integrity and an objective approach to professional work. It is an attribute which qualifies an auditor to express opinion on matters of financial reporting without bias or undue pressure. As a result, possession of independent status constitutes an important ingredient in assessing quality of financial reports. The reasoning by Yamani (1991) that auditor's independence and auditing quality are viewed as important factors in auditor selection and thus indicate the confidence level in financial reports,

In addition, Wright and Wright (1997) in assenting to the essentiality of independence in financial reporting suggested that auditor independence is at the centre of the integrity of the audit process. Professional accounting bodies consider independence attribute as a key factor in measuring the performance of their members. For instance, the AICPA to secure quality control in the practice of its members, issued a statement on quality control standards which specifies five elements of quality control, amongst which is independence. In maintaining independent quality is to ensure that, personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional services with integrity and maintain objectivity in discharging professional responsibilities.

2.22.Technical training and proficiency

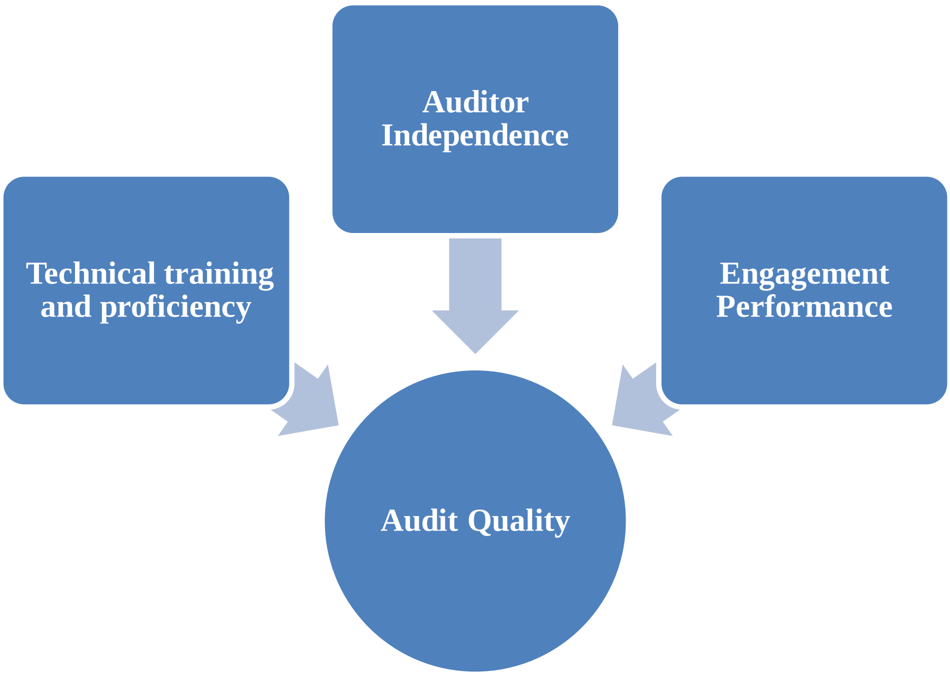
[1] **Loveday A. NWANYANWU,** Audit Quality Practices and Financial Reporting in Nigeria, InternationalJournal of Academic Research in Accounting, Finance and Management Sciences, Vol. 7, No.2, April 2017, pp. 145–155

As part of the criteria for the achievement of quality control in financial reporting, accounting bodies have made pronouncements in the area of technical training and proficiency aimed at providing guides in the retainership of auditors. AICPA's statements on Quality Control Standards on personnel management has the objective of providing assurance that audit personnel possess appropriate characteristics to perform competently; work is assigned to those with appropriate technical training and proficiency; personnel participate in appropriate continuing education and their professional development activities and personnel selected for advancement have necessary qualifications. Auditor's technical skill and proficiency impact on a variety of issues embedded in the audit process. For instance the technical capability of an auditor measured by the level of education, working experience and certification type increases his/her remuneration (Al –khaddash *et al*. 2013). Emphasizing on the importance of qualification in audit quality. Hameed (1995) reported auditor's experience and knowledge in accounting and auditing as prime factors that affect auditing quality.

2.23.Engagement Performance

This dimension of audit quality is anchored on ensuring compliance with established standards and procedures on every audit engagement. It is amongst the quality control procedures developed by AICPA. According to AICPA, the purpose is to provide assurance that work performed meets applicable professional standards, regulatory requirements and the audit firm's standards of quality. This is secured through extensive review of working papers and discussion of identified anomalies. Audit quality measures can be illustrated as follow:

Figure 2: Audit quality measures



2.3. Audit quality Control (ISA 220):

This sets standards and guidelines regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information and other assurance related services engagements. It requires that the firm should establish a system of quality control designed to provide it with reasonable assurance that the firm, and its personnel, comply with the professional standards and regulatory and legal requirements and that the reports issued by the firm are appropriate in the circumstances.

Quality control refers to the set of policies and procedures designed in the Company to obtain reasonable assurance of compliance with legal, regulatory and ethical requirements when performing and documenting financial and historical data. The nature and extent of quality control policies and procedures may vary depending on the size of the audit facility, the nature of the business carried out, the geographical location and the extent of the branching of the business and are also affected by the expected costs and benefits. The standard addresses the following elements, leadership, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance and monitoring. (ISA 220 requirements can be summarized below)

Figure 3 : Requirements

Source :Lesli Porter, ISA 220 – Quality Control for Audits of Historical Financial Information

2.4.Audit quality studies

Different studies have been done on audit quality that they can be divided into **Direct and Indirect Measure of Audit Quality. Direct measures** like: financial reporting compliance with GAAP, quality control review, bankruptcy, desk review and SEC performance are used as a measure of audit quality. **Indirect measures** like: audit size, auditor tenure, industry expertise, audit fees, economic dependence, reputation and cost of capital are used as a measure for audit quality. Perhaps the most commonly used indirect measure of audit quality is audit size.(Below a summary of some studies on Audit Quality measures)

Table 1 – Summary of some studies on audit quality measures

Studies	Indicators of audit quality

Al-khaddash *et al.* (2013)	adopt internal control, firm size, auditor's fees, auditor's independence, auditor's reputation, industry specialization and auditor qualifications and proficiency as measures of audit quality.
Al-khaddash *et al.* (2013)	adopt internal control, firm size, auditor's fees, auditor's independence, auditor's reputation, industry specialization and auditor qualifications and proficiency as measures of audit quality.
irth *et al*. (2012)	adopting auditor's tendency to issue a modified audit report as a measure for audit quality report a positive effect of mandatory audit partner rotation on audit quality in areas with weak legislation. The perceived audit quality associated with big audit firms as a consequence of their size also influences their retainer ship by high income earning organizations, thus measuring audit quality in relation to earnings quality of organizations.
Giroux and Jones (2011)	identified five theoretical constructs to evaluate audit quality: auditor type, audit experience (industry and specialization), audit fee, demographics and local government type.
Salehi and Kangarlouei (2010)	Suggest that measures of audit quality are : - auditor size, -auditor tenure, -specialty in auditor industry, -auditor authenticity risk - client legal claims, -auditor independence
Al-Ajmi (2009)	. in study of the assessment of credit and financial analysts on the association of the effectiveness of audit committee and size of auditing firm with audit quality, found that both analysts relate credibility of financial statements to size of auditing firms; assume that the nature of big firms permit them to produce better quality reports than small firms; non- audit services impact auditor's independence and as a result, diminish audit quality and agree that effective audit committee improves quality of audit reports.
Hameed (1995)	reports auditor's experience, honesty and knowledge of accounting and auditing standards as factors affecting audit quality
De Angelo (1981)	associates audit quality with size of audit firms.

Source: Arezoo Aghaei chadegani, Review of studies on audit quality, 2011 International Conference on Humanities, Society and Culture IPEDR Vol.20 (2011) © (2011) IACSIT Press, Singapore

III-Financial reporting quality :

Quality according to the Office Of Government Commerce (2009: 48) is degree to which a set of inherent characteristics fulfills requirements. Quality is generally defined as the totality of features and inherent or assigned characteristics of a product, person, process, service and/or system that bear on its ability to show that it meets expectations or satisfies stated needs, requirements or specification. financial reporting quality can be defined in terms of the fundamental and enhancing qualitative characteristics underlying decision usefulness as defined in the CF (IASB, 2018). The fundamental qualitative characteristics (i.e. relevance and faithful representation) are most important and determine the content of financial reporting information. The enhancing qualitative characteristics (i.e. understandability, comparability, verifiability and timeliness) can improve decision usefulness when the fundamental qualitative characteristics are established. However, they cannot determine financial reporting quality on their own (IASB , 2018).

According to IASB, the essential principle of assessing the financial reporting quality is related to the **faithfulness** of the objectives and **quality** of disclosed information in a company‘s financial reports. These qualitative characteristics enhance the facilitation of assessing the usefulness of financial reports, which will also lead to a high level of quality. To achieve this level, financial reports must be **faithfully represented, comparable, verifiable, timely, and understandable.** Thus, the emphasis is on having transparent financial reports, and not having misleading financial reports to users; not to mention the importance of preciseness and predictability as indicators of a high financial reporting quality .

As it is defined in the Conceptual Framework for Financial Reporting of the FASB and the IASB, there are agreed upon elements of high quality financial reporting. The qualitative characteristics of financial reporting quality include: relevance, faithful representation, understandability, comparability, verifiability, and timeliness. They are divided into fundamental qualitative characteristics and enhancing qualitative characteristics.

The *Conceptual Framework (2010)* identifies comparability, verifiability, timeliness, and understandability as the four enhancing qualitative characteristics.

3.31-Approaches to Measure and Assess Quality of financial reporting

Assessing the quality of financial reporting requires a broad range of measurements using models, proxies, qualitative characteristics, and other elements of financial reports. In the literature, three different dimensions of financial reporting quality are frequently used: Accrual-Based Models, Accounting Conservatism, and Earnings Managements (abnormal accrual). Many approaches have been used to measure and assess financial reporting quality, and new approaches are still being developed. In the literature and prior studies, the reason behind the large reliance upon using indirect measures (e.g. proxies for the financial reporting quality or stock prices) is that some of the financial reporting qualities are unobservable [2].

The existence of standards to achieve the quality of financial reports will have a significant impact on the development and activation of the role of regulatory bodies through the establishment of structures to regulate the administrative process, enact laws regulating the work of companies and the custody of shareholders' rights, as well as the importance of oversight and the role assigned to the external auditor The need for accountability increases investor confidence in the management of the company.

In order to measure the quality of financial reporting in terms of the qualitative characteristics (Ferdy and others , 2009) construct a compound measurement tool to comprehensively assess the quality of financial reporting in terms of the underlying fundamental qualitative characteristics (i.e. relevance and faithful representation) and the enhancing qualitative characteristics (i.e. understandability, comparability, verifiability and timeliness) as defined in ‘An improved Conceptual Framework for Financial Reporting’ of the FASB and the IASB (2008). They suggest that the measurement tool used in their study is a valid and reliable approach to assess the quality of financial reports. The measurement tool contributes to improving the quality assessment of financial reporting information, fulfilling a request from both the FASB and the IASB (2008) to make the qualitative characteristics operationally measurable.

3.32- Determinants of accounting information quality :

Several factors are pointed out in the literature as influencers of companies’ accounting information quality, such as corporate governance, audit firm, audit committee, ownership concentration, institutional investors and company internationalization.

[2]) Ferdy van Beest and others,Quality of financial reporting – measuring qualitative characteristics, Institute of Management Research Working papers ,April 2009 Nice

In this sense, a study done by (Geovanne , and others , 2017) revealed that a medium disclosure index equivalent to 78%. Most companies were listed at differentiated governance levels; were audited by the big four and had an Audit Committee. The mean percentage of stockholder concentration was 41.37%; in 44% of the companies, the stockholders included institutional investors; and only 19% had their stocks traded on the American stock market. As regards the determinants, being audited by the big four; having an Audit Committee; including institutional investors among the stockholders and being traded on

the American stock market reflect in higher quality of information disclosure.

IV.Audit quality impact on Financial reporting quality

Audit quality produces qualitative financial reports which in turn prevent financial crises (Kaklar *et al*., 2013). In another development; Palmrose (1988) viewed audit quality from the perspective of providing assurance that the financial statements will contain no material misstatements. By extrapolation, the reliability of financial statements is reflected in audit quality practices adopted in their preparation. Similarly, Shockley (1981) documents that perceptions of audit quality are vital as they determine the credibility of audit reports.

In addition, audit quality when considered in conjunction with auditor independence; impact the confidence level which users of financial statements have in financial reports (Al Khaddash *et al.*, 2013). Choi and Jeter (1992) illustrated a reduced stock market response to earnings reports when qualified opinions are issued and found that, if auditor quality is endangered, audit reports provide a lower level of assurance to users of financial statements. In other words, qualified audit reports as a consequence of poor audit quality, lead to reduction in the demand for shares of an organization in the stock exchange[3].

V. Conclusion:

Audit quality is a concept that has different definitions for different people. Users of financial statements perceived audit reports to provide absolute assurance that company financial statements have no material misstatements and do not perpetrate fraud . Audit quality has been investigated within a variety of perspectives in the literature. This paper has viewed the impact of audit quality on financial reporting quality , A key audit quality measure in the achievement of financial reporting quality. Professional accountants are therefore, expected to maintain independence posture in every audit assignment. This is vital for reliability and relevancy of financial reporting quality.

References

1.Audit quality an IAASB perspective, IAASB CAG Agenda (March 2011)

2.Arezoo Aghaei chadegani, Review of studies on audit quality, 2011 International Conference on Humanities, Society and Culture IPEDR Vol.20 (2011) © (2011) IACSIT Press, Singapore

3.Djemaa Haouam (2019),IT Governance impact on financial reporting quality Using COBIT framework, Remeh –Aman-Jordan , 35 issue , September 2019

4.**Ferdy van Beest and others**,Quality of financial reporting – measuring qualitative characteristics, Institute of Management Research Working papers ,April 2009 Nice

5.Hasan Maleki Kaklar, Saeid Jabbarzadeh Kangarlouei, Morteza Motavassel, AUDIT QUALITY AND FINANCIAL REPORTING QUALITY: CASE OF TEHRAN STOCK EXCHANGE (TSE) , Innovative Journal of Business and Management 1: 3 May – June (2012)43 – 47.

6.Lisa M.Gaynor,Andrea S.Kelton,Molly M.and Teri L.Yohn, Uderstanding the Relation between Financial Reporting Quality and Audit Quality,American Accounting Association

Volume 35, Issue 4 (November 2016)

7.Lawrrance J. Abbott, Brian Dothery, SUSAN Parker, GARY F. Peters, Internal Audit Quality and Financial Reporting Quality: The Joint Importance of Independence and Competence, Journal of Accounting Research, volume 54,issue 1, March 2016 pp3-40

8.Loveday A. NWANYANWU, Audit Quality Practices and Financial Reporting in Nigeria, International Journal of Academic Research in Accounting, Finance and Management Sciences, Vol. 7, No.2, April 2017, pp. 145–155

9.Shehu Usman Hassan , Musa Adeiza Farouk, Audit Quality and Financial Performance of Quoted Cement Firms in Nigeria, European Journal of Business and Management, Vol.6, No.28, 2014

10.**Siriyama K, Norah. A** , Financial Reporting Quality: A Literature Review, International Journal of Business Management and Commerce Vol. 2 No. 2; March 2017.