Independent Review into the quality and effectiveness of audit – Call for views

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Through its public interest remit, ACCA promotes appropriate regulation of accounting and conducts relevant research to ensure accountancy continues to grow in reputation and influence.

ACCA is a Recognised Supervisory Body (RSB) for audit under Schedule 10 of the Companies Act 2006. The FRC, as the audit competent authority, delegates certain audit regulatory tasks to ACCA as an RSB under a Delegation Agreement. This places an obligation on ACCA as an RSB to fund the FRC's performance of any tasks that have not been delegated where these relate to the regulation of auditors registered with ACCA. This funding covers the costs of the FRC's audit review activities, audit enforcement activities and standard-setting procedures.

We welcome Sir Donald Brydon's independent review into the quality and effectiveness of audit and its commitment to demonstrate an open-minded approach to the legitimate questions on the purpose of audit, its social usefulness and the extent to which it fulfils user demands. We would also agree that it is important that action is taken - there is an urgent need for audit to evolve –and all participants in the corporate governance arena need to address how the scope and purpose of audit can change to meet these expectations. It is vital that the UK economy has efficient and effective capital markets and there is confidence in the corporate framework with greater transparency of the health of a company through effective forms of audit and wider assurance.

Our response comprises a number of key points which we consider to be fundamental to the call for views. It has a particular focus on the expectation gap which is pivotal to this debate. Auditors cannot address the expectation gap in isolation. This may require changes outside of audit – such as the directors' responsibilities and in the framework of financial reporting. We also include responses to the individual questions posed in the Call for Views.

We welcome the opportunity to be involved as the review process progresses to support the development of an audit system that is proportionate, effective and credible and which operates to uphold the public interest.

ACCA Think Ahead

Executive Summary

- We welcome Sir Donald Brydon's independent review into the quality and effectiveness of audit. It is vital that the UK economy has efficient and effective capital markets and there is confidence in the corporate framework through greater transparency which works in the context of a global economy.

- In assessing the remedies proposed by previous reviews, including those conducted by the Business Energy and Industrial Skills Select Committee, Sir John Kingman and the Competition and Markets Authority (CMA), ACCA reiterates our long-held belief that any proposals must focus primarily on increasing audit quality. This is fundamental to investor and public confidence and the longevity of reform. It is also important to guard against unintended consequence. Adverse changes have the potential to impact on the attractiveness of the UK for business.

- The successful reform of audit (and change is needed) is dependent on the implementation of reforms across the wider reporting and governance ecosystem. Audit can ultimately only meet the needs of the user if reporting requirements also evolve to meet their needs. The responsibilities and accountability of directors and audit committees are critical and those who fall short of these responsibilities must be held properly to account.

- We consider that directors should be required to make a more explicit statement in respect of risk management and internal controls. This is of critical value to users. The importance of risk management in an organisation is critical to the sustainability of an entity - it is an essential element in the success or failure of organisations.

- The board, and in particular the audit committee, is essential to ensuring there is the right amount of challenge of the external auditor during the process and it is important that this challenge is transparent. The investor also has a key role in challenging the audit committee to ensure that this has operated effectively.

- ACCA supports the expectation gap's inclusion in Sir Donald's review. However, we believe there are in reality several gaps. We propose dividing the expectation gap into three components; namely, a knowledge gap, a performance gap and an evolution gap. Our research on the origins and perceptions of the expectation gap has highlighted a clear difference in opinion between the profession and the UK public over what is expected of an auditor.

- The performance gap, referred to as the delivery or quality gap as referenced in the call for views, is a crucial element of the expectation gap. Narrowing the performance gap should be a continuous exercise for firms of all sizes to ensure that audit quality is achieved and maintained.

- Our research highlighted the expectancy of a broader range of assurance over the activities of a company: it is critical we ensure there is clarity both now and in the future on what is and critically, what is not within the scope of a financial audit and wider assurance. If this is not considered from the outset then the expectation gap will not be addressed and will instead expand and cause greater confusion.

- Whilst the primary beneficiary of audit should remain the investor, audit is of immense value to other users. All participants in the regulatory and the wider profession must also do more to improve the understanding of the purpose and value of a quality audit. This must be underpinned by the exercise of professional scepticism - an essential part of the auditor's mind-set and the cornerstone of a quality audit.

- Enhanced narrative reporting by the auditor (supported by wider assurance requirements) will help to address the expectation gap and demonstrate the often hidden value of audit.

- It is important that in assessing all proposed changes that an impact assessment is undertaken to assess the cumulative, additional costs of expanding the scope and purpose of an audit and wider assurance.

- Our responses to the individual questions posed by Sir Donald's review are outlined in the following pages.

ACCA Think Ahead

Chapter 1 - Definitions of audit and its users:

Q1: For whose benefit should audit be conducted? How is it of value to users?

Audit has a vital role in underpinning confidence and trust in the capital markets. It is a fundamental element of the broader corporate governance in the reporting of the management of the company to its shareholders. Therefore, the primary beneficiary of audit is (and should remain) the investor.

However, there are a broad range of stakeholders who have an interest in the audit – this includes potential investors, regulators, lenders, credit agencies, tax authorities, employees and wider society and the interests and concerns of this broad range of stakeholders need to be considered when determining the future scope and purpose of audit. These users want greater targeted assurances over areas that are important to them. Some of these areas will involve more disclosures. There is an urgent need for audit to evolve and to listen to the public's legitimate concerns about audit.

Audit is of immense value to users but could be of greater value. All participants in the regulatory framework and the wider profession must also do more to improve the understanding of the purpose and value of a quality audit. A shared understanding of what constitutes a quality audit is the cornerstone in determining the future of audit. Fundamental to any definition of audit quality is the exercise of professional scepticism. If professional scepticism operates effectively audit quality will improve. ACCA has undertaken research in this area (Banishing bias: audit, objectivity and the value of professional scepticism)[1]. This research recommended changes to the standard-setting, regulatory and audit processes to improve and encourage audit quality and tackle unconscious bias, allowing for a more holistic approach that encourages market participants to think actively about cognitive bias – underlying behavioural drivers that could influence decision making – and take steps to minimise its impact on audit quality.

A quality audit requires a professional working relationship between the auditor and the audited entity as well as maintaining professional scepticism. In ACCA's further research on audit quality[2] we have identified the key tensions in the audit process and provided a guide to the features that a quality audit should possess, recognising that these features can be interrelated and sometimes act in tension. The 'closeness' between auditor and audited entity is an important factor; however, the report also notes that closeness may militate against independence. Balancing these tensions requires extensive consultation with stakeholders, drawing on their viewpoint of the role of the audit, and the value of the process to company, stakeholder and society.

The board, and in particular the audit committee, is essential to ensuring there is the right amount of challenge of the external auditor during the process and it is important that this challenge is

[1] https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

[2] https://www.accaglobal.com/gb/en/professional-insights/global-profession/Tenets-of-quality-audit.html

transparent. The investor also has a key role in challenging management to ensure that this has operated effectively to maximise the value to users. This should take place throughout the year and should seek to understand the areas of disagreement and areas where auditor engagement has led to changes in the financial statements and annual report. The extended auditor report provides additional insight to support this discussion. Further opportunities that could be explored are discussed in our response to question 25 to question 27.

The Call for Views (paragraph 19) states that some commentators consider that audit has not substantially changed in decades. Audit is part of the wider corporate reporting environment and this has changed dramatically in recent decades. It is important that these changes are considered to ensure that any future actions consider what has and has not been effective. The global financial crisis led to far-reaching changes to international financial reporting standards and auditing standards. The European Union's audit reform legislation in 2016[3], included restrictions on audits of public interest entities (PIEs), limitations on non-audit services that audit firms can provide, mandatory audit firm rotation and new requirements for audit committees to review audit quality. Changes to International Financial Reporting Standards (IFRS) included new, tougher requirements for financial instruments, revenue recognition, leases and insurance. Auditing standard setters also responded with new proposals in such areas as auditor reporting, accounting estimates, quality management, risk assessment and more.

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

Confidence in an entity and confidence in the financial statements are inter-related and therefore the audit of the future cannot be designed with only one of these objectives in its design. The financial statements reflect the activities and actions taken by an entity as these have impacted on the cash-flows of the organisation. Audit (as currently scoped) provides investors with confidence that the financial statements reflect the decisions and assumptions of management; in the future a broader scope of audit (and assurance) could support a consideration of the overall health of an entity.

The Annual Report and the financial statements currently contain both backward and forward looking information however it is evident that there is a broader demand for more holistic corporate reporting.

The success of this review will be dependent on a broader consideration of the full financial reporting ecosystem and the roles that finance staff, account preparers, management, board, audit committees, regulators and investors play in ensuring robust, reliable and transparent reporting. It is therefore critical that corporate reporting is considered in tandem with the future of audit.

Corporate reporting should provide a holistic picture of the performance of a business, beyond just showing investors its financial performance. In order to provide this, investors need more

[3] Directive 2014/56/EU https://eur-lex.europa.eu/legal-content/GA/TXT/?uri=CELEX:32014L0056 and Regulation (EU) No 537/2014 https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32014R0537

information on the business and the business model; management's view of the business outlook and prospects; strategy and intentions and performance, measured against both financial targets and the non-financial operational objectives that are used to manage the business and are often more leading indicators than the lagging financial ones.

Users want more disclosure from companies, particularly of non-financial information, such as on sustainability, and forward-looking information. Users also want assurance that this information is being disclosed fairly and accurately. In addition to investors, there are other stakeholders who are interested in the corporate track record, whether that concerns the entity's contribution to society more generally or to important societal objectives, such as limiting the effects of climate change or environmental degradation. Longer-term financial performance is influenced by these considerations. The International Integrated Reporting Framework is one mechanism of providing such information.

The audit evolution (which is required) should be designed to provide confidence in the annual report and finance statements that meet the changing demands and needs of users. The responsibility for the annual report and accounts is ultimately the responsibility of the directors in reporting their stewardship of the organisation. The role of audit is to provide confidence that this stewardship has been discharged responsibly. This currently focusses on the financial statement; however, a broader scope would provide the opportunity for a more informed evaluation of further elements of the stewardship of an organisation.

Q3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?

As outlined in our response to question 2, it is not possible to consider audit in isolation from the requirements for accounting standards. This will avoid changes being made which conflict with the responsibilities of directors of companies. It is also important to recognise that large business is dependent on global trade. The wellbeing of the interconnected global economy is predicated on the basis of robust, comprehensive, high quality and transparent financial reporting, auditing and ethical standards. These are supported by educational standards for professional accountants. It is therefore important that the UK avoids any changes which would result in unintended consequences and require business in the UK to incur far greater costs and therefore be less attractive to do business with. This is not to state that the UK cannot lead in areas; for example, key audit matters was developed and adopted in the UK before it was adopted globally.

International Financial Reporting Statement has been part of UK financial reporting since 2005 (EC Regulation 1606/2002). This Regulation requires companies with securities admitted to trading on a regulated market of any member state of the European Union (EU) to use 'international accounting standards' in preparing their consolidated statements. Non-consolidated reports can use UK GAAP under law and listing rules. International standards are those issued by International Accounting Standards Board for use and endorsed by EU.

The Companies Act[4] is the legislative basis which defines the roles of the auditor currently. Chapter 3 of the Companies Act 2006 details the function of the auditor and provides the following sections:

- auditor report (which includes the auditor opinion, directors report, directors remuneration, corporate governance statement)
- duties of auditor (which includes the basic company records, directors remuneration and the statement if information is not forthcoming)
- auditor duties regarding corporate governance statement
- auditors rights to information

The roles and responsibilities as detailed in the Companies Act are well known to auditors and the profession but are by their nature more difficult to highlight (or promote interest in) to a wider audience. This is outlined in more detail in our response to questions 4 to 6 which consider the expectation gap. The evolution of audit will require legislative changes to ensure that the function of the audit reflects any new requirements. Consideration should also be given to further enhancing the powers of auditors and their right to information to demonstrate that the directors of companies are required to provide information and to provide greater sanction if information is not provided. This is currently reflected in Section 501 of the Companies Act but is rarely used. Consideration should be given as to why this is not used in more instances.

Chapter 2 - Expectation gap:

Q4: Do respondents consider there is an expectation gap?

Yes. Public confidence in audit is decreasing and large corporate failures have led to a lack of confidence in the audit profession and the regulator by Parliament and by the wider public.

ACCA has undertaken a global research initiative entitled '*Closing the expectation gap in audit*'[5] which was published on 9 May 2019. We conducted this research believing it to be in the public interest for an open dialogue involving auditors, company management directors, the broader accountancy profession, stakeholders and the public to explore what kind of audit future the public expects. All play a role. Our findings demonstrate that importantly the public sees audit as part (but not all) of the solution to unacceptable corporate behaviour, making sure financial statements give a holistic 'true and fair view', and ensuring fraud is addressed and appropriate levels of professional scepticism are applied. In order to close the expectation gap we also need to ensure that the responsibilities placed on directors and audit committees reflect the demands of the wider

[4] https://www.legislation.gov.uk/ukpga/2006/46/contents

[5] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

group of stakeholders. For change to be successful, the full ecosystem supporting financial reporting must be considered.

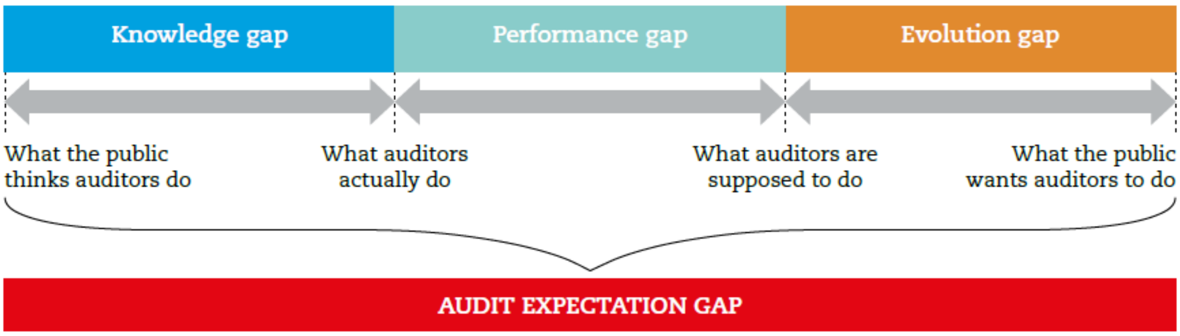
Our research on the expectation gap surveyed 11,000 people across 11 countries (including 1,000 in the UK), weighted evenly by sample size, gender and spread across age, education level and household income. The Countries included in the initiative are; Greece, Czech Republic, New Zealand, South Africa, Australia, Netherlands, Singapore, Canada, UAE, Malaysia and the UK.

The underlying data and statistics are available to the Brydon Committee.

Q5: If so, how would respondents characterise that gap?

In undertaking this research we defined the overall expectation gap as the difference between what the public thinks auditors do and what the public wants auditors to do. This is slightly broader than the definition provided in the Sir Brydon Review Call for Views which defines the expectation gap as “a perceived difference between what users of financial statements and the public expect from an audit, and what an audit is required to deliver under existing UK law and auditing standards”.

The definition used in our research reflects that whilst it is common to refer to the expectation gap, there are in reality several gaps. We propose dividing the expectation gap into three components; namely, a knowledge gap, a performance gap and an evolution gap. This distinction is critical in resolving the overarching expectation gap as different solutions are required to reduce each of them.



The characteristics of each of the expectation gaps that we have defined are outlined below:

<u>Knowledge gap:</u>

The ‘knowledge gap’ is the difference between what the public thinks auditors do and what auditors actually do. Firstly, it should be emphasised that the existence of a knowledge gap does not invalidate calls for auditors to do more, nor does it explain or excuse the performance gap.

In our survey, from a selection of multiple choice answers, only 34% of respondents globally were able to accurately identify what an auditor does - gives an opinion on whether the financial statements of a company give a true and fair view and do not include material misstatements due to fraud or error. This fell to 25% in the UK – which recorded the lowest level of public understanding across the 11 countries. Greece recorded the highest level of public understanding at 48%.

Addressing the knowledge gap cannot be achieved by auditors alone. As the Competition & Markets Authority has observed, 'most people will never read an auditor's opinion on a company's accounts'[6]. Reducing the knowledge gap will involve all stakeholders connected to the audit process, such as regulators, standard setters, professional accountancy bodies, audit firms, audit committees, investors, government and the media.

<u>Performance gap:</u>

The 'performance gap' focuses on areas where auditors do not do what auditing standards or regulations require. This could be because of insufficient focus on audit quality; the complexity of certain auditing standards; or differences in interpretation of auditing standard or regulatory requirements between practitioners and regulators. Audit firms are required to establish systems and processes to ensure quality in their engagements. As part of these processes, audit regulators regularly review files of completed audit engagements to monitor that quality is being achieved.

Further details are provided in our response to Question 6.

<u>Evolution gap:</u>

The 'evolution gap' reflects the areas of the audit where there is a need for evolution, taking into consideration the general public's demand, technological advances and how the overall audit process could be enhanced to add more value. Addressing the knowledge and performance gaps is, however, an important step in determining what needs to evolve in audit. This will help to avoid overregulation and inappropriate developments in audit and auditing standards, when the real problems could be lack of knowledge or poor performance.

Reducing the knowledge and performance gaps will allow greater focus on how audit should evolve. There is a need for a broad discussion between all closely connected stakeholders, such as auditing standard setters, regulators, professional accountancy bodies, audit firms, audit committee members, investors, governments and the general public on how the audit profession should evolve to remain relevant and meet investor and public expectations.

ACCA's proposals on evolving the audit are provided in our response to questions on Chapter 3 of the Call for Views.

A particular area for consideration is the auditors' response to fraud. The survey result in our research identified that the general public have high expectations from auditors when it comes to detecting and reporting fraud; and a substantial number of respondents believe that the audit

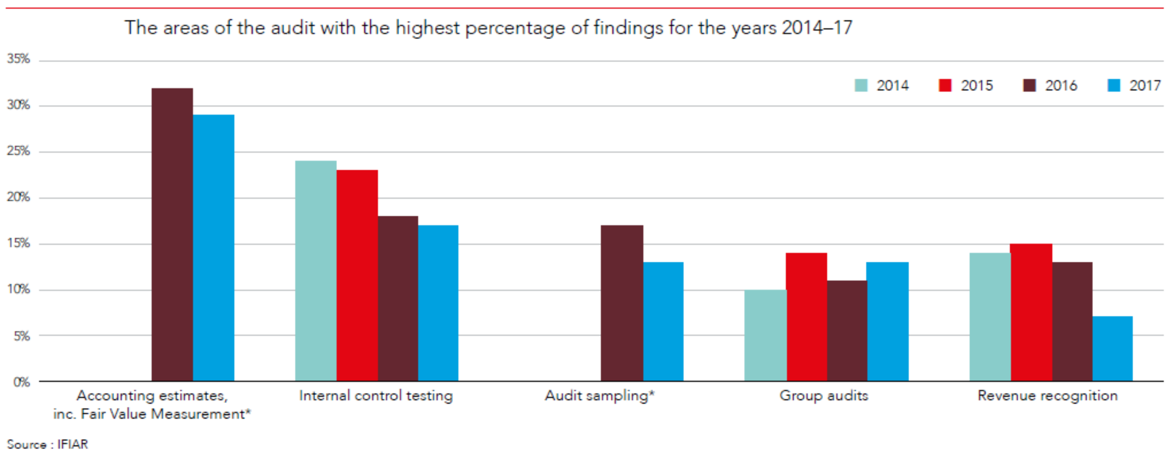
[6] Competition and Markets Authority2018

process can and should play an integral role in company safeguarding. This is addressed in our responses to question 36 to question 39.

Q6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

As outlined in our response to question 5, a critical element of the expectation gap is the performance gap (or delivery or quality gap as referenced in the Call for Views). Seeking to improve the quality of audit has been a focus of attention for many years. Narrowing the performance gap should be a continuous exercise for firms of all sizes to ensure that audit quality is achieved and maintained. However, even an audit conducted in perfect conformity with law and international standards of auditing may still not meet the expectations of all users.

The issue of audit quality is vital to public confidence in audit. Overall standards of auditing have improved due to the action of standard setters, regulators, firms and professional bodies. This is reflected in the fact that audited financial statements support confidence and decision making in all major economies and by reference to the latest available international inspection findings published by the IFIAR. IFIAR audit regulators tend to adopt a risk-based approach and focus on PIEs, so their findings may not be entirely representative of audit as a whole. Nonetheless, they can help to show trends in audit performance.



However, concerns and performance issues in individual audits remain. In ACCA's further research on the tenets of a quality audit[7] we have identified the key tensions in the audit process and a guide to the features that a quality audit should possess, recognising that these features can be interrelated and sometimes act in tension. Balancing these tensions requires extensive

[7] https://www.accaglobal.com/gb/en/professional-insights/global-profession/Tenets-of-quality-audit.html

consultation with stakeholders, drawing on their viewpoint of the role of the audit, and the value of the process to company, stakeholder and society.

Audit quality should be considered in the context of the tensions inherent in the audit process and the expectation gap debate should give consideration to a wider assessment of financial reporting requirements, the role of directors and audit committees as well as the audit arrangement, the scope and purpose of audit and the changing expectations on auditors.

Chapter 3 - Audit and wider assurance:

Q7: What should be the role of audit within wider assurance?

As outlined in our response to question 5, a key component of the expectation is the evolution gap. This reflects that stakeholders are seeking and expecting a broader range of assurance over the activities of a company and that they want auditors to provide more valuable insights into a wider range of measures.

A key element of the expectation gap (as outlined above) is a lack of clarity in what an audit encompasses – with only 25% of respondents in our survey of 1,000 members of the UK public being able to correctly define this. It is therefore critical when considering the role of audit in wider assurance that we ensure that there is clarity both now (and in the future) on what is and critically, what is not within the scope of a financial audit. If this is not considered from the outset then the expectation gap will not be addressed and will instead expand and cause greater confusion.

The terms of audit currently require the audit to consider backward-looking testing, in which the auditor tests historical transactions in the company's ledgers. At the same time, they increasingly require the auditor to have regard to forward looking information and to incorporate considerations of that information into the audit opinion and audit report.

The demand for the evolution of audit in the area of forward looking information is increasing. In our survey, the results show that the general public is demanding a far wider audit scope. Such scope includes assigning to the auditor more responsibilities for identifying and reporting fraud and undertaking more work on solvency, liquidity and viability. Many factors will influence and drive the general public's perceptions, particularly in times where information everywhere comes from various sources and it should be noted that those with the greatest understanding of what an audit does had the lowest demands for further evolution.

Evolving to meet increasing demands comes with opportunities but also risks and challenges. Currently, the financial audit opinion is only one piece of a range assurance that is available to investors. It is important that changes to the scope of a financial audit are considered in the context of this wider range of assurance. An articulated framework of assurance (with clear details of accountability) would help to bridge the expectation gap. This should also reflect the responsibilities of the directors of the company and the audit committee.

Testing historical transactions is different in nature from testing forward-looking information. Whereas in most cases it is possible to obtain evidence about a transaction that has already occurred, the auditor cannot test a transaction in the future. Instead, the auditor obtains evidence about the process by which forward looking information has been prepared as well as comparing assumptions about the future with evidence from present day data points and historical trends. With financial reporting standards making greater use of forward-looking information, public expectation of what auditors should do in this regard is also growing. The audit work includes an assessment of the assumptions made by management when considering the future performance. Management should ensure that their assumptions are clearly stated in the financial statements to allow the user to have an informed basis on which to consider the judgements. The inclusion of all assumptions in one section would also support transparency.

The Financial Reporting Council (FRC) considered the issues in auditing other information in a thematic review issued in December 2018[8]. This highlighted that changes to Standards and related guidance alone will not result in the necessary improvements in the quality and consistency of the work on the Other Information unless firms also drive improvement in the following areas:

- More prescriptive and targeted procedures, including templates and workbooks, to guide audit teams in the work they perform
- Specific consideration of the Other Information at the planning stage of the audit
- Greater emphasis on the review of key non-financial information, in addition to the financial information
- Increased scepticism and more attention on the completeness of the information, particularly the principal risk disclosures, and their linkage with the Viability Assessment/Statement
- Consistently requiring Boards to prepare, on a timely basis, separate papers and other documentation to support their Fair Balanced and Understandable (“FBU”) and Viability Assessment/Statements
- Ensuring staff with appropriate experience and knowledge of the audit are assigned to review the Other Information to identify potential material misstatements and inconsistencies.

The FRC report also emphasised that audit committees have a key role to play in supporting and improving the auditor’s work on the Other Information including:

[8] https://www.frc.org.uk/getattachment/7afae1fe-75c8-43fc-9f60-3f2a78b438a9/AQR-Thematic-Review-Other-Information-in-the-Annual-Report-Dec-2018.pdf

- Ensuring the Directors or their delegates provide the auditors with high quality papers and other documentation on a timely basis to support their FBU and Viability Assessment/Statements

- Engaging with the auditors at both the planning and completion stages of the audit on the work the auditor plans to/has performed on the Other Information to understand the level of assurance that this provides.

Q8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?

This would be technically possible however such a development would run a significant risk of creating greater confusion amongst both informed and more detached users of information and increase the expectation gap in audit and assurance.

Currently, International Standards on Auditing define a target level for the assurance required by the auditor. This is defined as 'reasonable assurance'. However, further articulation of what this means in the context of an audit would support greater clarity, consistency and provide for comparability and understandability across different entities within a sector and across jurisdictions.

If variable levels of assurance were to be adopted very clear disclosures would be required from both the company management and the auditors allowing this to be understood. An alternative option would be to provide for greater narrative reporting by the auditor. This would be particularly relevant in respect of the auditors' response to risk.

Recent development in the reporting on key audit matters (KAM) as required by International Standard on Auditing 701 have proved successful. The concept of a KAM was borne out of investor demand for more detail on the audit process: more contextual information to help investors differentiate between the large numbers of companies that receive 'clean' audit reports. The KAM requires the auditor to set out, in a separately identified section of the audit report, those matters that:

> '…in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period…selected from matters communicated with those charged with governance'

This has had a positive response from investors and audit committees as evidenced in ACCA's recent research 'Key audit matters: unlocking the secrets of the audit'[9]. This research provides an evidence basis covering 11 countries and draws upon a detailed analysis of 560 audit reports. The findings noted that the benefits of the additional information in KAMs went beyond the initial justification of useful information for investors and noted these additional benefits:

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[9] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Key-audit-matters/pi-key-audit-matters.pdf

- KAMs encourage better conversations between the auditor and those charged with governance; this in turn contributes to better governance

- KAMs help the auditor to focus on the areas of the audit requiring the most careful judgement; this in turn contributes to higher audit quality

- KAMs give preparers incentives to revisit financial reporting and disclosures in areas related to those KAMs; this in turn contributes to higher quality financial reporting.

However, it is also identified the risk that focusing too heavily on the precise requirements of auditing standards may lead to a 'tick box approach' to KAMs by some auditors and by regulators, thus losing the opportunity to communicate more effectively with audit committees and to stimulate better reporting. The experience of extended auditor reporting should be considered when assessing how best to evolve audit in order to draw from experience and understand what had the greatest impact.

Q9. Are the existing boundaries between internal and external audit clear?

Yes. The external auditor has and should continue to have full responsibility and accountability for an external audit report. It is clear both for auditors and company management and directors that internal audit is distinct from external audit activities but as noted in response to question 10 there are instances in which they interrelate. It is important that when this occurs work is conducted efficiently and effectively.

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

The current requirements are stipulated in International Standard on Auditing 610. This standard outlines the external auditor’s responsibilities relating to the work of internal auditors when the external auditor has determined, in accordance with ISA 315, that internal audit will be relevant to the audit.

We consider that the requirements of this standard remain appropriate. It ensures that the overall audit is planned effectively and efficiently and reflects that the external auditor retains fully accountable for the external audit opinion.

The divergence from UK practice with international standards in respect of providing direct assistance (as noted in paragraph 41 of the Call for Views) did not have any significant change on audit approaches in the UK as limited use was made of direct assistance prior to the change. The change also protects against the perception of a lack of independence. Internal audit staff report to and are remunerated by management and therefore there are risks (real or perceived) which arise when internal audit staff undertake work on behalf of the auditor.

The Call for Views recognises that the auditors of larger and more complex organisations need to have access to a range of specialist skills and experience beyond audit and accounting. We consider that this can be achieved through the continued use of multi-disciplinary firms. The

Competition and Markets Authority[10] recognises that audit firms rely on expert input of specialists for approximately 10-20% of a FTSE 350 audit, which is a material amount of expertise to outsource or retain within an audit-only firm. Most existing peer reviewed research points towards an increase in audit quality in cases where a firm offers both audit and non-audit services because it allows for the sharing of expertise and systems.[11] We would (based on the evidence) therefore support the continued existence of multi-disciplinary firms. Expansion to the scope of the audit will require a greater use of specialist skills and therefore changes to the scope of audit should be considered in conjunction with any changes to the structure of audit firms.

Q11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

No. We consider that the concept – and value – of external audit is based on the presumption that the auditor is independent from the audited company and free from any other conflicts of interest. The auditor must be objective in exercising professional judgement and therefore the existence of any threats to independence and conflicts of interest – to the extent that it is not possible to introduce safeguards to counteract them- can have a substantial and adverse impact on perceptions of the quality and reliability of the audit opinion and, ultimately, public trust in audit. It is therefore critical that the auditor is independent and is perceived as independent.

In our research considering the factors that contribute to a high quality audit[12] we did however note the tensions that exist between independence and the need to have a degree of understanding of an audit. This noted that a quality audit requires the auditor to maintain independence at all times when performing the audit. At the same time, audit quality is enhanced by the closeness to an audited entity that is acquired through repeated involvement in the engagement. For example, there is evidence that experience of the audit built up over several years can support the auditor's risk assessment under ISA 315.

An independent auditor is expected to challenge the audited entity more rigorously on contentious areas. As a result, greater independence is often proposed as a way of increasing audit quality. Yet an appropriate degree of familiarity with the business may help the auditor to identify the contentious areas of an audit more quickly, allowing more time for evidence gathering and challenge.

The main sources of threats to independence and conflicts of interest in UK PIE audits have arisen from long familiarity with audit clients and the revenue audit firms have received from providing non-audit services to audit clients. However, the regulation of these two areas has been tightened

[10] Par. 4.128, UK Competition and Markets Authority - Statutory Audit Services Market Study Update Paper

[11] What is the relationship between audit quality and non-audit services? An overview of the existing literature, Jan Bouwens (June 2018)

[12] https://www.accaglobal.com/gb/en/professional-insights/global-profession/Tenets-of-quality-audit.html

considerably in recent years. PIEs are now required to either appoint new auditors every ten years or reappoint the existing auditor for a single second term of ten years and the amount that audit firms may earn from providing non-audit services to audit clients has been capped. How successful these measures are in supporting auditor independence cannot be fully assessed until these have embedded.

In ACCA's response to the Competition and Markets Authority call for evidence we recommended that to further demonstrate auditor independence and not jeopardise audit quality and innovation that there be a "cooling-off" period following the end of an audit relationship during which the former audit firm is prohibited from selling services to the entity. This may help to allay public concerns that the auditor's judgement in the final years of the audit relationship could be affected by the firm's desire to sell consulting services to that entity in the following year. A cooling-off period of two years might be an appropriate balance between safeguarding independence and choice of service provider. This proposal was included in the BEIS Select Committee report on the Future of Audit.

Chapter 4 - Scope and purpose of audit:

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

Yes. We consider that directors should be required to make a more explicit statement in respect of risk management and internal controls. This is of critical value to users. The importance of risk management in an organisation is critical to the sustainability of an entity - it is an essential element in the success or failure of organisations.

ACCA has undertaken research considering the linkage between effective risk management and the performance of an organisation[13]. This notes that a Board's objectives can only be achieved when effective risk management is fully embedded across an organisation.

The nature of this proposed statement should be fact based and therefore remove elements of subjectivity. For example, it would be beneficial to the user of the accounts to understand how board-level risk taking and control objectives translate into the risk management activities. Board level risk taking is specifically linked to the delivery of the organisation's objectives including both management of downside risk and taking upside risk. That could include recognising how these activities are performed within organisations.

We consider that to have value this statement should be subject to audit. Effective risk management is supported by a range of internal factors which the external auditor will be well placed to consider. These include the leadership tone, internal communication and engagement and the success or failure of past risk management initiatives.

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[13] https://www.accaglobal.com/uk/en/professional-insights/risk/risk-and-performance.html

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

The current approach is designed to provide an effective but efficient audit. We would suggest that further engagement in this area would enhance the value of audit. This should include a requirement to consider the operating effectives of all key controls over significant risks or key controls relevant to the audit – regardless of the audit approach adopted. This could be supported by further narrative commentary in the extended auditor report providing an assessment on the operating effectiveness of controls. The adoption of formal auditing of controls (as in the US) should be assessed against empirical evidence of the Sarbanes Oxley experience in order to learn best from the experience.

To support this development, management and directors should be required to provide the entity's assessment of the issues identified as key risks and details of what action and systems it has in place to accept the risk or to mitigate against this risk.

In our research on the expectation gap[14] we asked the 11,000 respondents about the areas (from a list of options) which they would like auditors to do more. The most frequent response was in regard to the solvency, liquidity and viability of a company. This is considered in more detail at Question 22.

Q14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

Yes. As outlined in our responses previously, we consider that greater transparency through additional narrative reporting would serve to address elements of the expectation gap and meet the increasing needs of users. This should be included for all controls operating over significant risks or other key controls relevant to the audit and should include the evaluation of the risk arising from fraud.

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

We believe it is important that this area is revisited from both a company and auditor perspective. The regulatory framework requires further enhancement as trust in audit cannot be distinguished from trust in capital markets.

Going concern is the key responsibility of directors and management and changes must ensure that directors are held properly accountable. Assessment of going concern is based on directors and management's future predictions. It is critically important that they are transparent on the assumptions which they are basing their assessment on. For example, a clear articulation within one section of the annual report and accounts detailing the assumptions and beliefs that they are

[14] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

using would support users in applying their judgement to the robustness of the assessment. This could include far greater sensitivity analysis and seek to articulate the broader health of the company and the associated risks and dependencies.

As outlined in our response to question 17, viability is a fundamental element of going concern and directors should be required to make a positive statement on going concern which outlines the dependencies and assumptions on which they are relying.

The audit committee also plays a key role in their oversight of directors and management. Their role is to test and challenge the assertions and assumptions made by management. This challenge should be articulated in their report to ensure that investors and wider users of accounts can assess how effectively they have discharged their responsibilities.

A broader range of assurance considering the sustainability of the business model and the risks inherent within it would enhance the quality of the auditor's assessment. Our response to question 22 provides areas that would enhance audit quality in this area.

The Financial Reporting Council is currently consulting on the need for a stronger going concern standard[15]. This reflects their concerns[16] that:

> "Recent corporate failures and the FRC's own enforcement work has shown the existing Going Concern Standard needs to be strengthened. If the UK is to attract high-quality global investment, investors have to have confidence in audited financial statements and the prospects of businesses. Our proposals will significantly expand the work required of auditors – however, we believe this to be an important investment in the quality of the work that underpins what is a cornerstone of audit. This revised standard has been designed to better meet the needs of users and protects the public interest."

This consultation document proposes a number of areas and includes enhancing auditor's reporting in this area. We are supportive of this proposal.

The review should consider the evidence obtained from this consultation exercise in reaching its conclusion.

Q16: Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?

As outlined in our response, we consider that additional transparency through narrative disclosure in the audit process and findings would enhance value in the audit process. However, we would caution against any formal opinion on the viability of a business as this may have significant

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[15] https://www.frc.org.uk/consultation-list/2019/exposure-draft-proposed-isa-(uk)-570-(revised)

[16] https://www.frc.org.uk/news/march-2019/frc-consults-on-stronger-going-concern-standard-fo

unintended consequences and serve to hasten (or in some instances cause) the failure of an entity.

However, we support additional disclosure from management in respect of key risks impacting on the business and the business model of the entity. This should be supported by the audit committee's assessment of managements approach. This additional transparency could be supported by auditor commentary on the risks inherent in the organisation and on the business model adopted by the organisation and the effectiveness of actions being taken to mitigate these risks. The auditor would be well placed to provide this additional narrative commentary due to their understanding of the entity and the sector in which it operates.

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

The Viability Statement included in the Annual Report has the potential to be of immense value to users of the Annual Report. However, the impact and value of the Viability Statement has been limited. For the Viability Statement to meet its full potential the information included must be prudent, complete, relevant and reliable. Viability is a fundamental element of going concern and directors should be required to make a positive statement on going concern which outlines the dependencies and assumptions on which they are relying.

Q18: Should such a statement be subject to assurance?

We believe that the auditor should consider the director's statement in light of the knowledge that they have obtained in their audit of the financial statements and provide further public comment if they have material concerns.

The Financial Reporting Council's recent Audit Quality Thematic Review on Other Information[17] in the Annual Report considered the work conducted on Viability Statements. This highlighted that audit firms need to increase their focus on viability statements, noting in particular, that audit firms need to improve the application of professional scepticism and pay more attention to the completeness of the information, particularly the linkage of the Viability Statement with the principal risk disclosures.

The FRC report highlighted the following issues regarding quality (extract below):

> Audit files
>
> Overall, we noted that the auditor's consideration of viability and going concern was often combined. In some cases, the viability assessment work was viewed as an extension of the work on going concern. In other instances, the work on viability was considered as also covering going concern. In only a few instances were procedures targeted specifically at

[17] https://www.frc.org.uk/getattachment/7afae1fe-75c8-43fc-9f60-3f2a78b438a9/AQR-Thematic-Review-Other-Information-in-the-Annual-Report-Dec-2018.pdf

viability performed and documented separately from the going concern work (we comment on this under good practice).

Viability assessment

In five cases, there was no evidence of an explicit Board assessment of viability prepared to support the Viability Statement. In two of these cases (including one FTSE 100) the Viability Assessment had not been retained on the audit file in error. In one other case (FTSE 100) the audit team obtained the prior year's viability assessment but did not consider the appropriateness of one not being prepared for the current year.

We therefore consider that effort should be made to maximise the value of the Viability Statements prepared by companies (ensuring that these are prudent, complete, relevant and reliable) and address the audit issues identified by the Financial Reporting Council.

We are supportive of the recommendation by Sir John Kingman regarding the duty of alert for auditors to report viability or other serious concerns to the Board and to the regulator. This approach is adopted in other countries; for example, in Germany auditors report privately to regulators on a range of matters. This includes the going concern assessment and internal controls.

Q19: Who might be capable of giving such assurance?

In the context of our response to question 17 and 18, we consider that the auditor is best placed to undertake the assurance (as outlined). In undertaking this work the audit team will draw on the wider skills available to the audit firm (please see our response to question 10).

Q20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?

Yes. As outlined in our response to question 7 and questions 17 – 19 the demand for the evolution of audit in the area of forward looking information is increasing. In our survey on the expectation gap, the results show that the general public is demanding a far wider audit scope. Such scope includes assigning to the auditor more responsibilities for identifying and reporting fraud and undertaking more work on solvency, liquidity and viability. Many factors will influence and drive the general public's perceptions, particularly in times where information everywhere comes from various sources and it should be noted that those with the greatest understanding of what an audit does had the lowest demands for further evolution.

Evolving to meet increasing demands comes with opportunities but also risks and challenges. It is important that there is a clear framework supporting the range of assurance that is provided from auditors and other providers on company information. This should clearly articulate the level of assurance being provided and where accountability for both the provision of the information and the subsequent assurance provided rests.

Testing historical transactions is different in nature from testing forward-looking information. Whereas in most cases it is possible to obtain evidence about a transaction that has already occurred, the auditor cannot test a transaction in the future. Instead, the auditor obtains evidence about the process by which forward looking information has been prepared as well as comparing assumptions about the future with evidence from present day data points and historical trends. With financial reporting standards making greater use of forward-looking information, public expectation of what auditors should do in this regard is also growing.

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Yes. We consider that assurance over financial and non-financial information outside the annual financial statements would enhance its reliability. However, it is important that a distinction is drawn between assurance (which is specific to the information being presented) and an audit is emphasised. A financial audit is conducted in compliance with a complete set of international auditing standards on a complete set of financial statements prepared in accordance with international accounting standards. These would not apply for all areas outside of the annual financial statements. Therefore, there needs to be an assessment of what framework would apply for both the production of the information and the assurance to be provided. Ultimately, the financial reporting and auditing framework will need to evolve also.

In order to ensure that the user understands the assurance being provided on engagements that do not include the full financial statements, it is important that the scope and the level of assurance being provided (and any limitation) is clearly articulated for each area of assurance and that the beneficiary of this information is defined.

The assurance over financial and non-financial information outside the annual financial statements would have the additional benefit of potentially enhancing the robustness of the audit of the financial statements and audit quality.

Q22. If so, what information might usefully be subject to audit or another form of assurance and why?

There are a broad range of areas that might usefully be subject to assurance. These include:

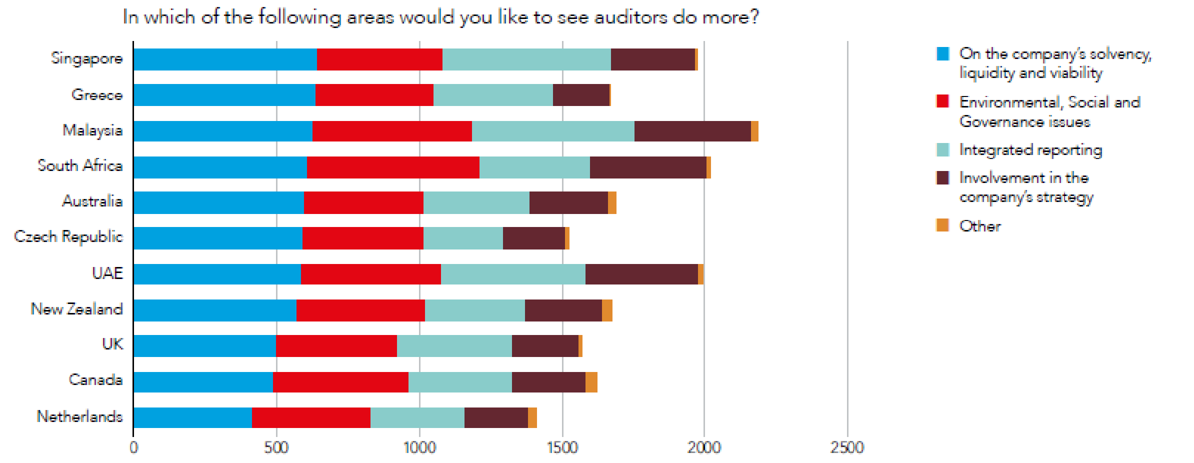
- A risk assessment of the business model in the context of the business, sector and external environment
- Key performance indicators linked to the achievement of the entity's strategy
- Overall tone at the top of the organisation and effective communication and engagement supporting corporate culture focussed on effective risk management
- Key performance indicators that are linked to the cash-flows of the entity
- Cyber-security

- Reliance on single sector for source of business (for example, Carillion and a reliance on government contracts) and an assessment of this against future cash flows

- Environment, social and governance issues

- Talent and capability – including the capacity of specialised knowledge required in rapidly changing environments.

In our response to question 13, we highlighted findings from our recent research on the expectation gap[18] where we asked the 11,000 respondents about the areas (from a list of options) which they would like auditors to do more. The most frequent response was in regard to the solvency, liquidity and viability of a company. The details of this area of the research are shown in the table below.



A broader range of areas will necessitate action to a wide range of skills and great use of specialists. This supports the continued need for multi-disciplinary firms. Superior audit quality can only be delivered if firms have the best people, services and knowledge at hand. Research shows the multidisciplinary model is one of the best mechanisms to develop the skills, expertise and consistency needed for quality audits[19]. This allows for a blend of specialists and providers and supports the added value of the ability to provide cross sector solutions.

[18] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

[19] [19] What is the relationship between audit quality and non-audit services? An overview of the existing literature, Jan Bouwens (June 2018)

ACCA Think Ahead

Chapter 5 - Audit product and quality

Q23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

Yes. We concur with the opinion expressed in paragraph 71 of the Call for Views. A quality audit should be considered from the perspective of the investor/end user and in the quality and confidence held in the audited financial reports. The audit process is merely a route to achieving a high quality audit. It should also be emphasised that the audit is only one part in the production of high quality financial information. We need to consider the full financial reporting ecosystem and the roles that finance staff, account preparers, management, board, audit committees, regulators and investors and auditors play in ensuring robust, reliable and transparent reporting.

A quality audit is vital to public confidence in the audit process and its value. However, the key elements of a quality audit can sometimes exist in mutual tension, and robust discussion among key stakeholders is required to align expectations, improve quality and maintain effectiveness of the audit system.

In 2014, the International Audit and Assurance Standards Board (IAASB) issued 'A Framework for Audit Quality'[20], which aimed to raise awareness of the key elements of audit quality, encourage key stakeholders to explore ways to improve audit quality and facilitate greater dialogue between stakeholders on the topic. We have sought to build upon the IAASB's Framework and articulate the features that a quality audit should possess. This is reflected in our guide the 'Tenets of a Quality Audit'[21] which outlined the features that a quality audit should possess, recognising their interrelation and occasional tension. These features were defined as:

- **Thoroughness and timeliness**: thoroughness in an audit is required to ensure that all risks are addressed and all issues are resolved prior to issuing the audit report; but at the same time, the value of audit to investors and the public also lies in its timeliness.

- **Independence and closeness**: an auditor is required to maintain independence at all times when performing the audit. At the same time, audit quality is enhanced by the closeness to an audit client that is acquired through repeated involvement in the engagement.

- **Standardisation and autonomy**: there is a certain degree of standardisation to an audit: at a basic level, the auditor must follow auditing standards. At the same time, however, the auditor must exercise some autonomy in determining where risks lie and which areas require greater investigation.

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[20] https://www.ifac.org/system/files/uploads/IAASB/Framework-for-Audit-Quality-Outline.pdf

[21] https://www.accaglobal.com/gb/en/professional-insights/global-profession/Tenets-of-quality-audit.html

- **Delivering a holistic opinion and responding to fraud**: audit quality requires the delivery of a holistic opinion – the 'true and fair view' – over the financial statements. A risk-based approach is vital to ensuring that, as far as possible, the auditor spends most of their time on the riskiest parts of the audit and that the opinion is holistic. At the same time, the auditor is required to respond to fraud or suspected fraud, so must test specific transactions.

- **Transparency and confidentiality**: Users expect an auditor to be transparent with them and not to withhold salient information from the audit report. At the same time, the audit process relies upon a shared understanding that private information (that, if disclosed inappropriately, could be damaging to the company and investors) will remain confidential.

Owing to the way the factors interrelate, in some areas there may be different views about how best to achieve audit quality. In part, these views will be influenced by the political, economic and social environment, as well as technological developments. Hence, the notion of what makes up a quality audit may change over time.

This review and the call for evidence is focused on the quality of the audit output in meeting the legitimate demands of those for whom the audit report is intended (as outlined in paragraph 70). One potential approach is to think about the psychology of audit. ACCA has undertaken research in this area (Banishing bias: audit, objectivity and the value of professional scepticism)[22]. This research recommended changes to the standard-setting, regulatory and audit processes to improve and encourage audit quality and tackle cognitive bias, allowing for a more holistic approach that encourages market participants to think actively about cognitive bias – underlying behavioural drivers that could influence decision making – and take steps to minimise its impact on audit quality.

Q24. Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgment?

Yes. This is a clear risk. A high quality audit and robust financial reporting is achieved through the exercise of sound judgement and professional scepticism by both the auditor and the preparer. As a state of mind, professional scepticism cannot be directly observed. It feeds into judgements which drive actions that the auditor then documents. It is therefore natural that regulators and oversight bodies tend to focus more on documentary evidence. This can drive negative impacts and incentivise a compliance based approach which can impinge audit quality and slow innovation. Similarly, other drivers of audit quality such as the tone at the top of an audit firm (and at a team management level) and the quality of the audit team are difficult to opine upon.

The proper documentation of an audit file is not however purely to support inspection. It supports effective oversight and review of the audit within the audit team, provides the granular detail

[22] https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

required to understand potential consequences of findings, supports against subsequent challenge and assists the preparer in ensuring that the evidence and judgements that they have obtained and made meet the objectives of the testing conducted. This demonstrates the professional competence of the individuals. Professional bodies have a clear role to play in ensuring that individuals have the requisite level of competence through the provision of high quality education, continuing professional development and ethical compliance. For example, ACCA has a competency framework[23]which sets out the highest standards of professional competence.

Whilst recognising this risk it should be noted that the audit inspection regime of the regulator is an important factor underpinning audit quality and its associated incentives and penalties. The desired objectives of an inspection regime should be considered as part of the wider review on audit. Currently the inspection regime considers whether the auditor has followed process and that the audit is undertaken in compliance with international standards on auditing. This does not conclude on whether the opinion presented on the financial statements is correct.

Q25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

The adoption of extended auditor reporting has demonstrated the value provided by additional disclosure by the auditor. Its implementation has been viewed in both the UK and globally as a positive development. In particular, early feedback from the UK was positive, although further evolution of the audit report has not developed as hoped.

This demonstrates the value and demand for additional information to be provided by the auditor. However, further research is required to assess whether a graduated approach will support greater engagement and understanding of audit and audit findings by investors and the wider users of financial statements. If a graduated approach is adopted then it is critical that this is based on the principles of proportionality, understandability and objectivity. There is a clear danger that graduated reports will become overly complex and subjective and therefore fail to meet the needs of users and increase the expectation gap.

ACCA undertook research in 2016 which included a consideration of auditor reporting by investors and auditors. Entitled ‘The Future of Audit’[24], this found that investors liked the ‘binary’ audit report in which the auditor must either commit to a ‘clean’ opinion or qualify the accounts. In general, however, users also wanted more contextual information to be provided, to explain the process whereby the auditors reached their opinion and the challenges they faced and overcame along the way.

More informative and relevant reporting by the auditor will help to clarify the public’s perception of what an audit is. It will also stimulate greater professional dialogues between the company, its investors, auditors and regulators. We would therefore support greater transparency through

[23] https://www.accaglobal.com/gb/en/qualifications/why-acca/competency-framework/competencies.html

[24] https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/ea-future-of-audit.pdf

ACCA Think Ahead

additional narrative reporting rather than the adoption of graduated findings which risks unintended consequences and may not help improve the value of audit. The audit report should reduce complexity, allowing users easy access to the information they need.

Q26. Could further narrative be disclosed alongside the opinion to provide more informative insights?

Yes, as noted in our response to question 25, our evidence supports the inclusion of additional narrative disclosure. For example, additional information could be included to articulate the audit findings and conclusions in respect of the risks addressed, greater visibility on the areas discussed with the audit committee and any resulting changes to the annual report and financial statements as a result of the audit work completed.

Technology provides the opportunity for more granular information to be accessed by those who want greater detail. This could support the communication of the audit findings in a tiered way – those wishing to only have assurance over the traditional binary conclusion would be able to see this and further narrative information would be available to those who required greater insight into the audit process.

Communication with stakeholders on the audit process is end-loaded. Consideration should also be given regarding transparent communications at the outset of the audit and throughout the engagement. At the outset of the audit, the auditor could articulate the key risks identified by management, the audit committee and the auditor and the planned approach.

It is important that clear principles supporting clarity, conciseness and objectivity underpin this development.

Q27. What would prevent such disclosures becoming boiler plated?

This requires the collective action of audit firms, regulators, audit committees, investors and professional bodies. If the disclosure is genuinely to add value and meet the expectations of users then it must focus on the specific risks of the entity. The audit committee has a key role in challenging the auditor if these disclosures are not suitably specific or do not reflect the full nature of the audit activity undertaken. The investor demand will also be a critical factor in their success.

ACCA's research 'Key audit matters: unlocking the secrets of the audit'[25] considering the experience of 11 countries and a review of 560 audit reports in the implementation of key audit matters identified that there is a risk that focusing too heavily on the precise requirements of auditing standards may lead to a 'tick box approach' to KAMs by some auditors, thus losing the opportunity to communicate more effectively with audit committees and to stimulate better reporting. The experience of extended auditor reporting should be considered when assessing how best to evolve audit in order to draw from experience and understand what had the greatest impact.

[25] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Key-audit-matters/pi-key-audit-matters.pdf

ACCA Think Ahead

Q28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

Audit must continually evolve and we welcome this opportunity to undertake a review of the purpose and scope of current audit. We do not agree that producer-led audit has inhibited innovation in audit or in standard setting however recognise that the regulated nature of this activity means that innovation is evolutionary rather than revolutionary.

In the last decade since the financial crisis, there have been far-reaching changes to international financial reporting and auditing standards. In Europe, the European Union introduced the audit reform legislation in 2016, including restrictions on audits of public interest entities (PIEs), limitations on non-audit services that audit firms can provide, mandatory audit firm rotation and new requirements for audit committees to review audit quality. Changes to International Financial Reporting Standards (IFRS) included new, tougher requirements for financial instruments, revenue recognition, leases and insurance. Auditing standard setters also responded with new proposals in such areas as auditor reporting, accounting estimates, quality management, risk assessment and more.

In respect of auditing and assurance standards, these must be set in the public interest as the role of the financial statements audit is to provide an independent viewpoint on the financial statements. Much of the current debate surrounding the setting of auditing standards provides the impression that auditing standards are in crisis, with concern over the involvement of the profession in standard-setting undermining public confidence in auditing standards. We do not recognise this depiction of the status of international auditing standards (ISAs). ISAs are used in over 120 countries. In many of these countries, ISAs are adopted voluntarily rather than due to the force of law. This does not provide an evidential basis to support the assertion that the involvement of the profession in the process undermines the principle of public interest nor that there is a lack of public confidence in the standards.

Chapter 6 - Legal responsibilities

Q29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

Management's responsibility, with the oversight of those charged with governance, is to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

The auditor should consider laws that impact on the reported information. It is important to ensure that the scope of the auditors' role is clear and therefore this should distinguish between matters that materially affect the financial statements and other matters.

This approach is reflected in current international standards (ISA 250 (Revised), Consideration of Laws and Regulations in an Audit of Financial Statements. This standard stipulates the following objectives for the auditor:

- to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements

- to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements

- to respond appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

The areas of focus for the auditor should be on those which have the greatest impact. This should be well known by the organisation and those charged with governance, the auditor based on their knowledge of the entity and sector; and the market.

A key area of focus must be on those laws and regulations that will impact on the entities ability to trade. There are many laws and regulations that a reporting entity may have to comply with in order to continue in business. For example, many entities will have to comply with strict health and safety legislation; a food manufacturer may have strict food hygiene legislation to comply with, and an accountancy firm will have a code of ethics to follow from its professional body. Such laws and regulations will have both a direct effect on the financial statements and an indirect effect.

Laws and regulations that would have an impact on the entities ability to trade would include capital maintenance as reflected in the Call for Views paragraph 89. As outlined in our evidence to the BEIS Select Committee we consider this to be integral to the financial audit. Please see our response to question 30 and 31 for our views on additional disclosures and clarity in this area. It would also include where the consequence of a failure will result in political pressure on activity. This would be particularly relevant to laws and regulations relating to environmental concerns which would have a significant impact on petroleum, mining and extraction industries.

Identifying non-compliance with laws and regulations can be challenging for auditors, particularly where fraud and/or money laundering is concerned. It is for this reason that the auditor must maintain a high degree of professional scepticism and remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

Q30. Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

Firstly, we support the supremacy of law over accounting standards and believe that the auditor has a responsibility to ensure that dividends are only paid out of realised profits and to report accordingly if this is not the case. This is especially important where an entity records significant unrealised gains on assets valued by directors.

It is clear from the current debate that the perception of an inconsistency between company law and accounting standards remains and this has been exacerbated by the circumstances surrounding the collapse of Carillion. It is important that this issue is addressed and resolved. To address this, we suggest that the guidance on this subject is revised to provide a simpler guide for preparers, auditors and users to follows. As outlined in our response to question 31, it follows (as a consequence) that entities must disclose in their financial statements the amount of total reserves that are realised and unrealised. This is - and should be - subject to audit.

The responsibility for assessing distributable reserves rests with the directors of the company and it is critical that this is discharged in a prudent and responsible manner with full consideration of the sustainability and long term reputation of the organisation.

Q31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

Yes. There is no requirement under law or accounting standards for financial statements to distinguish between distributable profits and non-distributable profits. A clear statement should be available in the financial statement disclosing the amount of realised and unrealised reserves and clarifying distributable reserves. This would be subject to audit and consideration should be given to an explicit requirement for auditors to report on the legality of dividends in their audit report.

For interim dividends, full accounts are not currently required. However, the directors are required to have sufficient information available in order to enable them to make a reasonable judgement as to whether the amount of the ‘distributable profits’ at the date of payment are acceptable. This could be strengthened and a specific requirement introduced for companies to involve their auditors prior to declaring a dividend. The nature and scope of this engagement would need to be precise and a determination of whether the auditor would provide assurance or undertake agreed upon procedures concluded.

Q32. How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records? Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?

The Companies Act requirements as stipulated in Section 386 present only the minimum requirement that a company must comply with. It would be beneficial if the requirements for directors were enhanced to reflect that accounting records must support the effective management of a company – including the payment of any interim dividends – and that in effectively discharging their responsibilities the accessibility of information and the speed with which it is available are considered.

The auditor is currently required to consider whether accounting records are adequate. This is a basic requirement of audit approaches but does not fully reflect the speed with which the information can be collated.

Advancements in technology mean that the basic checks undertaken by both management and the auditor regarding the veracity of the data can now be undertaken automatically.

Chapter 7 - Communication of audit findings:

Q33. Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

Increased visibility on the audit process may well have a positive impact on audit quality and if enacted correctly would support greater trust in audit and seek to reduce the knowledge gap that is intrinsic within the wider expectation gap. However, we believe that the introduction of an annual assurance meeting open to all stakeholders could lead to unintended consequences and would not have the desired effect. We therefore (as outlined in our responses to questions 25 -27) are supportive of greater narrative commentary by the auditor to provide more transparency on the audit process.

The call for views (at paragraph 97) recognises that the audit committee holds the direct relationship with the auditor and we would welcome greater engagement between investors and the audit committee.

Q34. Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?

Yes - The audit committee is an important part of effective corporate oversight and audit committees play a vital role in capital markets' investor protection. We believe that the audit committee's role and the accountability mechanisms supporting the effective operation of their functions and demonstration of their engagement, oversight and challenge of the external auditor should be further considered. This would support a constructive engagement and enhanced accountability.

As part of this, greater disclosure of the communication and the judgements that occur between the auditor and the audit committee would be a positive development. This would support the additional narrative reporting by the entity, the audit committee and the auditor to which we have referred to in our response to questions 25 -27. This additional communication should focus in particular on the risks identified and managements' and the auditors' response to the risks and provide insight into the hidden value of an audit. This can be achieved by detailing areas of disagreement and challenge between management and the auditor and the impact on the annual report and accounts of the audit process.

Q35. Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?

Yes. As outlined in our response to question 8, the impact of the introduction of key audit matters has been a very positive development. This is evidenced by research from the FRC and ACCA's recent research 'Key audit matters: unlocking the secrets of the audit'[26]. In addition, to the inclusion of 'key audit matters' in which the auditor lists the areas of the audit that involve the most risk - and therefore require the most judgement – and explains the audit approach to those areas, the changes also enhanced communication and understandability by re-ordering the audit report to include at the front the information that is most relevant to users. There are also improvements in highlighting going concerns issues.

This research also demonstrates that the value of the extended audit report goes beyond the information disclosed and includes better governance, enhanced audit quality and better corporate reporting. For example, our research identified:

- Publication of KAMs has provided new focus for discussions between the auditor and the audit committee. For the first time, there is transparency in the most important audit issues that were discussed between the audit engagement partner and the audit committee. As a result, feedback from audit committee members shows that disclosure of KAMs has resulted in improvements in corporate governance.

- There is also evidence (in ACCA et al. 2017) that reporting by the auditor in relation to part of the financial statements has, in some cases, led companies to add to the disclosures in the financial statements made in previous years. In this way, KAMs have catalysed better financial reporting.

ACCA believes that these benefits will be the true legacy of KAMs. Hence, it is important that auditors are given the encouragement to continue to deepen their reporting of KAMs in audit reports and further additions are considered.

Further innovations in the audit report are clearly possible and desirable. This would include greater linkage between the current year audit and the prior year audit and the suggestion in the call for views for the extended auditor report to include an update on KAMs featured in the prior year would help meet support this continuous narrative. In addition, consideration should be given to the auditor presenting a public planning document which outlines the risks that will be addressed in the current year audit. This would provide opportunity for the shareholders to challenge the proposed approach or seek clarification or understanding of the approach in advance of the audit being undertaken.

[26] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Key-audit-matters/pi-key-audit-matters.pdf

ACCA Think Ahead

Chapter 8 - Fraud:

Q36. Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?

No. As outlined below the expectations of broader stakeholders exceed the requirements placed on the auditor. This is a significant contributing factor to the expectation gap.

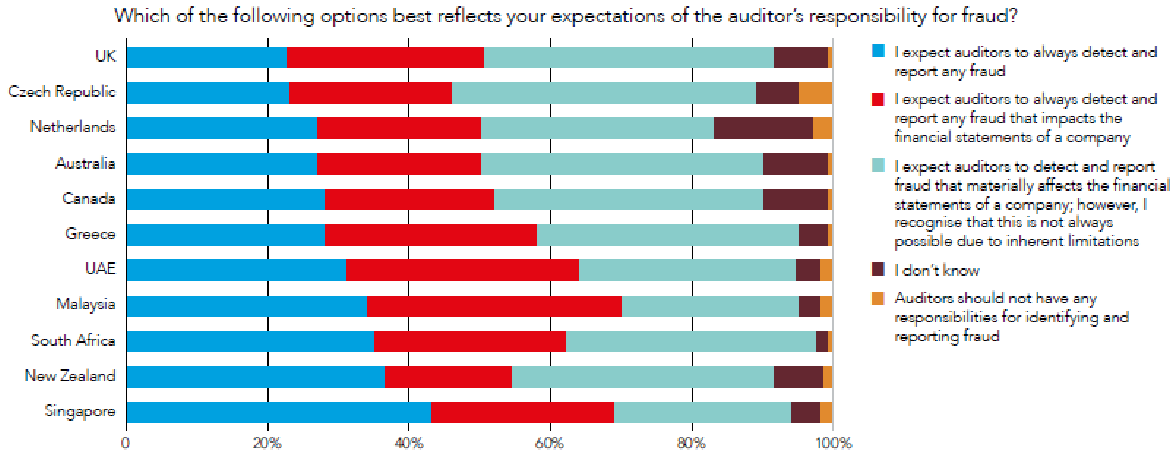
The requirements in UK law and auditing standards stipulate that the objectives of a financial audit is to obtain reasonable assurance as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This provides a high level of assurance, but is not a guarantee that an audit will always detect a material misstatement due to fraud.

Therefore under the current requirement, any material misstatement should be (but is not guaranteed to be) detected if impacting in the reporting period. Cases in the media often relate to instances where a fraud is not only material but ultimately has led to company failure. Such instances arise in areas of weak governance where audit focus on the potential risk of fraud should be higher.

In our research exploring the expectation gap [27] we asked the 11,000 respondents what (from a list of options) did they consider the auditors' responsibility in respect of fraud to be. This question was intended to find out what the general public expect from auditors in detecting and reporting fraud.

The aggregated results of the survey (see below) show that a large percentage of the respondents expect more from auditors in relation to fraud. Some 35% want auditors to 'always identify and report any fraud'. Surprisingly, only 6% chose the option 'I don't know', indicating that the general public has a strong view when it comes to the responsibilities of the auditor in relation to fraud.

[27] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf



It is not reasonable or feasible for audit to detect all fraud and therefore in this area there is a need for education on the limits of what an audit can reasonably achieve – it should not be considered a forensic analysis or equivalent in rigour to a fraud investigation. In order to support this education piece, standard setters, regulators, audit firms and professional bodies should develop strategies for improving communication on existing auditing requirements and to make these more accessible through the use of plain English and through a wider channel of dissemination.

However, it is equally important that the quality of the audit work meets the requirements of the standard. The increase in the use of technology in audit will support higher quality risk assessments in respect of fraud and more targeted sample selection. Technology provides the opportunity for the auditor to consider 100% of a population against agreed parameters and identify all exceptions. This should not be considered 100% assurance (which would increase the expectation gap) but it does provide the opportunity to enhance the quality of the audit work in this area.

Q37. Do existing auditing standards help to engender an appropriate fraud detection mind-set on the part of auditors?

Yes, however more can be done. Professional scepticism is an essential part of the auditor's mind-set and the cornerstone of a quality audit. Professional scepticism is defined in the standards as:

> '*An attitude that includes a questioning mind, being alert to conditions that may indicate a possible misstatement due to error or fraud, and a critical assessment of evidence'*

ACCA believes that, because professional scepticism is defined in terms of a state of mind, further improvements in professional scepticism must be informed by an understanding of psychology. In particular, the literature on cognitive biases is particularly helpful in understanding how all stakeholders in the financial reporting process – auditors, preparers, investors, regulators, standard setters and the public – use information, in practice, to make decisions. We explored this in our research 'Banishing bias – audit, objectivity and the value of professional scepticism'[28]

This report argues that a new approach to professional scepticism is needed if expectations of further increases in audit quality are to be met. There are two main reasons for this. Firstly, existing auditing standards are susceptible to cognitive biases by auditors. Auditors need to plan and execute their audits differently in order to mitigate the effects of these unconscious biases. Additionally, in some areas, the auditing standards themselves may need to change.

Professional accountancy bodies and audit firms also have a key role to play. At ACCA professional scepticism is embedded in our qualification and in the ACCA Rulebook to which all members are held accountable to.

The mechanisms available to audit firms to promote and develop professional scepticism in their partners and staff vary from establishing an appropriate 'tone at the top' down to making sure that junior staff are coached individually on the importance of professional scepticism in their work (see also our response to question 56.

The detection of fraud by management (and which may be supported by collusion at senior levels within an organisation) is by its nature difficult to detect. Additional responsibilities placed on banks and government agencies may provide further intelligence to the auditor in discharging their responsibilities. For example, a reporting requirement on banks could be introduced which requires them to report all new bank accounts to the entity's auditor. Similarly, there may be value in introducing a whistle-blowing requirement for government agencies who have suspicions about a private sector entity to report those suspicions to the entity's auditor.

Q38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

Yes, it would be possible to devise such a test. However, in doing so it is important that the test reflects the structural limitations placed on all audits. There will always be an information asymmetry between the entity and the auditor. The entity has much better knowledge about its business than the auditor does.

When considering the appropriateness of actions and conclusions, particularly where one is judging the standards expected of a professional accountant, the test applied is the 'reasonable and informed third party' test. This test is an evaluation of the appropriateness of the professional accountant's conclusions in an impartial manner. It involves, therefore, a consideration of whether another party, weighing up all the relevant facts and circumstances that an accountant is expected to know or could reasonably be expected to know at the time a conclusion was reached, would reach the same conclusion.

[28] https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

The reasonable and informed third party test is applied by the International Code of Ethics for Professional Accountants (and in turn by the ACCA Code of Ethics and Conduct), including in assessing the implications and possible courses of action when responding to non-compliance with laws and regulation. A reasonable and informed party may be an individual, a disciplinary tribunal or any other third party with appropriate experience and knowledge to understand and evaluate the matter concerned.

The test should also avoid the cognitive bias referred to in our response to question 37. For example, hindsight bias - once people know that something has happened they overestimate how easy it should have been to predict it. Academic research finds that hindsight bias could affect the regulatory process (Anderson et al. 1993). Regulators, with the advantage of knowledge about misstatements and fraud, may take the view that misstatements and fraud should have been identified by the auditor. Therefore, the auditor's failure to identify them is portrayed as a lack of professional scepticism.

Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

The principal responsibility to ensure that an audited entity's systems to prevent and detect fraud are adequate rests with directors and those charged with governance.

From an audit perspective, unless rebutted, there is a presumption in ISA 240 that there is a risk of material misstatement due to fraud in revenue recognition (ISA 240.26). Hence, it is very likely that the issue of fraud in revenue recognition and what the auditor has done to address it will form part of the discussion between the auditor and the audit committee. And therefore it will, in almost all cases, be a candidate for inclusion as a Key Audit Matter. Whether it is selected as a KAM will depend on whether it is 'of most significance in the audit of the financial statements in the current period'.

In the first year of implementation in the UK, most audit reports did include the risk of misstatement due to fraud in revenue recognition as a KAM. The FRC's first year review was critical, noting that it was unhelpful for there to be KAMs that are generic rather than specific and that such disclosure did not comply with the requirement for KAMs to be 'of most significance… in the current period'. As a result, disclosure of fraud in revenue recognition as a KAM dropped significantly in the second year and subsequent years in the UK.

We believe that there is now value in revisiting whether this approach and resulting disclosure meets the public expectations on the auditor's approach to fraud and the demonstration by the auditor of professional scepticism. We would support additional disclosure in the extended auditor report to support greater transparency on the work taken by the auditor to address the risk of material misstatement due to fraud.

Chapter 9 - Auditor liability:

Q40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

Yes. We believe that the audit professions' willingness to embrace change is constrained by the exposure to litigation. However, this may only be one of the barriers. This is a significant issue and must be addressed if audit is to evolve to meet the needs of users. It has not however prevented the UK being viewed as a world leader in auditing and this is reflected in the confidence in the capital market.

Q41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

It is not necessarily the case that a quantifiable limit on auditor liability would necessarily lead to improvements in audit quality and/or effectiveness (in the context of what constitutes an audit at the present time). We would agree with the call for views statement in paragraph 119 which reflects that the reputational damage arising from an audit failure is a more significant threat to the continued viability of the larger firms than the potential inability to meet a successful claim.

However, the challenges presented by auditor liability impinge on the audit to evolve. This issue has been live for many decades and resolution proves elusive. We would therefore support the approach proposed in paragraph 121 in the Call for Views which suggests retaining the current liability regime for the statutory audit against defined standards and applying a different approach to liability in respect of wider assurance services within the context of a redefined statutory audit. The Review should also consider the liability regimes in different countries and the impact that this has had on audit quality and evolution of the audit and wider assurance activity in these jurisdictions. Many countries within Europe have limited or proportional liability regimes.

Q42. Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?

An audit is conducted on the basis of an assessment of materiality and therefore an auditor cannot be held to account for all balances and disclosure contained within the annual report and account. Any extension must be considered in tandem with auditor liability and a loss must be able to be demonstrated. Under an unlimited liability regime this development is likely to stifle innovation.

Q43. How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

There is no direct correlation between reducing an auditor's liability and the quality of the current financial audit. However, we consider that the level of innovation would increase and the options of providing a level of assurance on more forward looking information (as sought by stakeholders) would be greater. The changing and increasing expectations of users can be used as an opportunity to demonstrate the currently hidden value of an audit. As a result of the audit process material changes are made to annual reports and accounts, control weaknesses and governance are highlighted and addressed and recommendations supporting wider business improvement are implemented. The evolution of the audit product would allow greater visibility of these by-products of an audit. It could also provide for a comparison between entities and across sectors.

Q44. To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?

Individual firms will be best placed to respond on this question. However, it should be noted that the level of insurance required will not just relate to the claim but also to the costs associated with any litigation. The litigation landscape is continually changing and speculative claims are evident in certain areas of litigations and this may impact in the future on audit and insurance costs.

Chapter 10 - Any other issues:

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

The latest advances in technology promise significant benefits for the audit process and audit quality. They will also be pivotal in supporting the broader range of assurance that is being demanded. ACCA is currently undertaking research considering the use of technology in the audit process. This will be published in late June 2019. This considers the impact of data analytics, robotic process automation, natural language processing, artificial intelligence, machine learning, deep learning and distributed ledger technology.

The findings (supported by panel discussions and interviews from audit practitioners, audit regulators, technology experts and client representatives) indicate that data analytics is the most mature of the technologies being used in audit, while artificial intelligence (AI) is not yet at a stage when it is embedded in everyday practice.

Medium and larger audit firms have invested heavily in data analytics in order to capitalise on new technology and improve audit quality. The most common area of focus was initially focused on journal entry testing and in risk assessment activities but this has now expanded into the areas of receivables, payables, revenue and salaries.

The use of sophisticated computer algorithms to analyse large amounts of data could reduce cognitive biases in the audit process and provide for richer sampling. For example, rather than deciding which transactions to test and taking the risk that the selection process is affected by bias, the auditor can use data analytics to query 100% of transactions against set parameters and test all outliers. Data analytics also promises to reveal patterns in a company's data that will make it easier for the auditor to identify and follow up unusual items, as well as providing stronger audit evidence.

However, as noted by the IAASB in Exploring the Use of Technology in the Audit, with a Focus on Data Analytics[29] (page 8) 'Being able to test 100% of a population does not imply that the auditor is able to provide something more than reasonable assurance opinion or that the meaning of 'reasonable assurance' changes.

Technology cannot replace the audit judgement that is derived from experience. Automation can reduce errors and spot patterns that may reveal underlying problems but this merely sets the stage for auditors to exercise thought and judgement, and to bring into play other skills, such as communication, persuasion and empathy. The evaluation of results still requires assessment, judgement and human evaluation and the auditor to be the filter, narrator and independent challenging voice. Professional scepticism will remain a key competency.

In the future, the use of more advanced technologies such as Artificial Intelligence, machine learning and distributed ledger technology provide the platform for a more transformative change in auditing in line with the increasing expectations, supporting audit evolve from the historical backward-looking exercise to a proactive, source of forward looking insight, with the auditor as the custodian and interpreter of the underlying data. However, the widespread use of these technologies in audit is still at early stages and they are used in limited cases.

The challenges and opportunities posed by technological advancements (including but not limited to data analytics, robotics and Artificial Intelligence) cannot yet be fully ascertained and we should not seek to standardise nascent practices while the full benefits may not yet have been realised. This review should therefore recognise the possibilities of technology whilst simultaneously maintaining the quality of the existing reporting, auditing and regulatory environment.

Therefore although technology might have the potential to enable higher assurance in the future, that does not appear to be the case at the moment.

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

As outlined in the response to question 45, new technology or advances in existing technology will enhance the quality of assurance that can be attained through broader coverage and more targeted testing. This should therefore improve audit quality whilst provide efficiencies in audit effort.

Our research on machine learning[30] considers its impact across the finance professions (including audit) and highlights the opportunities for the use of machine learning technology in the risk

[29] https://www.ifac.org/system/files/publications/files/IAASB-Data-Analytics-WG-Publication-Aug-25-2016-for-comms-9.1.16.pdf

[30] https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/machine-learning/pi-machine-learning-report.pdf (page 20)

assessment process and how this could support improvements in fraud detection. In risk assessment, supervised learning algorithms can be used to help identify specific types or characteristics that warrant greater scrutiny and improve targeting areas of focus for the audit. However, whilst technology advances will allow audit tools to be more sophisticated, auditors will also need to consider, and appropriately manage, potential new ethical compromises that may result from decision making by an algorithm.

Advances in Natural Language Processing and Deep Learning will allow information beyond the financial statements to be considered. This could include social media to inform considerations of future predictions. These technologies can analyse a range of internal and external sources and provide complimentary audit evidence and feed into the narrative requirements of audit.

The developments in technology have – and will continue – to remove the need for low level processing and high volume testing as standardisation and automation of data collection change the accounts production process. The auditor role will pivot towards non-transaction management elements requiring human judgement, business context and complex technical accounting experience. The longer term impact for audit as an industry may mean a reversal of the current model, in which largely predictable, high volume work is charged on an input basis, with the attendant risks of commoditisation and low margins (as raised in the Call for Views and in the BEIS Select Committee hearing). Instead, the audit model could move towards a value based model based on outputs – higher margins, fewer people and more high-end skills.

Technology advances also impact on the entity that is being audited. The technology can lead to greater complexity in the business model but also can support improvements in internal controls. This can reduce the risk profile of an organisation and therefore have a corresponding impact on the external approach adopted. For example, we now see organisations using predictive analytics and experimenting with blockchain and drones to strengthen their internal controls.

Q47. Are there aspects of current audit procedures or output that are no longer necessary or desirable?

Changes to the scope and purpose of the audit will clearly result in procedures changing. However, we cannot foresee circumstances where the existing audit opinion will not still be viewed as valuable and desirable.

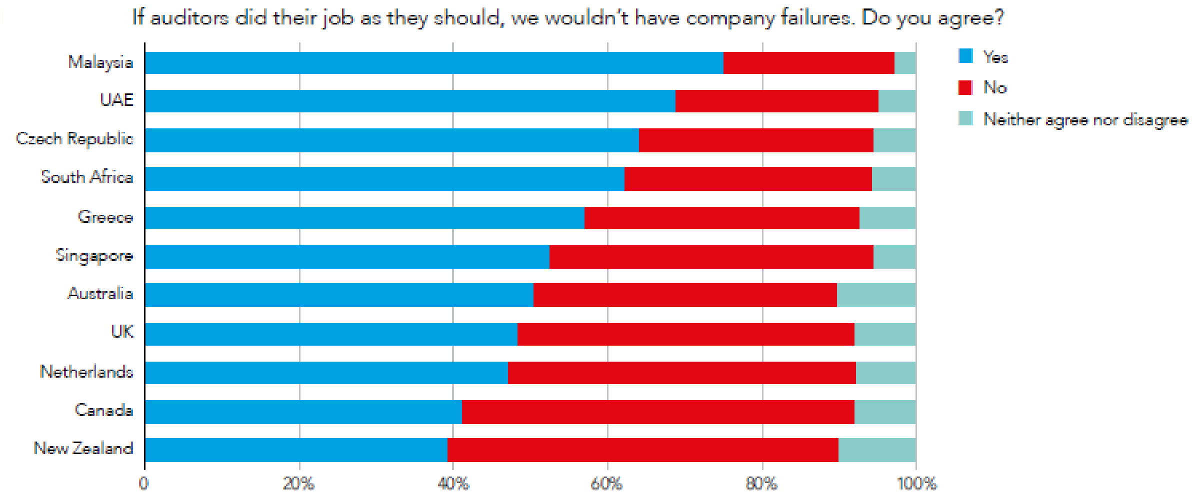
Current audit procedures only need to be applied where relevant and therefore whilst changes in the scope of the audit and advances in technology may mean that assurance can be obtained through different mechanisms or more efficiently (for example, through automation of reconciliations etc.) the desired outcome of the audit procedures will remain as a minimum at their current level.

The call for views in paragraph 128 notes that some have questioned whether all notes to the financial statements need to be audited. Limiting the audit opinion to certain sections of the financial statements will cause confusion and potentially increase the expectation gap. Much of the debate on the future of audit is in reality a challenge to the information that is required to be reported and whether this provides a sufficiently forward looking perspective. Therefore, in any consideration of the scope and purpose of audit there also needs to be a consideration of the information that is required to be reported. A great deal of effort has been invested by the International Accounting Standards Board in seeking to streamline financial statements and the related disclosures. We have been very supportive of this endeavour. If notes to the financial statements are not deemed to need independent verification then a key question is whether these notes are required by the users of the financial statements.

Q48. Given that a zero failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

Audit is assurance, not insurance. It does not – and cannot – inoculate against loss from 'any diminution in value of shareholders' invested capital'. Risk-free investment would pay a risk-free return, not an investment return. We do not think it will be helpful to seek to calibrate the value of an audit in relation to the limitation of potential failure.

In our research on the expectation gap we sought to understand whether the public considered that an audit as defined today should prevent corporate failure.



According to the aggregated results of the survey, 55% of the respondents believed that existing auditing standards, if followed, would prevent company failure. Where survey respondents chose the option 'neither agree nor disagree', they were invited to explain their answer further. The fact that 93% of respondents chose either a 'yes' or 'no' answer indicates that the majority of the respondents had a strong view when answering this question. The reality is that while an audit may identify some conditions that could lead to company failure in the future, if overlooked, such as a material uncertainty in relation to 'going concern' or 'significant control' deficiencies, there will always be risks to a company that the audit does not currently address, such as the sustainability of the company's business model. This gap should be considered as an area for additional assurance as the scope of the audit evolves – see question 16 to question18.

Avoiding company failure is primarily a responsibility of a company's management. While the results of this question indicate a knowledge gap in this area, it is important to recognise that the respondents see audit as having a role in preventing company failure. Audit must respect what the public wants, needs and expects – while also recognising that this may change over time and there is a need for an on-going global conversation among business, the audit community, government and other stakeholders to tease out these factors and help us understand them better. For example, these research findings would support consideration of the scope of the audit being extended to encompass and assessment of the risks inherent in the entity's business model and management's response to these risks (see our response to question 22).

The value of audit should be calibrated to consider whether a high quality audit has been delivered which provides value to the users of the financial statements. This needs to be supported by the audit inspection regime of the regulator and its associated incentives and penalties, including the public opprobrium that follows company failure.

Q49. Does today's audit provide value for money?

Yes. Financial audit is of value and presents value for money. A value for money assessment considers the economy, efficiency and effectiveness of audit.

At the highest level, the wellbeing of the interconnected global economy is predicated on the basis of robust, comprehensive, high quality and transparent financial reporting, auditing and ethical standards. It is vital that the UK economy has efficient and effective capital markets and there is confidence in the corporate framework through greater transparency. This is fundamental to investor and public confidence and the longevity of reform. The importance of global standards is critical as divergences lead to additional cost for business.

At a lower level audit's value comes from three key areas:

- **Technical** - there is value from the audit testing that auditors do. For example, when an auditor determines there is a risk of material misstatement from revenue, it is the procedures the auditor designs to reduce that risk that delivers value to investors.

- **Emotional** - the human side of auditing delivers value. Investors and wider stakeholders receive a premium on the emotional intelligence and judgments exercised by the audit team.

- **Psychological** (the 'Hawthorne Effect') - employees respond positively to knowing that somebody is taking an interest in their working environment. For example, an auditor being interested in financial reporting and controls will stimulate better financial reporting etc.

High quality audits can only be achieved if they are adequately funded and have sufficient resources. Therefore, the audit fee charged must reflect the underlying costs of the audit. Any expansion to the scope of an audit will incur additional costs (see our response to question 50). It is important that the value in these changes is recognised by shareholders and that any resulting increase in audit costs is met. For investors, in the vast majority of listed companies, the audit fee is immaterial in relation to total dividends paid. Usually, the most important determinant of the price of ordinary shares is amounts of dividend expected in the future.

From an economic perspective, the BEIS Select Committee explored whether audit costs were recovered. In the evidence sessions, all firms stated that audit remained profitable but at lower margins than other lines of service in a mutli-disciplinary firm. All stated that they prioritise quality over profit whenever extra work is needed The value for money from an economic perspective could be supported by greater transparency on fees and therefore we are supportive of the proposal by the BEIS Select committee which recommends that:

> FRC and its successor require greater reporting on audit fees, potentially including the disclosure of audit hours, staff mix, and rate per hour. Auditors should also report instances where they have performed additional procedures but have been unsuccessful at increasing their fee[31].

Q50.How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?

It is important that in assessing all proposed changes that an impact assessment is undertaken to assess the cumulative, additional costs of expanding the scope and purpose of an audit (and wider assurance). The shareholders ultimately agree the audit fee and therefore they can make an assessment on whether the additional assurance represents a good return on investment. In addition to the financial cost of the changes, an assessment will need to be made as to the additional time that will be required to complete work and again the market will need to determine the optimum return on receiving more granular information with a broader range of assurance versus timely information. Thoroughness and timeliness both contribute to audit quality - a detailed, thorough audit may not be timely and a fast audit may not be thorough.

A detailed impact assessment will provide an evidence base for changes to audit.

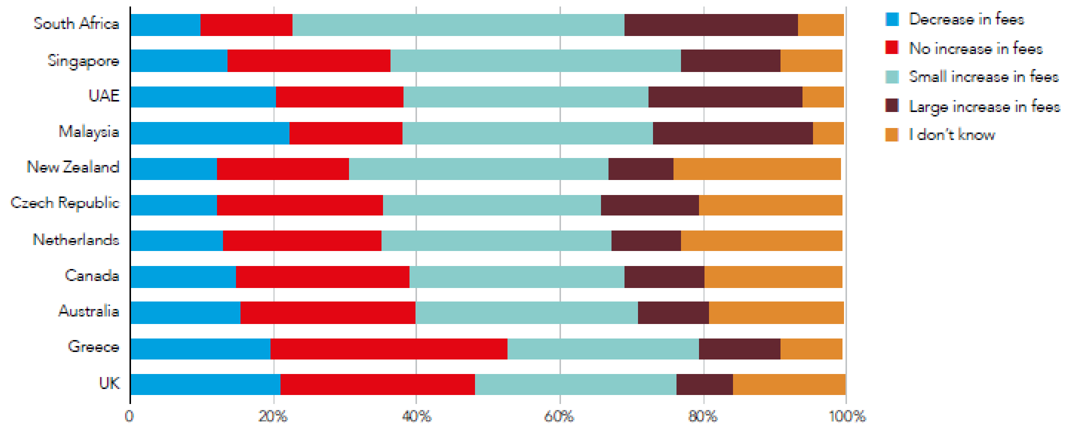
While there appears to be a clear appetite for auditors to do more, particularly in relation to fraud and preventing company failure, in our research exploring the expectation gap, we sought to understand whether the public provided a consensus on whether auditors should be given higher fees or more time to undertake these responsibilities.

Our questions sought to explore the extent to which the public is willing to accept higher fees and slower audits (i.e. an increase in the time allowed for completing the audit) if their proposal were adopted. The answers to these two questions proved to be very interesting, with 34% of the respondents willing to accept a small increase in both audit fee and time. It is therefore important to recognise that although the public's demand levels for an increase in the scope of audit are high

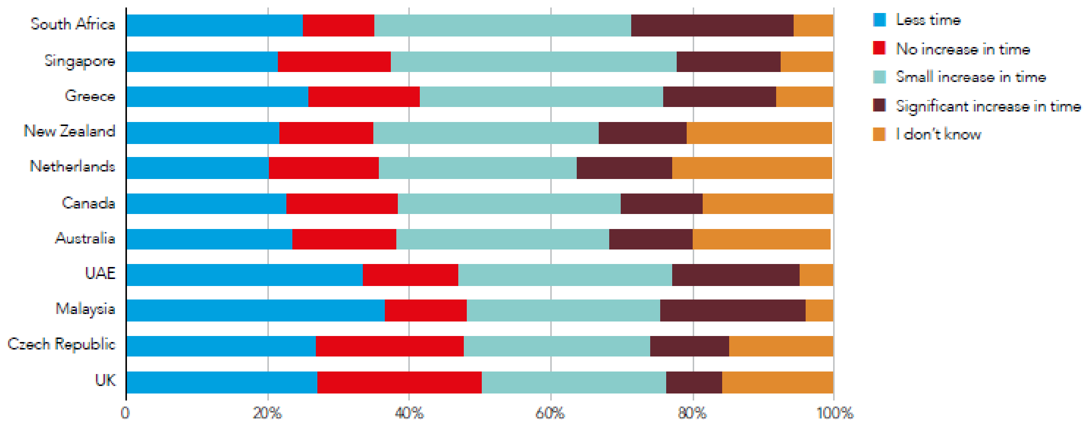
[31] https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171808.htm#_idTextAnchor082 (page 150)

in the UK (and other counties surveyed), not everyone is willing to accept the consequences that would follow such a change.

: If your recommendations were to be implemented, which of the following statements best represents your views about fees?



If your recommendations were to be implemented, which of the following statements best represents your views about time to complete the audit?



Q51. What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

Shareholders are best placed to respond on this question. Our understanding is that investors do use audit reports in their assessment of financial reports or at the very least gain trust from the fact that the financial statements have been subject to audit. However, shareholders are not a homogenous group and practice will be varied.

It is important to understand what use shareholders currently make of audit reports and the additional value derived by them from extended auditor reporting before making further changes. If this is not undertaken there is a high risk that the changes made will not address the specific concerns or issues that they have.

We are aware that analysts use technology but we are not sighted on any specific use of artificial intelligence in reading and analysing audit reports. It is clearly feasible and potential technology advances should be considered in any changes in order to maximise the longevity and applicability of reforms.

Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

There may be some benefit in further interaction. As noted in paragraph 112 of the Call for Views there is currently little evidence suggesting that there is significant interaction with auditors outside of the AGM and indeed the interaction within the AGM is often limited. In order to assess the benefit it is necessary to seek the view of shareholders.

One potential area to explore is the opportunity for shareholders and auditors to engage before the audit work commences; for example, through the publication of a planning report. This would provide the opportunity for discussion in advance of the audit being undertaken and could (as a result) encourage more engagement and dialogue. Written communications reduces the risk of miscommunication.

Q53. How could shareholders express to auditors their ex ante anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

As outlined in our response to question 52, we can see the potential for a planning document to be shared or made available to shareholders to increase engagement but we do not believe that shareholders should approve planning matters for individual audits. The audit committee currently takes this responsibility and is best placed to discharge this responsibility on their behalf as they have the requisite knowledge of the entity. The proposal may well have unintended consequences and lead to a disparate range of risks to be addressed and therefore be counter to increasing audit quality.

Q54. What assurance do shareholders currently obtain other than from audit reports?

Shareholders can currently obtain assurance from a number of areas including credit reports and investor analysis as well as payment codes. The main assurance will ultimately be from the assertions made by the Board and management of the entity. The wider range of stakeholders (especially the public) will ultimately be influenced by press reports and social media.

Q55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

Corporate culture is decisive in determining whether an organisation will do the right thing. Furthermore, culture is often driven from the top - corporate leadership has the responsibility for ensuring that organisational values are lived and breathed throughout the organisation. These judgements are by their nature very subjective.

The current auditing standards require the external audit to consider the tone at the top of the entity and in in undertaking their risk assessment will often by default consider the culture within an organisation. However, this will be a by-product or finding of their work. There is the potential to make a consideration of culture (through a risk based audit approach) more explicit and to require auditors to consider their findings and undertake a root cause analysis of issues identified during the course of their work for issues that may relate to culture. But caution must be exercised; this raises the potential for a new expectation gap to arise as an audit of culture is based less on quantitative data and more on subjective and qualitative data.

The potential adoption of additional narrative reporting by the auditor would provide an opportunity for the external auditor to provide commentary when issues are identified, noting however that the ability to provide such commentary would in many ways be dependent on the risk maturity of the organisation.

Internal auditors have a clear role to play in reporting to management and those charged with governance on the culture of the entity.   The Institute of Internal Auditors has provided guidance on this area. However, there is value for an entity in using an external party to undertake this work - this can provide specialist support as the skills required differ from technical skills.

Finally, the audit committee is a central tenet of effective corporate oversight and they also play a vital role in considering the culture in the organisation. In determining the role that the external auditor should play, consideration must also be given to the wider oversight exercised by other parties in the wider governance eco-system. These responsibilities should be clearly articulated to ensure that users understand the level, scope and accountability for each element.

Q56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

Professionalism scepticism is the key driver of audit quality and as a result this area has received a lot of attention form policymakers, regulators, politicians, and the public over the years since the financial crisis.

As a state of mind, professional scepticism cannot be directly observed. It feeds into judgements which drive actions that the auditor then documents and therefore demonstrating that it has been applied can be challenging. The extended auditor reporting is a key opportunity for demonstrating the scepticism applied in reaching audit judgements in respect of key audit matters.

Those charged with governance have a key role in assessing the level of scepticism that has been exercised by the auditor. This can be demonstrated by understanding the areas of debate and challenge between management and the auditor.

The audit committee can also consider the supporting pillars that an audit firm has in place to create a sceptical audit function. The culture and tone of a firm is fundamental in supporting and developing a sceptical audit team. In most cases where professional scepticism is applied, the auditor will not ultimately identify an issue. This incurs cost and time and the audit firm must support its staff in investing what may appear to be nugatory effort but which is in fact fundamental to a high quality audit.

The board, and in particular the audit committee, is essential to ensuring there is the right amount of challenge of the external auditor during the process and it is important that this challenge is transparent. The investor also has a key role in challenging the audit committee to ensure that this has operated effectively. The new regulator (and professional bodies) can further support this by developing best practice guidance for audit committee members in relation to audit quality. Best practice guidance on audit tendering would also ensure that quality was considered at all stages in the audit life cycle.

We considered why professional scepticism has remained an area of challenge for the profession in a research project called 'Banishing Bias, Audit, objectivity and the value of professional scepticism'[32]. Our work recommends a holistic approach from all stakeholders in the audit process, with each called upon to acknowledge the inevitability of cognitive bias and to take steps to minimise the impact of bias on audit quality. Some of the recommendations include:

- **Standard-setters** are advised to design audit standards with an eye to mitigating the impact of known biases on decision-making. We recommended that, among other methods, the standard-setter reviews the use of 'bias' within auditing standards to conform with its use in psychology and articulates the importance of minimising known bias in application guidance or other explanatory material.

- **Regulators** are encouraged to focus on improvements that support greater audit quality, rather than reacting to audit biases. We urged regulators to be realistic about the limits on completely mitigating bias, and to ensure there is a 'human factors' approach to regulatory processes. Regulators should also avoid their own potential for hindsight bias, or the overestimation of how easy an event should have been to predict, in audit reviews.

- **Auditors**, when designing and performing audit procedures, must be more aware of their own subconscious bias, and should implement activities and processes to mitigate its impact on the audit.

It is important that all these stakeholders, as well as auditors themselves, understand the extent to which cognitive bias affects the audit process and the ways in which it can be managed, but stakeholders should also recognise that bias cannot be eliminated entirely. The 'human factor' in the audit process is both essential and inescapable: even a machine-led audit may be subject to bias as a result of the information provided and the process of analysis.

The research was designed to provide some first steps for auditors, standard-setters, regulators, audit committees, investors and others to better understand the scope and limitations of professional scepticism in audit.

[32] https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

Q57. Should the basis of individual auditors' remuneration be made available to shareholders?

There may be utility in shareholders being informed of the overall governance cost. This may include the basis of all areas including audit fees. In order to assess the drivers of audit quality it would also be helpful for shareholders to understand the drivers for performance related pay for the audit partner and the audit team. This will allow them to assess how these reflect audit quality and independence as opposed to any performance metrics that could drive a conflict or which reward profitability.

Q58. Do respondents view audit costs as generally too high, about right or insufficient?

Under the EU Audit Regulation and Directive, effective since June 2016, audit committees are responsible for managing the tendering process for (re-)appointing the company's auditor. This has led to market testing of fees and overall fees have remained constant or increased.

We consider that indicative audit fees are set appropriately and the proposed audit fees payable are not being challenged by shareholders. We also do not see evidence that audit committees are aggressively challenging audit fees.

Changes in the scope of the audit would incur additional costs – as explored in response to question 50.

Q59. Would users of financial statements wish more detail on the make-up of audit fees?

Greater transparency on the audit fee would be of benefit. We were supportive of the CFA Institute in their response to the CMA Update Report and as reflected in the BEIS Select Committee report on the Future of Audit which recommended additional disclosure to inform both competition and audit quality:

> "[Audit fees] are generally large lump sums with very high-level qualitative explanations. This fee reporting, and the tendering process create perverse incentives. […] Investors need greater reporting on audit hours, staff mix of hours, and rate per hour to be able to be well informed participants in the market place."[33]

However, the cumulative impact of all additional disclosures and information proposed across the review should be considered to ensure that total information requirements are sufficiently concise, consistent and relevant.

[33] https://assets.publishing.service.gov.uk/media/5c63fcc7ed915d04479aef9f/cfa_institute_response_to_update_paper.pdf

Q60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

Yes – we believe so. However the audit firms will be best placed to respond to this question. In the recent evidence sessions to the BEIS Select Committee, audit firms confirmed that audit remains profitable. Ultimately, it is the shareholders who agree the audit fee and therefore must consider the return on investment of additional assurance. As outlined in our response, high quality audits can only be achieved if they are adequately funded and have sufficient resources. Therefore, the audit fee charged must reflect the underlying costs of the audit. Any expansion to the scope of an audit will incur additional costs. It is important that the value in these changes is recognised by shareholders and that any resulting increase in audit costs is met.

We do however believe that higher costs are an acceptable consequence of ensuring high quality audit which meets the expanding demands of stakeholders and ensures that trust in audit is restored and that audit is fit for the future.

We welcome the opportunity to be involved as the review process progresses to support the future development of audit that is proportionate, effective and credible and which operates to uphold the public interest.

ACCA Think Ahead

Appendix 1 – Source research publications

The following ACCA research publications are referenced in our submission to the Call for Views. The underlying statistical data and research are available to the review team:

Closing the expectation gap in audit

https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

The tenets of a quality audit

https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Tenets-of-quality-audit/pi-tenets-quality-audit.pdf

Banishing Bias - Audit, objectivity and the value of professional scepticism

https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/pi-banishing-bias-prof-scepticism.pdf

Key Audit Matters - unlocking the secrets of the audit

https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Key-audit-matters/pi-key-audit-matters.pdf

Thinking small first: Towards better auditing standards for the audits of less complex entities

https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Supporting-SME-audit/pi-SME-auditing-standards.pdf

The future of audit

https://www.accaglobal.com/content/dam/ACCA_Global/Technical/audit/ea-future-of-audit.pdf

Ethics and trust in a digital age

https://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2017/august/ethics-and-trust-in-a-digital-age.html

Machine Learning – more science than fiction

https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/machine-learning/pi-machine-learning-report.pdf

ACCA Think Ahead

ACCA also responded on the Kingman review, the Competition and Markets Authority study and provided evidence to the BEIS Select Committee.

The submission to these can be accessed below:

ACCA Kingman review response

ACCA CMA study response

ACCA BEIS Select Committee response