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Independent Review into the Quality and Effectiveness of Audit – Call for Views

Introduction

Members of the Association of Practicing Accountants (APA) collectively audit a significant proportion of the real economy from SMEs to the AIM market. We also bring sector expertise in areas such as the media, education and charities where a number of our firms undertake public interest audits.

Collectively we help drive employment and growth across the mid-market while at the same time ensuring that this vital sector of the economy is well managed and kept on a sustainable footing.

While our clients do not pose the same systemic risk as the top end of the market, in aggregate they represent a significant proportion of GDP – some 14,000 entities with turnover ranging from millions to hundreds of millions.

We also differ as a sector in that the entities that we audit are typically owner-managed businesses where the management of the entity are typically also its primary shareholders. As a result, there is generally an alignment of incentive in terms of the assurance we provide.

As a sector we are concerned to ensure that any regulatory and market interventions imposed on the largest companies and their auditors following recent high profile corporate failures do not disproportionately impede audits of the mid-market where there is everything to suggest our firms provide robust and high quality audits and where the current system is working well.

We are also keen to support the evolution of the audit framework so that it continues to meet the needs of beneficial owners and smaller firms can be encouraged to take on more of the listed company sector.

Chapter 1 – Definitions of audit and its users

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

An audit provides an independent opinion on the financial health or 'going concern' of an entity for the benefit of those who invest in that entity. An audited set of financial statements can also provide useful information to wider interested parties such as employees, creditors and those in connected supply chains.

The value of an audit is that it provides an external validation of financial performance, which helps underpin investor and business confidence.

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

Intended users - by enhancing confidence in the financial reporting of that entity.

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?

If these amendments help address expectation gap issues around the value, purpose and scope of an audit then yes, we would be supportive of such a move.

Chapter 2 – The 'expectation' gap'

Q4: Do respondents consider there is an expectation gap?

At the top end of the market it appears that there is an expectation gap. Across the mid-market for audit where the beneficial owners of the entity are often also the directors of that entity, research undertaken by the APA suggests that there is a good understanding of what an audit is there to provide.

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

There appears to be a public expectation that an audit is there to provide a guarantee of future performance and that it should be capable of detecting all instances of fraud.

On the first of these points the profession needs to provide a better explanation of what an audit is actually there to deliver. On the second, while an auditor should be reasonably expected to spot material fraud / explain the steps they have taken to do so they should not be held responsible in circumstances where management has deliberately misled them.

Given that many of the public are also beneficial owners of companies through their pensions savings there is also an onus on the audit profession to evolve what it delivers to better meet public expectations.

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 a group of firms representing some 14,000 entities the majority of which are owner-managed businesses, feedback from our audited clients suggests that what we deliver largely meets client expectations. We also consider that the audits we deliver are of a high quality and comply with applicable auditing standards. Nonetheless we note the FRC 2018 Audit Quality Review, which indicated a decline in audit quality at the top end of the market.

Chapter 3 – Audit and wider assurance

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

At present audit is there to provide assurance on the truth and fairness of financial statements. This focus is important and the current audit model, as well as the regulatory frameworks that support it, have been constructed to that end. However, we believe any meaningful debate about the future of audit should include an assessment of wider assurance including non-financial company performance where there is increased investor / public interest.

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?

Investor confidence depends on the audit profession being able to deliver to a consistently high standard regardless of size or sector of entity. Depending on the complexity of a particular entity the level of work / degree of expertise required to provide this level of assurance will obviously differ.

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

Yes.

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

Internal audit can provide a valuable source of information for the purposes of assessing company performance provided the external auditor treats this information with the same degree of professional scepticism they would any information provided by the audited entity.

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?

Auditor independence is critical and is not something that should be compromised. However, we do not see this as being a significant impediment to innovation of the audit model.

Chapter 4 – The 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?

Where a particular entity is complex and multijurisdictional there is a good case to be made for requiring a more explicit statement in respect of risk management and internal controls. Moreover this statement should be capable of being assured.

For the majority of mid-market companies where the business model is generally more straightforward the risk is that such an approach would drive up cost without any significant investor benefit. To that end we would encourage a proportionate approach here.

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

See Q12. Above

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?

If potential material issues are identified here then these will be included as part of the audit report which is a public document.   There is a case for more narrative commentary here.

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

This issue is currently under review by the Financial Reporting Council (FRC) and may result in UK auditors having to adhere to more stringent requirements than under current International Auditing Standards.

A criticism of the current model is that it is too binary and that a more graduated system would serve investors better. If an overarching objective of the Brydon review is to give users of accounts 'greater assurance about the future of the entity concerned' we believe this is something that should be considered.

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"?

While disclosure here is already mandated under existing requirements there may be benefit in increasing the narrative reporting around such disclosures particularly for larger, more complex PIEs.

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

We believe there would be merit in such an approach provided that what was produced avoided boilerplate and provided additional insight for investors.

Q18: Should such a statement be subject to assurance?

For it to be meaningful is should be capable of being assured. A consensus would need to be reached about what this assurance would look like in addition to existing requirements.

Q19: Who might be capable of giving such assurance?

This is something the audit profession should be capable of developing and delivering provided there was regulatory / market demand.

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

This question gets to the heart of the debate around the expectation gap. As noted above, if there is a public expectation that this is what auditors should provide, then the profession should give serious consideration as to how this expectation could be met.

However, such an approach would require significant evolution of the current audit model, which has been developed to provide an historic view. It would also require a fundamental review of the current liability regime to reflect the significant additional risk this would place on the auditor given that the future is inherently uncertain.

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. At least for PIEs.

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

All of the suggestions in Q21 might usefully be considered. In addition, the current debate on integrated reporting (of for example human, environmental, social, intellectual, manufactured and natural capitals) points towards an evolution of the current financial reporting model. If these capitals were to be adopted they would need appropriate assurance to command investor confidence.

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. Process and product are two distinct things. However, they should both be assessed against whether they meet investor expectations of value.

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?

While the audit process is important and needs to be completed methodically this should always been in support of an overarching professional judgment about key matters such as whether an entity is a going concern. It should always be underpinned by the exercise of professional scepticism. Research we have carried out among mid-market audit clients suggests APA firms have got the balance right here.

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

As noted about a graduated system could potentially yield a more fully rounded picture of a particular entity, which might serve investors better. There are a number of ways this could be achieved including increased narrative reporting around a binary judgment. Any changes would need to be built into the regulatory framework so that there was clear guidance as to how they should be applied.

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

See Q25.

Q27: What would prevent such disclosures becoming boiler plated?

As noted above the current regulatory framework / reporting requirements would need to prescribe that these disclosures were meaningful relative to the entity in question.

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

Audit is something that has to deliver not only high quality but also commercial return, which requires innovation and development that meets the needs of end users. While it has been argued that concentration at the top end of the market stifles this innovation our sense is that the profession as a whole is committed to delivering high quality audits which means being open to innovation and change.

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?

The role of the auditor is to ensure compliance in those areas where there may be a material impact on the financial performance of the entity being audited.

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?

As a general principle legal requirements and accounting standards should be aligned where possible. It is worth noting that this is an area where APA firms give robust management challenge. Not just on distributable reserves but the need to ensure the audited entity has sufficient funds to meet its commercial obligations over three, six and twelve months. This is also an issue for charities. The importance of provision in this area cannot be overstated.

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

While this is not currently a requirement we think this could provide considerable additional benefit to investors.

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?

Under International Standards on Auditing as adopted by the UK regulator. We believe these standards are currently fit for purpose and would be concerned at any changes at the capital market end of the spectrum that might unduly impede our work in this area across the mid-market.

Chapter 7 – The 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?

Dialogue between APA members and their audit clients is generally good as evidenced by recent research we have undertaken. At the higher end of the listed sector we can see merit in such an approach.

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?

Much of the challenge auditors give to management takes place ‘behind closed doors’. As a result, investors have to take it on good faith that auditors bring the appropriate degree of professional scepticism. This is less of an issue for the mid-market, where as noted above, the beneficial owners are often also the buyers of audit services.

We could see merit in greater transparency in this area provided this did not act as a disincentive to directors to provide materially relevant information to their auditors or impact client confidentiality.

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 we would see merit in this approach.

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?

As noted above, anecdotal evidence suggests the public expect auditors to be able to identify all fraud as opposed to fraud that could reasonably be expected to be identified as material to the entity being audited. To increase the burden of responsibility here would be to put an unrealistic burden on auditors who are not equipped under the current framework to do more in this area.

Q37: Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

In order to be able to reasonably detect material fraud - yes.

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

Yes provided that such a test was in keeping with the principle that auditors should be watchdogs not bloodhounds.

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

This would seem a reasonable requirement but its introduction would need to be proportionate. For example smaller, less complex entities may not have the resource or expertise to introduce such systems / could find the cost of doing so out weighs the accrued benefits.

Chapter 9 – Auditor liability

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

Yes. While liability reform alone is not enough to increase choice across the sector it would represent a significant step forward, which is why APA firms have been arguing for the introduction of shared audit. This would allow our members to gain valuable experience across the listed sector without being joint and severally liable for a degree of risk that would not be worth the exposure.

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

Such a limit would encourage smaller firms to consider taking on more of the listed sector, which would increase competition and in turn drive up quality and innovation. Because of scale difference between existing and challenger firms such an approach could take a decade or more to yield results but it would represent an important step in building a more sustainable audit profession.

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?

No. This would place an unrealistic burden on audit firms and disincentivise smaller players from taking on more of the listed company sector.

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

As noted above we think the introduction of shared audit would enable smaller firms to compete over time for more of the listed company sector, which in turn would help drive quality and choice.

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?

This is not generally an issue for mid-tier firms. Nor do we envisage it would become an issue if we were to take on more listed company audit under a shared audit model.

Chapter 10 – 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?

Technology is playing an increasingly important role in helping APA firms move up the value chain. For example, the drive to make tax digital means that we can spend more time talking to our clients about their business challenges. In terms of audit, the ability to use data analytics tools means that we can now assess a broader range of inputs enabling better quality outputs.

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 noted above data analytics enables us to review a far wider range of inputs than has historically been the case using traditional sampling methods.

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

No. However, block-chain and AI are evolving at a speed that will increasingly give rise to this question.

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?

In any risk based system there will be corporate failures. Any changes to the current regulatory framework must address systemic risk while not unduly burdening the smaller end of the audit market. That means a proportionate approach that (for example) recognizes a clear distinction between a large and complex financial institution and a manufacturing company that has recently floated - and calibrates accordingly.

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

Research we have undertaken among our members suggests that audit provides value for money on a number of different fronts including lowering the cost of borrowing and providing expert external insight into the entity concerned.

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?

Where there is merit in extending what an audit delivers this should be done on a user pays basis and in terms that are proportionate to the entity concerned.

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?

From a mid-market perspective anecdotal evidence suggests that owner managers get value from their audit reports, which are used not just to meet compliance obligations but also to provide strategic insight into their businesses.

The key point here however, is that our audit clients benefit most, not from the audit report itself but the objective and independent challenge we give them in the process of arriving at this audit report. Our ability to play the role of sceptical advisor here not only helps drive company performance but in aggregate, across all our clients, contributes towards UK competitiveness and growth.

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

Potentially depending on the size and complexity of the entity and its specific stage of growth. From a mid-market perspective this is less of a consideration because the directors are also typically the beneficial owners.

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?

At the PIE end of the market this could be achieved by shareholder meetings at the outset of any audit engagement, independent of management, where these issues could be discussed. We do not believe it would be proportionate for any such requirement to be applied to businesses other than PIEs.

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

Internal audit provides assurance as do a range of wider non-regulatory metrics such as ratings agencies, market commentary etc.

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

Provided standards could be developed here this kind of reporting could form an important part of the evolution of the current model for larger entities enabling investors to get a more complete picture of the entity in question.

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

The audit working papers should demonstrate that appropriate scepticism has been applied in relation to areas of material risk. The audit report itself should avoid boilerplate and instead include meaningful narrative in relation to risk.

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

In the case of Public Interest Entities we think there would be value in transparency here.

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

Across the mid-market we think the balance is currently about right. However it is likely that the cost of audit will need to increase at all levels to tackle the expectation gap issues raised by this review as well as regulatory and market changes that are currently being considered elsewhere.

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

This is not something we have specifically researched among our audit clients but would be happy to do so if there was interest in a mid-market perspective here.

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

Currently yes albeit that there is some anecdotal evidence of under-cutting, which serves neither the profession nor the client. Profitability is something we would need to reassess relative to any structural reforms that were introduced as a result of this and related reviews.

Other Comments

Audit is integral to the effective operation of capital markets as well the sustainable growth of many of the owner managed businesses which help drive employment and prosperity across the UK. Research we have undertaken suggests that our clients value audit for a variety of reasons from better access to capital through to the challenge we provide management.

There is every indication to suggest that audit across the mid-market, which includes a significant proportion of the real economy, is currently providing a valuable service to its stakeholders who rely on the assurance we provide in order, among other things, to secure funding for growth.

While there are legitimate questions to be asked of the audit profession when there is corporate failure it is worth remembering that there are many examples of high quality audit that go unremarked because the profession has done a good job.

At the top end of the market more needs to be done to bridge the expectation gap between what an audit provides and what stakeholders might legitimately expect it to provide. If this requires that the profession work with wider market participants to rethink the current audit model would be supportive of this move provided it does not disproportionately impact the mid-market whose stakeholders are different and value the service we provide.

As noted above if the overarching objective is to encourage a more competitive audit market with multiple players helping drive quality and choice, an important consideration should be how to encourage smaller firms to skill up to take on larger audits.

A significant minority of APA firms would like the opportunity to take on more of this work but lack the scale and expertise to be able to do so. While joint audit may enable the sector to get over the immediate concentration issue by allowing two or three challenger firms to take on FTSE 350 audits, introducing shared audit would enable medium size firms to scale up over time, providing the pipeline that the sector needs to mitigate the risk of future market concentration.

This need not be an either or approach. Giving listed entities the choice between joint and shared audit would enable a market led approach which we believe would help deliver much needed choice to the sector.

We would be happy to brief you in more detail on the points raised in this submission.

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