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Re: INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Dear Sir/Madam

I welcome the independent review which follows the CMA consultation in which I participated in both stages. As statutory auditor I have direct interest in the outcome of the review, but I have also experience as chief accountant in business and understand the view of the audited entities. Having worked in Bulgaria, Guernsey and UK for small and big audit firms throughout my career I have audited SMEs, as well as big and complex PIEs, both commercial and financial services businesses.

In my responses I have not used any confidential information and I do not object to be mentioned as respondent.

I support the recommendations of CMA and I hope that this review will come up with meaningful proposals to make the audit more efficient and effective. All audit reforms have to be carefully designed in logical stages to allow the profession time to implement the best practices.

Yours faithfully

Filip Lyapov, FCCA, CPA

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

Audit should be conducted for the primary users of the financial statements and addressees of the audit report – the shareholders, however having regard to other intended users.

The key value is derived from the high level of assurance on whether the financial statements give a true and fair view in accordance with the defined reporting framework. The audit opinion provides secondary value by covering other matters and other information – going concern, accounting records, narrative reporting.

Another driver of value for the direct users is the provision of efficient, effective, seamless and consistent (inlc staff continuity) audit service by the audit firms.

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

In the last 10 years the scope of audit has been extended beyond its historical remit which has put pressure on the audit firms to implement the new audit requirements. I have not seen evidence that users are now paying more attention to the enhanced audit report. It is not clear how given the current accounting standards the auditors can express confidence in the entity, this function is more relevant to valuation experts and business analysts. The auditors should stick to their core competence.

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?

Like some EU countries UK should adopt a separate independent financial audit act. The act would define the purpose and scope of audit, the register of auditors, the competencies and educational requirements for senior statutory auditors, the audit register, the responsibilities of auditors and their liability, the regulatory audits, the professional indemnity insurance, the ethical and independence requirements, the joint audit process, the tendering and mandatory rotation rules. Some of there provisions are mandated by the RSBs but the latter have different practices.

Q4: Do respondents consider there is an expectation gap?

Yes, audit is not a very popular profession and is rarely studied in university which makes it less known to the public.

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

The general public is influenced by the articles in the media and the views of the politicians. The gap relates to the fact that auditors are expected to find fraud and provide assurance over the viability of the entity. I think these groups of influencers need to improve their knowledge of the audit process and the audit product.

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?

No, failures are exceptions. Audit process is driven by ISA (UK) and is heavily standardised and regulated. It involves a high degree of professional judgment over complex accounting estimates and transactions.

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

Audit is equipped with the methodology to deliver wider assurance. This is being embraced by the larger audit firms as a new business product.

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?

No, I do not see any justification for such an approach.

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 should be able to provide direct assurance to external audit on less risky areas.

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?

Independence is a fundamental quality of external audit. It can be measured as opposed to innovation and quality of the audit product which is bound by standards.

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?

Risk management is currently stated in the directors' report or the strategic report; and the Audit committee report for PIEs. If required, financial risk management is part of the disclosure in the notes to the financial statements. Therefore, these statements are subject to audit or negative assurance.

Certain countries like USA and India have legal requirements for the directors to report their assessment of the effectiveness of the internal controls over financial reporting and their auditors have to audit the assessment and issue a separate audit report. Many UK subsidiaries of US corporations in the scope of Rule 404 of the Sarbanes-Oxley Act report on internal controls and their UK statutory auditors (Big Four) express an audit opinion.

This would require a new Act to introduce such a legal requirement for all FT100 companies. It has to be noted that the introduction of fully compliant internal control system and its certification by management and auditors is a long and expensive process. A new audit standard has to be issued to cover the scope of audit work.

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

Yes, both USA and India have adopted separate audit standards for the audit of internal controls.

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?

No, this is internal communication.

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

It can be improved by making it mandatory for the directors to produce a formal written assessment of going concern with supporting evidence and board approval. This statement will be internal and will be subject to audit by the auditors. The extent of going concern disclosure will depend on individual circumstances but should avoid the current usual boiler plate language.

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"?

This is an area of professional judgment and both directors and auditors are aware of the risk that sensitive disclosure may jeopardise the financial position of the entity.

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

No

Q18: Should such a statement be subject to assurance?

No

Q19: Who might be capable of giving such assurance?

No one.

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

No, audit should focus on the past results.

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.

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

Various industry KPIs are historic in nature and could be useful in comparing sector performance:

Market share

Gender pay gap

Assets under management

Claims loss ratio

Subscriptions data

Members data

Exam pass rate

Proven mineral reserves

Customer satisfaction

Average review rating

CO2 emission rates

Diversity rate

Payment days to suppliers

Claims settlement days

Staff retention rates

Such assurance would add more cost, therefore shareholders have to be consulted if they would be interested to obtain such report.

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

In extreme scenarios it is possible to have an efficient and effective audit process resulting in a poor quality audit report and vice versa, however there is a strong correlation between the two because the audit product is the culmination of the audit process and is not a procedure on its own. The audit report reflects all key matters as identified during the field work. The more indirect users of the audit are primarily interested in the quality of the audit product while the shareholders, the directors and the Audit Committee are equally interested in having an efficient and effective audit process. Audit is a compliance-related product and its outcome is based on following the ISA (UK). In my opinion a quality audit is an audit which is efficient and effective and results in the issuance of the correct audit opinion while maintaining compliance with ISA (UK).

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?

FRC should take into consideration the following factors during its inspection:

- *Time element – all audits are conducted real-time with tough budgets and deadlines. I am keen to see some statistics for the time spent by FRC inspectors on quality reviews and how long the whole process takes. The time can exceed the actual audit and the process can take years. In my experience FRC are always looking for perfect ISA documentation with long explanations for every audit decision and judgment.*
- *Interaction with management – It is not always possible in completing the audit file to document each and every minor discussion, meeting, phone call with management that reflect auditor's challenges.*

Yes, in the light of the above reasoning I agree that FRC focus should be more on matters requiring the exercise of considered judgment.

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

Information insight into the entity's risk exposure and how it is managed.

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

No, the extended audit report is already too lengthy and difficult to understand with its terminology. I suggest it is better to issue separate shorter audit reports that cover:

1) *Audit report on the financial statements and the notes*

2) *Audit report on the requirements of the Companies Act 2006 – Directors' Report, Strategic Report, accounting records, directors' remuneration, other matters*

3) *Audit report on internal controls over financial reporting for FT100 companies*

4) *Wider assurance report for entities in scope or voluntary choice*

Q27. What would prevent such disclosures becoming boiler plated?

I think boiler plate is inevitable because audit uses highly standardised language and auditors carefully choose the words to minimise the risk of exposure to liability. The legal and accounting profession also tend to use standard language. Boiler plate is not necessarily bad as it provides consistency and comparability across audit report.

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

ISA are developed through a consultation process that involves users. In my view ISA do not impede innovation. Wider assurance standards have been developed but users have not been enthusiastic. If there was no mandatory audit probably the number of audited entities would decrease significantly.

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?

Auditors test directors' assertions on matters in the Annual Report and the financial statements. Yes, please see my proposal in Q26 response which suggest separate audit report on the financial statements and separate one on other matters.

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?

Yes. Company law should adopt a definition of realised and unrealised profits and losses for the purpose of distributions and reserves should be legally split into distributable and non-distributable. I don't think IFRS care so much about such split and the accounting standards will follow the company law because it is a matter of law. There will not be hundreds of pages guidance from ICAEW and directors and auditors will have clarity in extinguishing their respective obligations.

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

Yes – see above Q30.

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?

This is an integral part of the audit process and every audit test checks an entity's accounting records. Yes.

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?

The only appropriate place for the auditor to communicate with the main users, the shareholders, is at the AGM. We have to remember that the main product is the financial statements, not the audit report. No stakeholder opens the financial statement to read first the audit report. I do not see practical value in holding "assurance meetings" with stakeholders who not always have sufficient professional knowledge of the auditing standards and to whom the auditor owes no duty of care.

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?

No, this is internal communication and the resolutions of most problematic issues are reported as key audit matters in the enhanced audit report which is sufficient.

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?

Such obligation should not be imposed, it has to be a matter of the auditor's professional judgment. The reason is that there will always be one-off key audit matters that will not be recurring in the next year, as well as constant/recurring topics like revenue recognition or management override of controls. On the other hand, auditors will follow up on key audit matters from the previous year to give update on the outcome of previously reported KAMs – e.g. movement in provisions; impairment of goodwill; outcome of litigation, going concern material uncertainty. The auditor is sufficiently capable to link the current story with the previous audit report.

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, there is a gap and in many cases the media or the politicians are quick to blame the auditors of an entity where fraud is found. As statistics show fraud is often not detected by auditors. If fraud detection was the main purpose, this would require a different mindset and skillset. Auditors should not be primarily held responsible to detect material fraud. The general public has to be made more aware of the auditors' remit with regard to fraud.

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

Yes, ISA 240 (UK) is a very prescriptive standard.

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

Fraud enquiries and fraud considerations are an integral part of each and every audit program. The extent of enquiry depends on the auditor's knowledge of the entity's business and the fraud risk factors. I don't see the need for such a 'reasonable person' test to be devised in the presence of ISA 240 (UK).

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

First, the entity should develop such a formal system. Second, its design and implementation should be assessed by the directors. Third, they should be required to make an explicit assertion in the Annual Report on the system. Fourth, the auditor should be required to report on the directors' assertion for the effectiveness of the system. This is a process similar to the evaluation of internal controls and could be applied to FTSE100 companies. New legislation governing this process and new audit standard should be developed. It could be combined with the system of internal controls.

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

No, I have not come across evidence of such correlation.

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

I cannot vouch for such a connection between the two matters

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.

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?

To me the unlimited liability does not have direct impact on high quality. It simply deters auditors from auditing PIEs or big and complex high risk private companies because any audit failure would lead to litigation, high insurance premiums and loss of reputation.

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?

Generally, I do not see a problem; PII cover is available on the market. This risk for small audit firms undertaking PIE audits is significant because the higher PII cost cannot be spread over a bigger population. When we add the high demands on audit documentation, FRC inspections, staff training and pressure from management we end up with only a few audit firms willing to enter the PIE audit market.

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?

It is mainly used in Big Four by IT auditors who utilise Oracle, Excel and other tools to test internal controls, journal entries etc. As audit gives a high level of assurance already the technology can achieve cost efficiencies in certain audits where very high volumes of transactions have to be tested.

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?

Actuarial models; valuation models; system interface; IT application controls; capital adequacy.

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

No.

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?

The review should define what failure means – FRC grading system can be used. For example, failure is when an audit needs significant improvement. Another example of failure is when the company goes out of business and there were material going concern uncertainties that the auditor failed to report in its opinion. Another failure would be restatement of prior year accounts for an accounting treatment missed by the auditors. There should be a clear causality between the failure and the audit conduct. Whatever measure is applied, the Review should set up target for improvement -say from current 25% audit failures to 5% in 5 years' time.

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

It still does for the reasons given in the response to Q1.

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?

Given the expected significant audit reforms I do not support any extension of audit scope in the next 5 years.

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?

Limited use. Not read. I don't know.

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

No.

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?

Shareholders can express their views at the AGM. No, they appoint AC as their nominees to deal with these matters.

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

Shareholders sometimes obtain limited assurances from depositories' reports and detailed information from investment managers report and audit committee reports.

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

Culture is not easily defined or measured. I don't see how auditors can audit such assertions which are not quantifiable.

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

The scepticism should be demonstrated throughout the whole audit process, in each working paper as appropriate.

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

Every audit major firm discloses the basis of remuneration of its audit partners in the publicly available Transparency Report under the EU Audit Directive.

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

It depends. From the perspective of the stakeholders the audit costs for the largest PIEs are usually viewed as high, while SME audit costs are about right.

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

The make up is disclosed in every audit tender document but the accounts disclose all audit and non-audit fees in sub-totals. If users have any concerns, they could ask the Audit Committee who approve the audit fees and all non-audit fees.

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

Not in all audits. There are various factors for the decrease of the profitability, as follows:

5) *Tendency to increase the audit threshold*
6) *Annual audit fees do not increase, if at all, in the same proportion as the consultancy fees*
7) *The tender fees are very high for PIE audits*
8) *Increased complexity of accounting standards*
9) *Enhanced audit requirements, in particular documentation, and revised auditing standards*
10) *Heavy regulation of the audit profession, incl ethics and educational requirements*
11) *Auditors are left to "sell" a low margin service with no additional services*
12) *It is expensive to retain the best people and motivate them to stay in the profession*

Some of these factors are general trends, outside the control of the audit profession. Increased profitability will bring more competition, more technical and staff resources which in its turn will enhance high-quality audits.