Purpose of Audit

Audited accounts are an important part of the process of creating a sustainable productive economy. My comments are based upon audit in terms of the following function:

The purpose of accounting and auditing is to align and engage investors and the (management of) businesses in which they invest in common pursuit of value creation through a common understanding of business opportunity and performance.

Following this view, the conduct of business, the conduct of investment and the conduct of accounting/audit must be in alignment and should be considered holistically. To engage managers and investors in the common cause of a *productive* economy the alignment must be in pursuit of value creation rather than value transfer or extraction. For all three stakeholders in the audit (managers, investors and auditors) audited accounts should be facilitative of improving the performance of *both* managers and investors. This is rather different start point to the traditional view which sees audit more in terms of a hierarchical accountability between managers and investors.

I focus my comments upon the traditional pairing of managers and (shareholder) investors because there is much important work to be done on this relationship. Other audits with their own set of issues can be developed with regard to the alignment of other stakeholder pairings. My comments also focus upon audited accounts and in this context the value of audit is bounded by the value of the accounts on which it reports. Thus the starting point for a search to advance auditing is a search to advance the value of accounting and for the latter I start with my 2013 book published by Gower (now Routledge) entitled 'The Failure and the Future of Accounting: Strategy, Stakeholders and Business Value'. Although focused upon the future of accounting, it is equally relevant to the future of auditing.

The future of accounting

The following three paragraphs are taken from the book:

The book introduces a six-dimensional stakeholder proposition in which the selection, engagement and alignment of stakeholders depends upon: (1) the specification of the product to be provided; (2) the price and volume; (3) the stakeholder knowledge and capabilities required; (4) the nature of the *relationship with the stakeholder; (5) the contractual promises made to the stakeholder; (6) the prospects for the entity and its business model (based upon non-contractual expectations). These are the six dimensions of the proposition that the company makes to each stakeholder.*

These dimensions are followed through to both returns and risk in order to identify how and where the network creates value. It is shown that equity value can reside in four distinct funds - the four slices of equity - being: (1) the traditional assets of tangibles and working capital; (2) intangibles; (3) promises and (4) prospects.

Each of the four funds corresponds to a different kind of value and a different kind of measurement. The 'value' of the ***traditional assets*** *(net of loans) is taken to be the same as currently given in the reported financial statements.* ***Intangibles*** *are taken as the capitalised value of the current residual profit; residual profit being what is left after providing an appropriate return on the traditional assets. Thus the value of both traditional assets and intangibles is underpinned by the profitability of current production and together they form the 'productive equity capital'.* ***Promises,*** *which can include pensions, warranties, deferred tax, derivatives and fixed price contracts, are taken at fair value net of any precautionary assets set aside****. Prospects*** *are valued as market capitalisation adjusted for the values of the other three funds and it is the credibility of this valuation which becomes the focus of attention for the investor. Promises and prospects both derive their value from expectations rather than current production and hence form the 'speculative equity capital'.*

The future of auditing

The four funds – four slices of equity - give rise to four different audits with different challenges, and different implications for the collection of audit evidence, wording of audit reports and for the design of an equitable liability regime. I shall concentrate on audit evidence since this drives the difference in auditability of the funds. Fund 1 (traditional assets) can be audited using conventional audit techniques. It is here that the development of distributed ledger technology may have the greatest impact since the financial report is essentially a collation of assets and liabilities derived from transactions.

Fund 2 (intangibles) is underpinned by the profit statement which is again audited by traditional audit techniques but there are additional challenges. The profit upon which residual income is based should be 'continuity profit' i.e. the profit which the business could sustain if underlying business conditions remained unchanged. One challenge is to ensure that this continuity profit does not include movements that should pass through promises or prospects. These include movements on pensions, warranties, derivatives and deferred tax which relate to revisions in fair values not generated by current production but by changes in expectations. At present accounting standards are inconsistent on this leading to the widespread adoption of Alternative Profit Measures (APMs) by management. These APMs must be audited to ensure that management have not selected a ‘continuity profit’ biased in their favour. Also excluded from continuity profit should be any impairment charge on goodwill and intangibles as this ‘impairment’ should be charged against prospects (fund 4).

A second challenge is the choice of appropriate return used to capitalise residual income to give a (current use) value for intangibles (fund 2). The audit report needs to explain the choice but of course investors can substitute their own judgement. The required rate of return should reflect the risk of the company not being able to sustain its current level of business and hence not being able to sustain its continuity profit. What matters as a benchmark for performance is a ‘continuity concern’ not a ‘going concern’. By explaining the choice of appropriate return the auditor is in effect expressing an opinion on the sustainability of the business. There are many important factors here including the continuity of all stakeholders and the conservation of the environment.

Promises can play an important role in securing stakeholder continuity. Fund 3 (promises) contains the fair values of outstanding promises made to non-shareholder stakeholders either through contracts or in the case of deferred tax as a consequence of legislation. To give an opinion on fund 3 the auditor engages the assistance of experts in each of the components of the fund and their expert valuation models. The audit of each component is in effect a joint audit between the audit partner and the component expert. However managers should manage the risks inherent in the company’s portfolio of promises recognising hedges where they occur and so the overall opinion on both overall risk and overall fair value should be that of the audit partner. It is sensible for an investment fund to manage fund 3 risks across its portfolio of shares and therefore the auditor should ensure that the auditee provides sufficient disclosure for the investment managers to do this.

The value of fund 4 (prospects) is the value to shareholders of the prospective development and leverage of intangibles over and above the value of intangibles already recognised in fund 2 because they are already generating residual profits. Fund 4 is increased during the year by the creation of new opportunity not previously recognised in fund 4 and decreased when opportunity previously included in fund 4 starts to generate profit and accordingly is transferred to fund 2. The rate of creation of new prospects, the rate of conversion of prospects into profit yielding activity and the ratio of the value of fund 4 to fund 2 are three factors that can drive a smart beta portfolio. For the auditor the same methodology can provide an analytic review of the plausibility of the values attributed to the two funds but in particular fund 4. For the auditor this analytical review needs to be backed up by evidence from trends in the environment, signals from stakeholders, and signals from management both in terms of strategic intent and actual expenditures on research, development and release of new products, new fixed assets, training, product protection etc. Buybacks and special dividends tend to signal a perceived lack of opportunity by management (and investors) or an unwillingness to take opportunity and the latter can be for a variety of reasons.

In essence the audit of fund 4 becomes in part a challenge to the market capitalisation (and hence share price) from which it is derived. If the auditor explains the basis of the challenge then this report becomes akin to an investment analyst’s report. There is a convergence of auditing and investment analysis. Given that both markets are under pressure this may be a way forward for both?

The market for the auditing firms

Whereas investment analysis by long term active investors may once have dominated share prices and transactions, this discipline (a ‘quasi audit’ by the market in which audited accounts play a key role) is arguably no longer effective. Index investing and its anticipated consequences, front running based upon algorithms and computer trading, short selling and contracts for difference, and speculation about mergers, acquisitions and disposals have all played a role in obscuring the share price from its fundamental value in terms of evidence of future profitability. Investors become more interested in anticipating each other than in anticipating the future of the business. In passive funds investors become more interested in responding to each other than considering the future of the business. In this environment much, perhaps the majority, of investment is not in alignment with business. By the same token the relevance of audited accounts to share prices and transactions is diminished and the market (in terms of value) for traditional audit is shrinking.

'De-equitisation' is another factor. Private equity and share buybacks underwritten by (artificially) cheap bank finance have reduced the availability of publicly provided share capital whilst (artificially) increasing the price of the shares that remain. Once again share prices and fundamental value may be driven apart but so long as share prices are rising both managers and investors are disinclined to challenge each other? If so the likelihood is that much of the alleged value embedded in share prices goes unchallenged. This is an environment that provides both a threat for conventional plc audit in terms of a shrinking market but also an opportunity if the accounting/auditing firms are prepared to extend their audit to an analysis of, and challenge to, the share price. A share price which is disconnected from fundamental value should not be used to determine pension surplus or deficit, management performance or the performance of (long term) investment managers. Auditors could report on whether the share price is disconnected and if so what an appropriate share price for performance measurement might be. Clearly this has implications for how auditors are appointed and what an appropriate liability regime might be. It has major implications for the status, motivation and influence of auditors and I believe it is the decline of these factors which is it at the heart of our current problems with the audit as it stands today.

Concluding remarks

I have read the sixty questions but my feeling is that they are grounded in the extant framework of accounting and auditing and this model is muddled? I have put forward a different framework based upon the four slices of equity (four funds). Some of the sixty questions remain pertinent to my framework and others cannot be answered from my arguments in this response because my analysis is restricted to the manager-investor relationship. I believe that audit reform should start with this relationship and then move on to embrace other stakeholder relationships and I have plenty of ideas for how that might proceed. I apologise for not answering your questions directly. Sir Donald's speech of 10th April shows that he is concerned that the review could result in a series of granular recommendations which in aggregate create a disproportionate burden. I believe the way to avoid this is to move the debate to one which looks at motivational alignment across business, accounting, auditing and investing. A common performance measurement framework is key and this needs to embrace the four funds both separately and holistically. The funds recognise the role of fixed and monetary assets, of intangibles in generating current profitability, the role of promises (to motivate non shareholder stakeholders) and of prospects (to motivate shareholders). I have focused on non-financial companies but I am aware that many of the most challenging audits are of financial companies. The four funds generate four different categories of risk and the accounts of financial companies should explain how they have processed each category of risk and the associated returns achieved. In essence each risk can be processed by acceptance, by passing it on in a financial product, by sharing (insurance) or by trading (selling it to another party who wants to take on more of the risk in question). For both financial and non-financial audits I believe the way ahead is for the auditor to engage with all four funds and to report the findings for each.

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