INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Call for Views

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Chapter 1 Definitions of audit and its users

Q1: For whose benefit should audit be conducted? How is it of value to users?
The auditors' report is part of the company's annual report to shareholders, so they are clearly the primary audience. They approve the auditors' appointment and payment. Since they bear the most risk of losing their money, satisfying their information needs should go a long way towards satisfying the needs of others.
It is also relevant that International Financial Reporting Standards, with which the auditors check compliance, list existing and potential investors, lenders and other creditors (including suppliers) as primary users of financial statements.
Regulation governing audit is not the only form of protection for those with an economic interest in the company – employment legislation, for example. On the credit side, banks and credit rating agencies may have access to more information than shareholders, who are particularly dependent on published and audited information.
The case for high-quality audit being in the public interest is that people's savings are invested in companies on the assumption that financial information is true and fair, and has been checked by auditors who affirm that it complies with both accounting standards and Company Law. When capital is deployed efficiently, the whole economy benefits.
But this does not mean that the public should be regarded as the primary audience. If it were, it should appoint the auditors via the government and its regulatory agents.

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?
It is difficult to separate the two. If a company's financial position is weak, as revealed by the audited numbers, then confidence in the entity and its ability to stay in business beyond the short-term is undermined.
The adoption of the 'going concern' basis of accounting provides some reassurance, albeit of a transitory nature because the balance sheet is a snapshot at a particular point in time. The FRC's proposed revision to ISA (UK) 540 is designed to make the auditor's work on the going concern declaration more rigorous, which should enhance confidence.
As Appendix 2 on the auditor's responsibilities makes clear, the auditor does have several options for modifying its opinion and for emphasising or communicating other matters. More use should be made of these options. Also, if the auditor's report included graded judgments (or where in a range of potential outcomes the management's number sat) that would help users of accounts to assess both the sensitivity of certain accounting judgments and the attitude of management.

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?

Not sure: many users of accounts do understand what audit is. Is the problem one of inadequate public knowledge of business generally as well as of audit? Or is it that auditors have not been delivering to a high enough standard on their current responsibilities? I think that both apply.

Chapter 2 The 'expectation gap'

Q4: Do respondents consider there is an expectation gap?
Yes. See answer to Q3.
Q5: If so, how would respondents characterise that gap?
The ACCA, in a report entitled 'Closing the Expectation Gap in Audit', found a substantial 'knowledge' gap, eg only 25% of people surveyed in the UK correctly identified that the auditor gives an opinion on whether the financial statements provide a true and fair view. There is also a 'performance' gap. Evidence for this has come from reviews of audit quality by the FRC (also its enforcement action) and IFIAR. The FRC's thematic reviews on audit quality and firms' culture have repeatedly identified a lack of scepticism and willingness to challenge management as root causes of the problem. The CMA's remedy of separating audit from consulting is to be welcomed as a way to tackle the issue. In short, I agree with the statement in the BEIS report (par 56) that 'the delivery gap is far wider than the expectations gap'.

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 to the first part. I believe the auditor should do what it says it has done ie provide assurance that the accounts present a true and fair view of the company's performance and financial position; are prepared in accordance with IFRS and audited in accordance with IAS; and comply with the Companies Act. This is not a box-ticking exercise – all these standards give plenty of prompts to challenge management.
Auditors check whether the accounts are free from material misstatement, whether due to fraud or error. It is disappointing that materiality continues to be trotted out as a percentage of (often adjusted) profit. It is supposed to be anything that would alter the economic decisions of users of accounts. This is why, as BEIS points out, even quite trivial fraud is material.
Auditors also state that they remained independent of the company and complied with ethical requirements. Again, they should diligently do what they say they have done.

Chapter 3 – Audit and wider assurance

Q7: What should be the role of audit within wider assurance?
Numbers in the annual report outside the audited section, but which are based on them, should be audited to ensure that there is no misuse of the audited numbers. This could include, for instance, banks' risk-weighted assets and the reconciliations of adjusted profit numbers to the GAAP numbers.
Auditors' focus should remain on information in and derived from the financial statements, and on the material that goes into them. This could include information on pay and so they are well placed to provide assurance over pay ratios and gaps.
For environmental and social information, I would prefer assurance from expert organisations that have protection of eg the environment as part of their purpose.

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?
They should have access to whatever information they need from the company.

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 an essential component of a quality audit.
Carrying out the established tasks (see Q6) is more important than innovation.

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?
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?
Sir John Kingman (3.18-20) looked at the case for Sarbanes-Oxley style regulation of internal controls, including signed reports by the CEO and CFO and auditor attestation. Recommendation 51 points to a strengthened framework around internal controls, learning from Sarbanes-Oxley. I hope that something very similar is enacted in the UK. This would improve auditors' public reporting on the effectiveness of internal controls.

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?
Yes, as enhanced by ISA (UK) 540.
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"?
Yes. See answer to Q2 re auditors making more use of the options they have.
Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?
This is what the viability statement is supposed to do. I see it as the bottom line to the principal risks section. It should include the 'what ifs' that might present an existential threat to the company.
Q18: Should such a statement be subject to assurance? Q19: Who might be capable of giving such assurance?
The auditor will have looked for any inconsistencies in the financial elements of this statement but responsibility for the business model and for the company's assets, whatever the circumstances, lies with the directors. There can never be the same level of assurance over narrative reporting as over the financial statements.
It must also be remembered that it is the job of investors, lenders and others whose money is at risk in a company to form their own judgments about its sustainability, using the wealth of audited and other information available.

Q20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?
Care needs to be taken here. Modern accounting already has forward-looking elements because of calculations that depend on cash-flow forecasts and risk assessments (eg impairment testing and the expected loss model in IFRS 9).
Spotting emerging/increasing risks and calculating probabilities based on current evidence is one thing, speculating about the future is another. There is no guarantee that any company will remain in business and attempts to react to uncertain future events can curb risk-taking.

There is an expectation gap here related to poor public understanding of business, investment and risk-reward trade-offs.

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? Q22. If so, what information might usefully be subject to audit or another form of assurance and why?
See answer to Q7. There may be a case for having an auditor's statement with half-yearly results. It could, for example, review issues it had commented on in the annual report either as part of its opinion or under key audit matters.

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?
No.
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?
No.
Q25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?
See answer to Q2.
Q27. What would prevent such disclosures becoming boiler plated?
The will to report in a meaningful way, which should be a given.
Q28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?
Sir John Kingman's report on the FRC made clear that users of accounts, notably investors, are the beneficiaries of high-quality audit and corporate reporting and so should have a more active role in standard-setting etc. This means more effective engagement by investors with standard-setters and regulators/supervisors. It is to be hoped that the new ARGA will make this a priority and that investors make a greater effort to participate.

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?
See answers to Q5 and Q6 re delivery gap.
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?
A Financial Reporting Lab publication in November 2015 – 'Disclosure of dividends – policy and practice' – revealed investor demand for disclosures about distributable profits. This should have been acted upon. Directors are legally responsible for ensuring that the company's reserves are not over-distributed. As par 84 notes, BEIS has made some recommendations about capital maintenance and definitions of 'realised' profits.
I do not believe there is a conflict between accounting standards and Company Law – company directors must comply with both.
Q31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?
Yes.

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?
Better use should be made of the auditor's presence at the annual meeting and of the vote on the appointment of auditors. Investors should have a right to speak to the auditor directly, via a separate meeting or ad hoc. Where the question and/or answer are price sensitive, this exchange would need to be public.
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?
Both the audit committee's and the auditor's reports are works in progress. Users need to know which judgments and calculations prompted the most debate between the auditors and the AC, and between both and the management. If the current system of boards appointing the auditors is to continue, the AC needs to demonstrate more independence. Its relationship with the external auditor (which needs to do the same) is critical.
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. See answers to Q2 and Q7. I am in favour of graduations of judgment (eg where in a range management's number sits) and in following up on previous alerts.

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?
See answers to Q5 and 6 re delivery gap and materiality.
Q37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?
Yes they help. But the auditors are responsible for their mindset, which should be independent, sceptical and focused on the needs of users of accounts.
Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?
See answer to Q 14 re strengthening the framework for internal controls.

Chapter 10 - Other issues

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?
See answers to Q1-6. The point about a zero-failure regime – on the part of companies, auditor and regulators – being unattainable is very important.
Q49. Does today's audit provide value for money?
Yes. Fees might have to rise to ensure that independent audit firms, or ring-fenced units within professional services groups, are sufficiently profitable to compensate for the risks of providing the service. Also, there should be no disincentive to the auditor doing additional work on sensitive issues.
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?
Any increase in audit fees is unlikely to be material. Investors approve the audit fee and their main concern is quality.

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?
I read them. They provide a useful guide to areas of potential concern. They prompt further study of the notes and other information, as well as consideration of the underlying issues – eg stretched balance sheet or disruption in a sector – that might pose threats to the company's future success.
Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?
See answer to Q33.
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?
It should be a routine part of the audit planning process to read analysts' reports and seek investors' views – and the views of those who have sold or shorted the shares.
Q54. What assurance do shareholders currently obtain other than from audit reports?
They should do their own homework on the company, its sector and any external factors, such as new competitors or regulatory change. For environmental concerns, for instance, they may use expert gatherers of information on emissions etc; some fund managers have in-house expertise and screening systems.
Q55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?
Graded judgements would help with this eg KPMG's reports used words such as optimistic and cautious. But there is a limit to the extent to which they can vouch for character. Investors have many other ways in which to judge this.
Q56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?
By reporting on the challenges they have made and the outcome of these. This should also be part of AC reporting because its members will be acting on questions raised.
Q58. Do respondents view audit costs as generally too high, about right or insufficient?
They are not too low and could be higher.
Q60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?
It is a pity that the CMA did not provide as much evidence on this as it might have done.

Jane Fuller
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NB The views expressed are my own