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6th June 2019

Response to request for views

Independent review into the quality and effectiveness of audit

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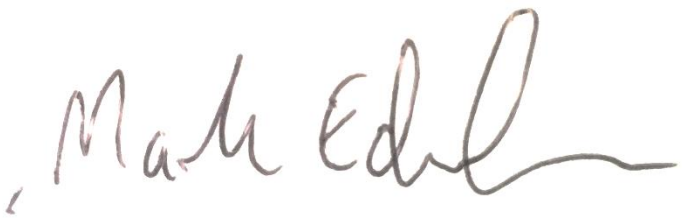
I am delighted to share with the Brydon Review team key observations based on my experience in relation to the request for views launched on 10th April 2019.

These represent my views in a personal capacity drawing on my extensive innovation and service delivery experience from working in the audit market, in the UK and globally.

The Brydon review represents a critical opportunity for the accounting profession to reflect on the approach and failings of the past and define a new future. Building on other reviews performed on the UK audit market in 2019, this review should be embraced to design an audit product meeting the evolving needs of stakeholders in modern financial markets.

Should my skills and experience be of further value to the review team I would welcome the opportunity to make further contributions to the review process.

Yours faithfully,



Mark Edmondson ACA

President & CEO, Inflo

Extent of technology adoption in audit and impact on assurance

Questions

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?

Views:

Audit technology is a broad field and so must be segmented to consider the extent of use and impact on assurance.

A range of technology solutions have been adopted to support audit delivery for some time. These cut across the lifecycle of an audit - including task-specific software to perform assessment of acceptance / continuance of an audit engagement, as well as more comprehensive audit documentation platforms supporting the design and execution of the audit process. These established technologies are used on 100% of audits.

Audit platforms, and the audit methodology they house, are a critical component of the audit product and for that reason the largest firms (top 7 in the UK) have all developed proprietary software in-house for this requirement.

Other technologies which are commonly used in audits today and highly impact the audit product relate to the use of transactional data to support or execute audit work. Commonly referred to under an umbrella term of "data analytics", these technologies allow an auditor to move from working with summary financial information and sub-sets of data to analysing the detail of 100% of transactions underlying the financial information.

The extent of use of such techniques is often dependent upon how closely data analytical techniques align to traditional auditing processes - or where traditional auditing processes have become ineffective against the nature of modern business. The most extensively used technique relates to the use of data analytics as part of an auditors work to address the risk of management override of control and fraud, commonly termed "journal entry testing".

Further techniques which are increasingly being utilised include auditing of revenue transactions, legal contract reviews and performing analytical review to identify risk, plan and scope an audit. The FRC thematic review "*The Use of Data Analytics in the Audit of Financial Statements*" provides a good summary overview of common technology use across the largest firms, although citing at the time of writing the level of technology use was lower than expected. Since time of writing (January 2017) the level of adoption of such techniques has greatly increased in these firms as well as those outside the top 6 included in the original scope of the thematic review.

The existing auditing standards were written at a time where the auditor's ability to respond to risk was heavily reliant upon sampling of balances or transactions to be able to obtain the audit evidence required - due to an environment where it would be commercially impossible to consider the whole population. However, technology has fundamentally changed this environment - meaning auditors now can analyse 100% of transactions on all their audits in a commercially viable way. This means either the same level of assurance can be obtained more effectively, or greater assurance can be provided from the same level of effort.

For example, a traditional audit approach to revenue might involve a core audit test of selecting a sample of 50, 100 or 200 revenue transactions (depending on a firm's proprietary methodology) and tracing these transactions through to a bank transaction - demonstrating receipt of payment from

the customer. This might result in the auditor testing less than 0.2% of the revenue balance in terms of value and concluding the revenue figure is materially correct.

Data analytical techniques can instead analyse every transaction, often demonstrating the conditions required for the traditional audit test are not present - such as the population being shown to not be homogeneous in nature. More advanced analytics can trace 100% of transactions recognised in revenue through to cash receipt, allowing the auditor to instead focus on the revenue entries which are unusual or invest greater time testing revenue streams where revenue recognition is judgemental or has been adjusted. This ability to perform a comparable technique over 100% of an amount, rather than under 0.2%, fundamentally changes the level of assurance provided.

Broadening the scope of audit, including impact on independence and liability.

Questions

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?

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?

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

Views

The willingness of firms to implement innovation which fundamentally changes the audit product, or for audit teams to deliver a different audit product to a client, is inhibited by concerns over independence as well the impact on liability of an increased scope of work potentially being relied upon by a broader group of stakeholders.

As a result, technology innovation has typically occurred to support, automate or enhance the existing scope of audit. Far fewer examples are know where technology innovation has fundamentally changed the scope of audit services and thus the audit product.

Demand for broader assurance would drive development of new technologies, whether in-house by firms or by third-party providers. Yet, there are opportunities for technology innovation and "art of the possible" innovation to drive broader assurance scope and thus an enhanced audit product.

We would be willing to share our ideas and research in this area privately with those interested.

Value of audit and the opinion

Questions

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

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

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

Q27. What would prevent such disclosures becoming boiler plated?

Views

An effective audit process delivers on the scope of an audit as defined by auditing standards. But the same audit can have a very different process dependent upon the approach designed by the audit team - which can heavily impact upon the value and quality of the audit product.

Even only considering the single revenue testing example above (a fraction of the total audit effort), both the manual sampling approach and 100% data analytical technique are compliant with the auditing standards and thus could be deemed an effective audit process. Yet the value and quality of the audit product could be argued to be very different - if this were known to the users of the audit product.

Ultimately, the audit product's core output is the signed (typically unqualified) audit opinion included in financial statements and different audit firms, or teams within audit firms, can deliver this product in such differing ways to still arrive at the same product. Enhanced audit reports in the UK listed space have provided more context regarding the audit approach performed. However, enhanced audit reports focus more on provide the context underlying the same product, not changing or differentiating the product. Outside of the listed space this audit product is incredibly boiler plated.

Switching from a binary audit opinion to gradations within the audit opinion might represent more value, providing the grading outcomes were sufficiently dispersed to highlight differentiation. Adding further narrative disclosure aimed at providing more informative insights could also provide something more valuable but closely aligned to existing reporting practices. Yet creating a more valuable audit product might be reliant upon finding an entirely new output format more targeted to the specific needs of users of these outputs.

The impact of such additional disclosure or new outputs on a firm's liability position would be key to avoiding such disclosures becoming boiler plated.

Value for money

Questions

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

Views

Value for money is a highly subjective assessment, but the concept of value is of increasing prominence in the audit market.

Often the audit approach, process, quality and value of the audit is subservient to the audit fee. The fee is agreed on a high-level intended way of delivering the audit. The audit approach is then designed in detail and articulated to stakeholders.

The audit process, and the value of the product and outputs produced, can vary significantly though. Listing a few variables of an audit approach which contribute to the outputs, value and product:

- The level of materiality the audit is performed to,
- The amount of IT systems and controls review and testing,
- The extent of controls testing during an audit,
- Benchmarking performed of the organisation against others,
- The format of outputs to management, and
- Whether communications to audit committees and those charged with governance meet the minimum requirements of auditing standards or include insights and other recommendations.

Greater engagement should be advocated between auditors and those procuring their services (whether audit committee, trustees or business owners) on what a valuable audit product and service represents. There is not a one-size-fits-all approach to the value of the audit product, it should be tailored to the organisations and associated stakeholders. Adopting a more collaborative approach to discussing upfront the desired value, and therefore scope of the audit delivers greater engagement and a more valuable product. This approach is sometimes encapsulated under a "value-pricing" methodology – differing from the legacy time-based billing or fixed-fee variation on the time-based billing theme. Value pricing is an effective tool in many industries and the accounting profession has also seen benefit in other compliance service lines such as Virtual Finance Director services.

A very important by-product of this approach in relation to audit is also the greater appreciation stakeholders have for what value an effective audit will and will not provide, the approach the team will be taking and the work that will be performed. This all contributes to a reduction in the expectation gap widely documented regarding the current scope and perceived scope of the audit process.

The scope of an audit is not set in stone - only the minimum scope is. Where the current definition does not provide the value desired by stakeholders the scope of work can be increased. Such an increase in scope could most likely be performed by the same audit firm, or where independence could be impaired by the additional work an alternative provider could be sourced to complement the overall engagement. Such collaborative working between firms will become commonplace as the joint audit recommendations of the CMA review are progressed.