



Enhancing Confidence in
the Value of Audit - 2016

A Research Report
commissioned by the
Financial Reporting Council

Enhancing Confidence in the Value of Audit

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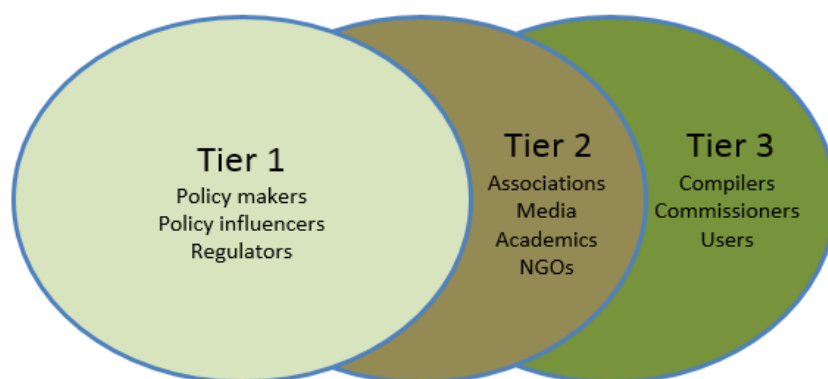
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Background and Methods

This report is the second that YouGov has completed for the Financial Reporting Council looking at levels of confidence in audit amongst stakeholders. The first report, published in 2014, provided an assessment of perceptions, levels of knowledge, and general attitudes to audit. That initial report not only gives a benchmark against which this year's findings can be compared but as the market, standards, and regulation have progressed since 2014, so this report examines these developments.

This report is based on primary research conducted by YouGov, made up of 49 individual interviews with stakeholders. The hour-long, depth interviews were conducted with stakeholders from across the audit process and wider policy landscape.

Three tiers were identified that broadly reflect the varying levels of direct involvement that stakeholders have in the audit process. These three tiers reflect the same approach used in the 2014 report. Respondents were recruited against these tiers with the achieved samples represented below. The only change in composition of the sample was an increase in individuals in Tier 3 including more audit committee chairs, chief finance officers, investors and audit firms. Where possible, respondents from the 2014 report were re-interviewed for the 2016 study to allow some direct comparisons over time. Full details of the composition of the different tiers are supplied in the appendix.



Tier 1 – this is a policy and legislation-based group focusing on political committees or regulatory roles. Amongst the individuals represented were Members of Parliament (including members of the Business Finance and Accountancy committee), regulators and civil servants from the UK, the EU (including the Basel Committee) and the US.

Tier 2 – this group included heads of business associations, business/City journalists, relevant academics (eg business schools), and also relevant NGOs.

Tier 3 – this is a professional audit group consisting of compilers, commissioners and users of audit. It included audit committee chairs, CFOs, audit professionals (from large and mid-tier firms), and major investors.

Executive Summary

It is clear that amongst the individuals interviewed for this study there is a sense of a higher level of confidence in audit than was seen in the 2014 report. A number of the areas mentioned previously have received direct attention in the intervening time period and while many of the amendments are recent or have yet to be fully adopted, the changes they herald are mostly viewed positively, if not without some concerns.

At the heart of confidence is the relationship between audit firms and the companies they audit. Confidence exists when auditors are felt to remain independent of 'client' companies, have the skills and mind-set to audit to a high level, are guided by a combination of relevant principles and rules, and operate in a fair and open market. Each of these four areas have seen some attention over the past couple of years and while not comprehensively positive, the balance is that improvements have been made.

However there is still a sense that an expectation gap remains between what audit does and what certain groups believe it does or indeed would like it to do. For this relatively engaged group, they see this being addressed through the expanding remit of audit but this in itself also causes concern for some respondents over increasing complexity, concerns over liability, false certainty to non-financial or non-audited data, and other issues. There is a fine line to tread here including a need for increased guidance.

The relationship between auditor and client company is central to many of the concerns expressed and the report finds that while being a trusted adviser to a company is seen by firms and companies as potentially beneficial, it worries investors – will the auditor challenge management, will they report concerns?

In general, new and forthcoming changes around capping non-audit services and mandatory retendering or rotation are welcomed but the fear is that the increasing complexity of audit for larger businesses and public interest entities (PIEs) means that the dominance of the Big Four will not change, if that is what these changes are primarily designed to do.

The future of audit looks to respondents as though it will be increasingly based on technology and data analysis capabilities. This raises further concerns about how smaller firms will be able to compete, what the role is for the auditor, and how regulators and standard setters will be able to keep up.

However the FRC is praised by many for the work it has done in recent years and the role it is playing both nationally and internationally. The view amongst some is that a more positive role, looking at what is being done well, would be beneficial.

What has changed since 2014?

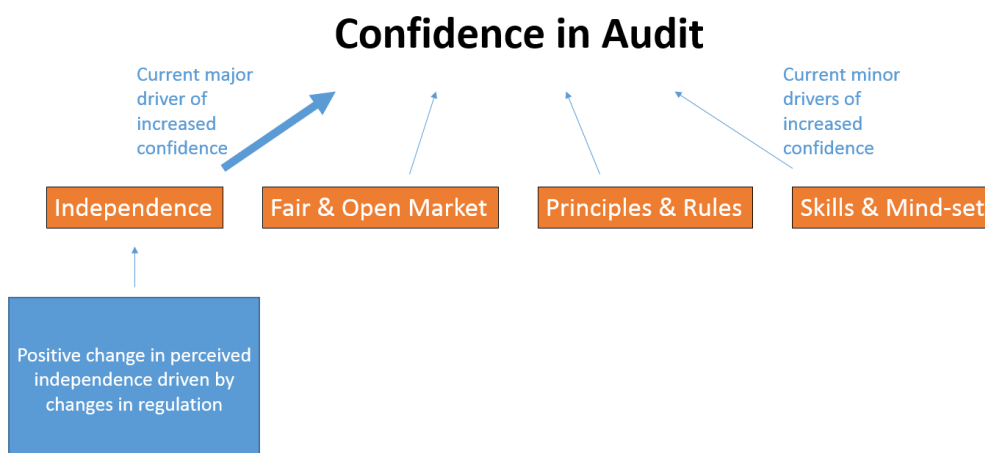
When this research was previously carried out in 2014 we found that stakeholders who were most closely involved with the day-to-day process of audit (e.g. audit firms, CFOs, audit committees) had the highest levels of confidence in audit. Lower levels of confidence – and accompanying demands for change - were found amongst those with less involvement in the day to day process (such as regulators, investors, politicians, academics and journalists). The prevailing sense was that there was scope for confidence levels to increase all round.

While differing levels of confidence are still apparent in 2016 it is also clear that confidence has generally increased since the research was originally carried out. Room for improvement, and an expectation gap between what audit does and what some may expect of it, though do remain.

*“I think auditors have been improving ... I do think we have a good audit system.”
(Audit Committee Chair)*

“Higher than it was previously, an awful lot of work has been done since the financial crisis to set better expectations around what audit can do. But people’s expectations are perhaps exceeding what is realistic in terms of what audit can deliver.” (Business Association)

The catalysts for improved levels of confidence are, broadly, all related to auditor independence. When we ask participants this year to think about the qualities they associate with a good auditor, it is independence that is most frequently cited, so it makes sense that anything which has a positive impact upon auditor independence should also have a positive impact upon confidence of audit.



As one stakeholder rightly notes, it is still though early days in terms of assessing the effectiveness or otherwise of recent reforms such as capping or prohibition of some non-audit services and mandatory retendering and rotation for public interest entities (PIEs).

“We’ll have to see. It takes quite a long while for changes like this to feed through into significant changes in behaviour, and then quite a while after that to judge whether those changes in behaviour have on balance improved the situation in terms of independence, objectivity and rigour.” (Business Association)

However, overall these reforms are seen as “steps in the right direction” (Member of Parliament) which have already had a positive impact in terms of reinforcing the independence which is so crucial to ensuring confidence in audit.

“There is a restriction now on the amount of non-audit services an auditor can provide to their audit clients ... I think it’s important that they help reinforce independence, whether that is perceived or real, it’s got to be positive ... I think we’re moving increasingly to a world in which the auditors provide very little to their clients other than the audit. I think that helps reinforce independence.” (Regulator)

“Opening it up to the market [through mandatory retendering] makes sense ... I get it. I think I probably came around to supporting the idea that audits should move between firms, in most situations, every-so-often. ” (MP)

Another change mentioned specifically by one participant is the clearer requirement for auditors to report problems to the regulator. According to the participant, this “has an extra dimension of encouraging ... independence” (Business Association).

Work in progress

While confidence has generally increased it is clear from our discussions with stakeholders that there is more work still to do in order for that confidence to be fully shared across the board.

“It’s still a work in progress because confidence in business, in general, post the financial crisis went down pretty low and it’s being rebuilt now. Is it back up to the same level that it was before? Probably in the public’s minds no, probably in business and investors’ minds and regulators’ minds, yes.” (Audit firm)

“I’m definitely confident with it. I’m not saying it’s perfect but I’m confident with it ... if I look at us, it does the job that it’s intended to do but I’m sure there would be room for improvement.” (CFO)

Calls remain for external audit to provide stakeholders with greater levels of confidence in the broader running of organisations...

What should audit do? Closing the Expectation Gap

...but while extending audit is positively received by most, there are clear concerns about how best to do it which must be acknowledged and managed

Measures to further increase confidence in Audit

There were a number of suggestions for ways in which this “work in progress” could continue over the coming years.

For the participants with the lowest level of confidence the answer to increasing confidence could be very direct, such as “prosecution of criminal malpractice” (Journalist), however this section of the report highlights three areas which came up more prominently in discussions. Some of these are areas in which the FRC likely has no influence, whereas others suggest scope for action from the FRC:

- Reducing the number of audits requiring significant improvement
- Increased choice of audit firms
- Investor action required

1) Reducing the number of audits requiring significant improvement

As part of the interview participants were prompted with a question to see whether a decrease in the number of FTSE350 companies whose audit requires ‘significant improvement’ from 30% to 10% by 2019 would provide evidence of an increase in confidence of Audit.

In some respects, this proposal could have the unintended consequence of reducing confidence in audit by revealing a problem which was not known to exist amongst the wider stakeholder community.

“I wasn’t aware that 30% of audits of companies of that importance required improvement.” (MP)

There is limited support for the proposal amongst those who are aware of it. One important insight is the suggestion that the proposal would only really have an impact upon those

stakeholders who are closest to audit who also tend to already be the most confident in Audit.

“I saw the 90% target again in one of the papers today, and I don’t think so, I don’t think stakeholders outside of the firms, FRC and the smallish group of audit committee chairs really pay any attention to those, sorts of, statistics.” (ACC)

“I actually think it’s a pretty good idea” (US regulator)

In addition, there are concerns that figures could be massaged in order to give the appearance of hitting the target. While there is no suggestion that this has been done, it is an important point worth bearing in mind and could be a barrier for those stakeholders who are less confident in audit.

“I’m sure that there’s always a risk that whatever measurement you come up with, will be gamed in some way and that people will work round it.” (Civil Servant)

That said, the same participant feels that “having some indicator is better than having none at all”, thereby suggesting that there is potentially value in this.

2) Increased choice

Amongst Audit Committee Chairs (ACCs) there is a clear feeling that choice is a major issue to be addressed. ACCs in particular want to see firms outside of the Big Four tendering for major audits.

“I would like to see more choice in the market and I think that boutique firms are potentially the way to do that. I’m not sure there’s anything that can be created by public policy. I think that just has to come out of the way individual businesses develop their business.” (ACC)

“I think the fact that they still only have four big firms doing most of the major audits, and most of the audits with PIEs, is not a good thing. It would be better to have more and therefore I would want the mid-tier to up their game a bit and be able to claim that space.” (ACC)

This concern is echoed by an academic who noted that the amount of choice currently on offer is considerably lower than was previously the case.

“It used to be the Big Eight, and we’re down to the final four, just because the Monopolies and Mergers Commission is not going to let them merge any further. I think that has to be a material issue.” (Academic)

A couple of ACCs take the issue of restricted choices further by noting that not only are they constrained in their choice of audit firm, but they are also constrained in their choice of lead auditor.

“At [FTSE100 company], I turn up on the board and I find that the lead auditor is exactly the same one as was the lead auditor at [a different FTSE100 company]. Now, what does that tell you? Well, it could just be a coincidence but what it might say is, actually, for the really big companies there is a narrow choice of auditing firms and of auditing individuals ... at [FTSE100 company] we asked ourselves, ‘How many individuals, in London, could lead our audit?’ We thought, ‘Five, maximum.’ ... So, in other words, you’ve got a limit of choice in firm but you’ve also got a limit in choice of sufficiently experienced individuals and that’s not very good either.” (ACC)

This particular participant was concerned primarily about the issue of choice, but there is a further issue that so-called “star auditors” are spread too thinly - so that they cannot get fully to grips with the complexities of the entities which they are supposed to be auditing – or have no role in the audit beyond winning the work for their firm.

“I think part of the problem is that the audit firms that got so greedy since the ‘80s, especially the Big Four, that they will win an audit based on high level partner representation, but then once they’ve got the audit in the bag they hand it over to relatively junior and inexperienced auditors who probably wouldn’t say boo to a goose.” (Journalist)

One action to help increase choice was mentioned by an ACC. Although the participant did not feel that their organisation could move away from one of the Big Four at present they told us that they had taken the initiative by giving “a sizeable piece of business” to a smaller audit firm.

“It was quite a material thing for them and if a few more people did that it might help that problem.” (ACC)

In addition to ACCs taking this kind of action, other participants feel that the FRC has a role to play. Indeed, one participant argues that the regulator has already been working effectively on this issue.

“I think the FRC has the statutory authority to hold audit committees to a higher standard of performance.” (US regulator)

“Bischoff, [FRC Chairman] has been, in a subtle way, very supportive of the medium-sized firms ... without saying to companies, ‘Well I expect you to be appointing a medium-size auditor,’ he’s made it plain that the FRC does see choice as an issue, and he would simply encourage the medium-sized firms to be there and be considered by audit committees.” (Accounting body)

3) Investor action required

Investors – the group which all stakeholders agree are the primary beneficiary of audit – also have an important role to play in fostering an increase in confidence by engaging more with ACCs and audit firms for the entities which they have invested in according to respondents.

“I do think that our peers and shareholders should be dedicating more effort to engaging with companies on their relationships with their auditors ... I think that’s an important thing to do to try and hold them to account in how they interact with their auditors and how they get the best out of them. I also think more engaging with the audit firms and particularly their independent non-executives to try and understand the processes that they’re using to oversee the audit firms ... The anecdotes we get back from independent non-executives is that very few investment firms do spend time to try and speak to them. I would like to see that improve a bit.” (Investor)

As with the suggestion of ACCs getting smaller audit firms involved in statutory audit work this is an area in which a specific stakeholder group could take the initiative in order to increase its own confidence in audit.

Independence & Transparency

All stakeholders agree that independence is key within audit; as we saw in the previous section independence is seen as a driver of quality and at the very heart of the purpose and role of audit. However a number of stakeholders believe that audit's independence is sometimes compromised. This can occur for one of several reasons including:

- an organization's long term relationship with their auditor;
- some auditors' inability to effectively challenge management;
- audit firms potential conflict of interest when offering other services;
- lack of competition within the market;
- the very fact that audits are paid for by the organisation being audited.

"I do think maintaining and protecting audit and independence is very, very important and its clear there's been some sort of compromise to audit independence...through partners or firms having had an extremely long-established relationship with the firm. Its times like that, I think, when sometimes the mistakes get made" (CFO).

"Independence should be a primary quality of an auditor because without that, the value of the report that you make is going to be diminished" (Journalist)

Across stakeholders, confidence in the independence of audit is strongly linked to their confidence in auditors' skill sets, specifically their knowledge of financial reporting standards and regulation and their levels of integrity, scepticism, and ability to challenge management. A singular stakeholder's assessment of the independence of audit is often in itself impacted by the individual's view of the effectiveness of the standards and regulations surrounding audit, as they set the operating environment. The Ethical Standard changes due in June 2016 are at the forefront of most stakeholders' minds. However stakeholders across groups hold mixed views on whether the changes will increase auditor independence and choice within the market.

2016 Ethical Standard

Currently those closest to audit (typically auditors, regulators, ACC's and CFO's) tend to have higher confidence in the independence of auditors, as seen in the 2014 study, due to existing measures such as rotation of lead partners as well as internal processes and checks within businesses and audit firms. Many of the stakeholders within this group welcome the 2016 Ethical Standard changes in principle but question whether those changes, such as mandatory re-tendering, rotation, and a cap on additional services, will have a large tangible impact on levels of independence. The uncertainty is often linked to the concern that there is a significant resource and skills gap between the so-called Big Four and other audit firms; meaning that audit commissioners at large and international companies will still predominately seek the services of the Big Four over others.

“Broadly speaking, they will result in a little bit more competition, they do result in fresh pairs of eyes...Mandatory rotation, mandatory re-tendering, I think probably is right... I think the independence point around audit services, non-audit services, the fee ratios, the calculations, I think are still a bit of a muddle. I think those are not quite right. It focusses on the firm that’s finding the audit opinion and the fee they’re getting for that” (ACC)

Specifically, a few within this group are concerned that re-tendering and mandatory rotation may compromise the quality of audit, through the loss of an auditor’s in-depth knowledge of the business which has grown over time, particularly in complex businesses. There is also a worry amongst a few that the cost of retendering may be too great for smaller audit firms to incur, leading to an even greater divide within the market.

“I think it’s important that auditors rotate after a period of time. I don’t think you should underestimate the challenge that that provides. I’ve got a very short of list of people I can go to for audit. I don’t have a problem if people are trying to reduce the dominance but the problem is I don’t see others coming through to take that place...we’re just limiting, in theory, the value the advisors bring to us” (CFO).

“We have other colleagues that are quite convinced that rotation is good, fresh eyes, etc. etc. and that would create an upward push on quality. Others, at the same time, point out that changing auditors, especially the first year when you talk about a huge global bank, may create some audit risks” (UK regulator).

“The re-tendering process is expensive for the company, it’s expensive for the people who have to re-tender. I think it is a huge mistake. Mandatory rotation I think is a mistake...It assumes that the existing alignment between the company and the auditor is somehow sub-optimal, and that probably isn’t the case if markets are efficient...Maybe you’ve increased objectivity, maybe, but there’s a good chance you’ve taken a hit in expertise. So I do think there’s always this inherent tension between objectivity and expertise... I think what you’ll see is the strong will get stronger, and the weak will get weaker, and you may have more concentration than you have now” (US regulator)

Those less close to audit, or less confident in audit, tend to also be unsure on the level of impact the changes will have on independence and quality. However, they tend to be more positive towards the changes as they provide a valuable and needed ‘perception’, if not evidence, to the public and investors of greater independence and competition within the audit market. Many are waiting with anticipation for the changes to be fully actioned and any impacts to emerge but several were quite sceptical about the chances of success.

“It’s something that, in theory, will reinforce independence... there is a potential to give a chance to mid-tier firms then.” (Journalist).

“Where you’re talking about large, FTSE 100 listed type companies, I think there's going to be very little impact. The Big Four...are really the only option available to them” (Investor)

“I think that the reforms that you described are probably going to be inadequate. They fail to address the root causes of the problems. They’re just skirting around the issues.At the moment the accounting standards devised by IASB that we use are enabling obfuscation, and these aren’t being addressed...It’s not going to change the quality of the audit or the validity of the information with which investors and the general public is being presented” (Journalist)

Some stakeholders who are less close to audit, such as journalists, business associations and academics, believe that currently a conflict of interest can be present within firms who undertake audit and non-audit work. These stakeholders tend to be more in favour of an additional services cap.

“Prevention of providing wider services is useful - wasn't always easy to show that the consultancy practice and the audit practice were working entirely independently. Reputation is improved by having those clear lines in place” (Business Association)

“A commercial firm which is no longer really professional but it’s basically a financial services firm or a business services supermarket is inherently conflicted whenever it does an audit” (Journalist).

“Essentially, an audit should completely be separated from any other activities, consulting or whatever, or tax advisory. So maybe the Big Four should shrink in size and focus on auditing” (Academic)

“There is concern that if audit firms also conduct other work at the same time...they are marking their own homework.” (CFO)

However there is a concern, especially from audit committee chairs spoken to that the additional services cap may lead to audit firms prioritising higher revenue non-audit work over audit, creating less choice within the market. A fear is that if the audit service is a shrinking part of an audit firm’s work and thus revenue, compared to other services, firms may place less resources in audit leading to a decrease in quality.

“I think I would rather see an approach where the company should have a policy for non-audit services, that there’s a proper approval process, and particularly going through non-execs as opposed to the execs” (ACC)

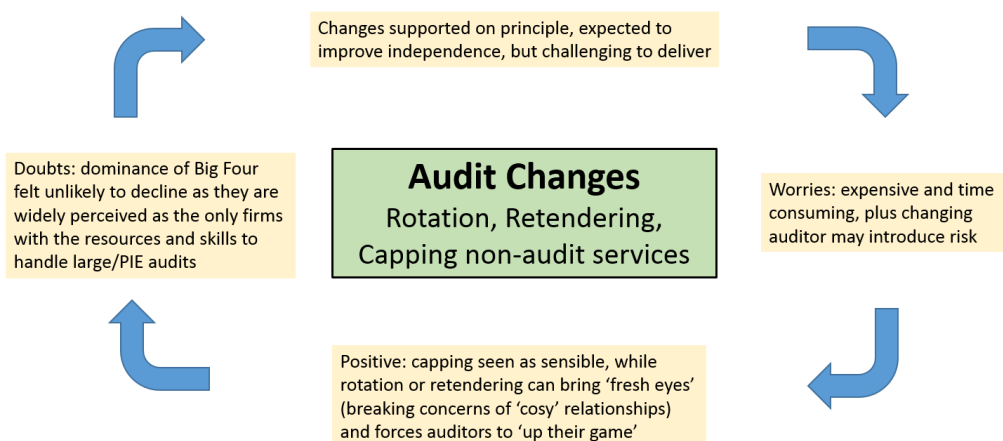
“If you’ve got three different consortiums bidding for the asset, you may find that already the other two accountancy firms have lined up with the opposing bids, you’ve suddenly got no one to advise you” (ACC)

“I think, actually, the pendulum’s gone too far... I understand why the rules are the way they are...but I think it’s really taken to an extreme and gone a little bit far...I think auditors can preserve their independence and still have others in the firm providing additional services, particularly when some of those additional services aren’t of an audit or a test nature” (ACC)

It is important to note that levels of confidence in independence, varies across and within audit firms.

“There’s always going to be cases, particularly I guess with smaller audit firms that have more reliance and more historic relationship with their clients. I think that’s changing now as the audit rotation rules have come into place a little bit more” (Investor)

“If I look back on my relationship with audit partners and I guess to a degree this will always come down to the people involved, because you’re not necessarily trusting an organisation, you’re trusting an individual” (CFO)



Dominance of the Big Four

The Big Four audit firm’s dominance in the market is still perceived as being a reality by nearly all stakeholders and they have mixed views on whether it can be decreased even if they feel it should.

Some CFO’s and ACC’s of large organisations have concerns over the very premise of trying to reduce the dominance of the Big Four, as they do not believe currently that there are any other firms which can be a credible alternative, particularly in regards to resources and skills to undertake large, international and complex audits. Others do though hope that the upcoming changes will help to reduce Big Four dominance which will boost independence and innovation, as well as competition.

“Even bolstering [the next largest firms] through artificial means doesn’t necessarily mean that the situation’s necessarily going to radically improve. I do think when you’ve got a large corporation it is going to have to go to one of the Big Four, because the other ones just don’t have the resources or the geographical spread to be able to handle a client of that scale” (Journalist)

“This is very difficult because the risk aversion amongst directors of companies, who make the appointments, unfortunately means that they tend to always go back to the big firms because they feel more comfortable there.” (Politician)

“I think we’ll probably be rotating through the Big Four. We had a set of criteria against which we assessed the market and the others didn’t match.” (Investor)

“In some cases the mid-tier audit firm just said, ‘It’s not worth it. We know we’re not going to win it. The fundamental hurdle that a mid-tier firm has to demonstrate to me is, ‘Do they have the expertise to audit the valuation of these assets?’” (ACC)

Expanding the remit of Audit

Over the last few years a number of changes to audit have been introduced in the UK which have sought to provide greater insight into the risks and challenges faced by entities. The research focused upon this expanded remit of audit in order to understand stakeholders' views of its usefulness and whether it has had any impact upon the levels of confidence which they have in the reports.

Attitudes towards non-financial reporting

All stakeholders are aware of the recent changes in audit's remit and are generally aware of non-financial reporting requirements on issues such as environmental, social and governance (ESG), cyber security etc.

Although welcomed by most, a small number of stakeholders suggest that this type of reporting should be covered somewhere other than the audit report. The reasons behind this are that auditors are not necessarily specialists in non-financial information areas and others are concerned by the costs associated with the expanded remit and the potential impact upon PIEs.

"I believe that there already exists a number of organisations that provide reports and provide assurance [on environmental issues and cyber security]. The audit firms engage in this activity, that is fine, but it should be distinct from the actual assurance that is provided of the numbers." (Regulator)

"I'm sort of adverse to this. I think it all can be done. An audit monitor can report on employees, and diversity, and KPIs and that sort of thing. I wonder why we need that in place ... the cost is not really justified. So, I'm not in favour of extending their lines of obligation." (CFO)

"[new requirements] will boost cost of audit to insurance companies by five times. So it becomes one of the most significant costs for smaller PIEs and this could end up driving strategy and the wrong behaviours." (Business Association)

However, on the whole, the inclusion of non-financial information in audit reports is welcome and often described as "critical" or "valuable". As the following quote suggests, the inclusion of non-financial reporting could help to address the expectation gap.

"Done well, the auditor could add tremendous value ... if you look at what really moves markets now, it's often non-financial information. It's often information in press releases, it's often information in a filing that goes beyond just the financial statements, and I think a lot of users assume that the auditor audits that." (Regulator)

“I think auditors have a really important part to play in enhancing the trust of that non-financial information. It is that non-financial data, that complete picture that builds the trust and integrity in the financial markets.” (Audit firm)

However, it is also clear that it is still early days. For example, the recently introduced viability statement is already seen as a useful document, but it is also felt that it is a document which will develop and become more useful as auditors become more familiar with the requirement.

“It’s really focused the minds on making sure that everything that’s done relating to risk dovetails into the business plans and with the way that the business looks at its viability. I think that’s one of the most valuable things the FRC has done in years.” (ACC)

“The viability report is a valuable thing to have ... we can look at the end of the year to say, ‘Do we think its valuable in this format or do we want to encourage some further reporting?’ ... I think as we work through and develop companies will hopefully say a bit more. The enhanced auditor reports were in a similar state a couple of years ago and auditors have been trying to work out how best to do it.” (Investor)

Concerns relating to expanded audit reporting

Of course, in addition to the generally positive views on expanded audit reporting, concerns are also apparent. These tend to be focused upon the following issues:

- 1) A lack of consistency in reporting non-financial information;
- 2) Auditors may become too “generalist”, which could affect the core financial reporting;
- 3) The increasing length of reports and the impact upon a report’s usefulness and accessibility; and
- 4) Concerns about auditor liability.

1) Lack of consistency in non-financial reporting

The lack of consistency in how non-financial information is reported is, to some extent, expected and understood to be a result of the inclusion of non-financial information in a report being a recent development with standards yet to be developed. As the quotes below suggest, there is an expectation of greater consistency in the coming years.

“The industry is trying to expand to other non-financial information. The problem is that it’s a new field, so there are no standards yet to look back on.” (Journalist)

“I think in the non-financial reporting area there are attempts to formulate standards but those are very much undeveloped still. So to be able to audit something, you need to have a clear standard against which you can audit it ... that’s a challenge for auditors from a practical point of view.” (Civil servant)

“Share owners would be very keen to see non-financial reporting. The problem is not being able to benchmark across companies though, as non-financial reporting is not consistent, what are the sensible metrics, what does good performance look like?” (Business association)

2) The risk of auditors becoming too generalist

While by no means a majority opinion, a couple of stakeholder discussions did reveal a slight concern that the wider remit that has been assumed by audit reports in recent years could have an impact upon auditors’ key skills.

“I think there may come a time when the auditor is being asked to do something which is so far away from where their natural skillset is, that they’re just becoming a reporter on literally everything, rather than where they should be a specialist. So they become a generalist rather than a specialist.” (Business Association)

The converse of this argument is put forward by an audit firm who argues that an expanded skillset is an important lever for attracting new people to the profession and retaining those who already work within it.

3) Report length

The increasing number of issues covered by auditors has, unsurprisingly, led to longer and more complicated reports being produced impacting both annual reports in general and the auditor’s report specifically. While stakeholders generally agree that these longer reports do contain useful information, a number of them did suggest that work was needed in order to reduce the size and complexity.

“My concern is that, for all that the FRC will occasionally say ‘We want you to cut out the excess verbiage’, there has been a process of ever-expanding quantities of information in annual reports, and I think you enter the realm of diminishing returns fairly swiftly, if you’re not careful.” (Audit firm)

“I think there is a gigantic amount of information which purports to tell you about the risks that are there. My concern is that you get lost in the wood for the trees” (Audit firm)

One potential risk associated with ever expanding reporting requirements is, as the quotes below suggest, that they could have an impact upon the usefulness and accessibility of reports for stakeholders – something which arguably could increase the expectation gap.

“If I look at our document today it’s just over 100 pages and is a very complex document and I think people will struggle to understand some bits ... we need to think about, ‘How does the shareholder, who may not be a corporate institution, actually read it, understand it?’” (CFO)

“In principle, you can understand the logical public interest of wanting to widen the scope of reporting ... [but] the acid test will be what do shareholders, regulators, policymakers, and the wider community, do with and make of these broader reports?” (Business Association)

“I think we need to be careful about what the annual report is for. I think to try and make it all things to all people would be a mistake ... I think, generally, reporting of companies in other areas is valuable but I wouldn’t necessarily say that it all needs to be folded into the annual reporting process.” (ACC)

4) Concerns about liability

A number of stakeholders working for audit firms spoke of the increased risk and the associated liability that comes as a result of expanded audit reporting.

“If auditors are charged with scrutinising things in, for example the ESG area, which are significantly more judgmental, the question is to what degree you are exposed to risk as an auditor if judgements in that area are proved to be wrong. I think that is a risk for the audit profession, and I think auditors should be wary of making hard and fast judgements on things that aren't necessarily subject to measurement in the way that financial accounts are.” (Audit firm)

“The more you say, the more risk that’s going to be out there, so this comes back to a pretty fundamental question; what liability should an auditor should face? Virtually every other liability that a company has got is limited in some way whereas an auditor’s liability seems to be pretty open-ended. If you want more and more, and broader reporting, then the auditors have to weigh up the risk and reward ... If people say that is going to be something that an auditor is going to be suable on, this debate does need to be picked up again at some point in the future.” (Audit firm)

The general feeling amongst audit firms was summed up by one participant who feels that if there were limited liability “auditors would be far more willing to give wider and wider views that would add more value” (Audit firm).

Those stakeholders outside audit firms are less likely to support this suggestion though as they feel that unlimited liability helps to keep auditors “on their toes”. A couple of ACCs also

feel that the audit firms have managed the risk of unlimited liability by becoming LLPs and through engagement letters with numerous let-outs which make it harder to sue auditors.

“My gut feeling is, I’d like to keep unlimited liability to the auditors. I think, historically, when auditors have been sued it’s probably been fair what’s happened. Ultimately, it is a big risk that they’re taking on by making these statements but they manage that risk in a number of ways. I think the balance is right.” (ACC)

Standards and Controls

Setting of standards and the impact on quality and confidence

The majority of stakeholders do agree that the setting of standards can be part of the answer in driving up quality in audit and the level of confidence in audit. No stakeholder interviewed feels that standards alone could guarantee best practice, as the role of the auditor's judgement is seen as more crucial for good auditing. Standards are considered beneficial when acting as a framework only and thus allowing the auditor space to be sceptical and the freedom to use their judgement.

*"An audit is about judgement, too, so I think compliance and a framework doesn't guarantee it, but it certainly helps support good quality. I think without a framework we'd be in quite a difficult position. **It's really important to set out clear standards, clear expectations, and a clear framework, and people will know what they're working to, what 'good' looks like.**" (Civil servant)*

On the whole stakeholders are keen to point out the perceived risk in potentially over-relying on prescribed standards. A fear mentioned by many is that a 'tick box' approach does not guarantee good quality.

*"Standards are a very good place to start, but obviously you've got to use that with professional scepticism and the evidence that you have as well, and the other information that you're gaining through the audit, and **not just rely on a sort of standard.** I think they teach you a very tick box type approach, particularly when it comes to auditing, so it is that scepticism that you've got keep in mind." (Investor)*

Within the audit scrutinisers group of respondents is a segment which is more critical of the current quality of audit. This segment is strongly dismissive of the possibility of standards to guarantee best practice as long as they are not policed and enforced. A view was also expressed that standards need to be relevant and those setting them must also be responsive to wider stakeholders in reviewing them.

*"Standards are useless if **they're not monitored, they're not enforced and there are no punishments** for people who break away from the standards. The standards are there, in a cosmetic way, but their application, enforcement etc., is virtually negligible." (Academic)*

*"That depends on how far standards are policed on a regular basis, and followed up. You can't just set standards and then walk away. **Standards have to be the subject of, sort of, continuous, iterative dialogue between those being regulated and those setting the standards, particularly as common sense and reality changes...** It's a question of setting standards and then following up by seeing how they're put into practice, and asking the auditors whether they're working, and then revising them." (Journalist)*

FRC Role?

There is some variance in understanding among stakeholders about the role of the FRC in setting standards and its role in monitoring and inspection. One stakeholder from the audit commissioners and scrutinisers group who has some experience dealing with the FRC was not fully confident in their own understanding of the FRC's role here and also felt that a broader group would be less clear on this:

"I think I broadly understand, but I don't know how clear it is to everyone... In particular I don't know if a wider audience understands where the FRC is on the spectrum between a body that is funded by companies and is about improving practice, and a body that is a regulator." (Business association)

Some with lower levels of familiarity simply put this down to having to focus on other areas. They may understand that the FRC has some role or is likely to have some role in a broad sense, but are less clear on the particular functions it has responsibility for.

"To be honest, with a fast-changing environment, it's difficult enough to keep up with accounting standards, law, regulation, you know, for your own side of things without having to understand too much about the environment the auditors are working in." (ACC)

Among those with greater awareness of the FRC's role there is a sense that it has the opportunity to have a positive impact on audit. This view draws mainly on the understanding the FRC has a wide remit in responsibility for control setting, including the impact it can have on international standard setting. Once again, however, there are calls for standards not to reduce the space for judgement.

*"There's a long tradition of corporate governance culture in the UK. I think the fact that the FRC has **a broader mandate** that also includes accounting standards setting and also includes responsibility for enforcing the Corporate Governance Code in the UK, is very valuable because it means that it can put audit within a broader picture. It can join the dots, which is not always the case, necessarily, for other auditors in Europe, who are very specialised and deal only with audit."* (EU civil servant)

*"The FRC does have a role to play, and probably **a leading role to play in that as it has primary responsibility for setting the regulatory framework**. It sets the accounting standards, it sets the auditing standards, it sets the ethical standards, it sets corporate government standards. So it's got quite an important role just to make sure all of it sort of tries to work as far as is feasible, a balance without it being so bureaucratic and just being about making sure all the boxes are ticked. **It just needs to allow that room for that judgement to be exercised.**"* (Regulator)

*“Yes, **the FRC can certainly lobby international auditing standards and look to change those where it's being adopted into the UK**, but increasingly, you know, the auditing standards, have increased, and the accounting standards, and they are quite rules-based.” (Investor)*

AQR

The work of the Audit Quality Review team was often mentioned spontaneously in discussions by those closer to audit in practice. On the whole the AQR is seen in a good light and is felt to have had a positive impact on the quality of the audit process.

One stakeholder who has worked with the team is impressed by the open approach and the wider support that goes beyond simply setting the standard.

“It's setting the standard, but it's also about helping support quality improvements as well. I welcome the FRC, it's been quite open. It's a time to help support and embed quality improvements and I've seen the FRC take slightly different approaches to that which I think will help things.” (Civil servant)

This is perhaps a positive answer to the criticism from more negative stakeholders that regulators cannot “just set standards and then walk away.”

An audit committee chair has also found the report from an AQR inspection to be particularly valuable and thorough.

“I found the specific report back on their review useful as well so I've certainly seen them in their regulatory mode and I've had a positive experience of it. What was quite interesting was watching the auditor squirm, being audited for a change and their view on the report that was done on them. It was interesting because one of the comments they made was, ‘The FRC team spent more man hours reviewing their audit than was spent on the audit itself.’ From what I've seen, the auditors are definitely aware of this process, sort of, behind the scenes and, you know, encouraged to pull their socks up as a result of it. So I think it is valuable.” (ACC)

However FRC inspections are not without some criticism. A CFO felt that more clarity and context is needed around FRC inspection grades.

“So the Audit Quality Review team may give a score that says, ‘We highlight an issue.’ ... but you probably need to put it in context of how many files they're having to deal with and how many hours and bits of paperwork. In reality, it was one file note out of probably 2,000 or 3,000 but yet that is raised as a concern for the audit committee which then we have to discuss and, if anything, we have to spend time explaining why it's not a problem.” (CFO)

Principles vs Rules

The arguments around principles vs rules-based audit is one in which most stakeholders in audit are well versed and articulate strong, even if nuanced, views.

No stakeholders believe that either purely rules based audit or purely principles based audit is the answer, but rather a balance between the two. There is a preference for the UK and European audit to lean more towards principles and judgement.

“Europe is still more judgment-based than the US. It’s like, it’s almost, [the US] doesn’t know what to do if there’s not a rule for it.” (ACC)

“We’ve always gone for a true and fair approach, rather than a very mandated standards approach. So, I think we do have to rely on some levels of the auditor’s judgement. It’s probably a better system to have than purely a tick-box exercise, which is open to some issues. Technically tick the boxes but are you giving a real reflection of what the company was actually doing or its financial health? So, I don’t think you would want to move away from auditor’s judgement.” (MP)

Guidance on the principles of audit is seen a preferable to prescribed rules, as already mentioned earlier in the section.

*“I think it’s better to move more towards principles-based reporting. Overt responsibility for making sure that information is fair and reasonable lies with management and the board. Then people apply their minds to presenting good information, in a fair, balanced way. I think the nature of it, is that it’s difficult to become very prescriptive about what’s acceptable, what’s unacceptable, in the way in which it has to be prepared. **I think having guidance on the principles that have to be followed, when presenting non-GAAP, non-financial information, is useful.**” (ACC)*

A consistent justification for principles based auditing is the notion that one size does not fit all. Ensuring that auditors are not restricted in how they can apply their judgment is seen as a crucial element of competency. This is where value can be added from the deeper knowledge of complex entities and the sectors in which they operate.

*“**Not every [audit] company has got exactly the same approach to every accounting standard, because the accounting standard is not that prescriptive.** ... [I]t’s part of that benchmarking exercise, it’s not just the finance function, it’s how people interpret things in certain ways, what’s the range of ways in which people deal with a certain thing. So that is of value. **These firms do build up a very good knowledge of you, and it’s not just the way you account, but I think it’s the culture of the business.**” (CFO)*

“If you look at a highly complex business like investment banking, then there are many grey areas, though there are some which are rules-based there are quite a lot that are principles based. To be able to do a good audit of a highly complex financial service institution you need really well-qualified people who have got a huge amount of experience.” (Audit firm)

There is a claim from one of those most critical of audit in general, that rules based auditing has in fact allowed or enabled some examples of bad audit practice to take place. The suggestion is that strict tick boxing can excuse auditors from using their judgement.

*“Actually, the rules are quite helpful to the big four firms, so that they don’t have to look at the big picture, **they can stand right behind the rules**. If you look at a lot of the big scandals in the last few years, like Co-op bank, the problems inside these organisations were glaring in front of anyone’s eyes. What the auditors chose to do is to focus on the narrow, ticking the boxes, rather than actually looking at the big picture and quickly identifying the risks and challenging the client on the risks.’ (Academic)*

On the other hand, a view is also expressed that some structure in standards is needed and a balance must be found. Being too principles based is not seen as the answer, but a balance between principles and rules based is considered most appropriate.

The key arguments for some level of structure include the need for a theoretical bar or standard on which to benchmark or provide a norm. A few stakeholders also mention that in many circumstances there are relatively junior auditors working who cannot draw on the experience which underpins some advantage in principles based audit.

*“If you have a standard, then, in theory at least, you have a common bar by which you measure people. **I think, providing that it’s seen in that way, then it’s beneficial**. I think one needs to be wary not to turn a standard into a rulebook, where people feel they can say, ‘Well, as long as I’ve ticked these boxes, I’ve done my job.’ (Audit firm)*

*“Often the people who are actually doing the work are **not that experienced**. So they have to work through a programme. So in a way, I’d like to say, ‘Yes, it’s all about judgement, it should all be about judgement and not about structure,’ but actually I think the nature of auditing is such. And also providing the evidential trail that can convince a court, or the regulator that the audit has been done effectively, and that the conclusion on an important matter has been reasonably developed.’ (Accounting body)*

There is also a global aspect for regulators to consider; principles based standards being potentially easier to keep consistent at an international level. Here again there is a

recognition that in trying to achieve a level of consistency across markets both rules based and principles based standards will need to play a part. It is worth noting that these issues were only raised by regulators in discussions and were not an area of focus for other stakeholders.

“Rules-based, when you talk about global standards, it’s very difficult, there’s a downside to that if you would make them worldwide.” (Basel Committee)

“So, we need something in-between, between the global standards on a principle-based level, and the, let’s say, day-to-day application, and that is where I think that the profession, through the firms or through professional bodies, should come in and say, ‘Okay, I’m going to do this’. On a professional level, or regional or national level, we do something in-between that can bridge the gap from operations to these principle-based standards. I guess the majority of our colleagues would prefer to stick to the principle-based standards, on a global level, and there’s a few that probably are mixed around ‘Okay, how do we bridge the principle-based standards into day-to-day instructions for auditors?’” (Basel Committee)

Interestingly, one investor felt that better explaining the principles based approach and what auditors do in practice to wider stakeholders could actually be an aid in reducing the expectation gap.

“I think there are quite a lot of rules-based audit approaches, and I think it would help to identify issues if there was a more principles-based approach. I think again, back to that expectation gap. To try and get people's understanding what an audit is there to do to a higher level, then they will very much appreciate the role that the auditor has to play, rather than just blame, maybe, the auditor for any wrongdoing that happens in the company. If that could be increased, I think there would be a significant change in approach for the audit firm as well. I think it could then move to a much more principles-based methodology.’ (Investor)

Key qualities required of auditors

Fundamentally, stakeholders believe that auditors need high quality technical audit and analytical skills; specifically strong risk analysis skills. Spontaneously a number of stakeholders across groups spoke of the growing need for data analysis and IT skills (examined in the next section). High knowledge of standards and regulation is needed and highly valued, especially by CFO's, regulators and audit chairs.

There are some concerns from many of those interviewed that auditors' technical skills outside the Big Four are weaker compared to those within, due them having less resources to attract strong talent and provide exceptional training. A few are also concerned about the quality and retention of new auditors, due to "relatively low wages" offered to them, compared to other areas of the finance sector.

"The reality is, if auditors make x, and other business professions make 2x, 3x, 4x, guess where smart people are going to go? They're not going to go into auditing"
(USA Regulator)

Across the groups, stakeholders believe that there are a number of specialist skills and communication capabilities which are required along with these technical skills, to turn a 'good auditor' into a 'highly proficient auditor', and to maintain independence and quality within audit. Stakeholders highly value the following non-technical attributes:

- **Communication skills;** the ability to build honest and positive relationships with management and audit committees. Auditors need to be able have difficult conversations, in addition to being a 'sounding board'.
 - Interestingly, while CFO's might view auditors as useful sounding boards and 'partners', journalists and academics preferred a stricter boundary between auditor and client. A couple of CFO's spoke of valuing auditors with whom they feel comfortable to have informal discussions about emerging concerns.

"So the definition of a good auditor is someone who basically the board of directors is frightened of. Someone who will challenge the board of directors. Someone who does not just bow to their needs and desires...is not influenced by the fear of losing non-audit work from that client or clients in the same sector by standing up to those clients. So it comes down to courage" (Journalist).

"You have to be sceptical, robust, technical, but you also have to be able to build very strong communication routes and working relationships, because you need to know what's really going on" (CFO)

"Interest in the business, analytical capability, a subtle understanding of nuance and a willingness to engage and ability to engage with people, to get people to talk and to, sort of, have an intuition about what's going on" (Accounting Body).

- **Integrity;** conforming to high ethical standards, reporting on concerns when found and maintaining objectivity. Many stakeholders do have confidence in auditors' integrity but a few worry that the growing commercial emphasis of large audit firms may compromise it.

"Integrity. You would expect these people to have the highest ethical standards, but also professional standards" (ACC)

"I would put ethics at the heart of a good audit...by ethics, I would mean independence, integrity, professionalism and a kind of conscience and a public conscience. Now, those are the things that the auditors don't want to talk about, because either they don't have it, or they don't know how to cultivate those qualities, because they've become so commercial and so compromised" (Academic)

"Integrity, quality assurance and business ethics" (Politician)

- **Cynicism and scepticism;** many spoke of the importance of auditors having a healthy dose of cynicism and scepticism to better help them identify issues and make sound judgements. A few worry that not all auditors, especially outside of the Big Four, act on their scepticism and judgement effectively, leading to unethical practices continuing.

"Understanding the business is understanding the business model, and how value is created and preserved. Clearly [an auditor needs] a knowledge of the rules and regulations, the ability to use those effectively, the ability to have integrity and cynicism. You're not just taking it at face value... The cynicism is very important." (Accounting body)

"Scepticism, listening, not believing everything you hear, challenging" (Business Association).

"I think it's about having an enquiring mind. Scepticism is a kind of current word, but I think there is something about an enquiring mind, an independent mindset, at being able to process and consider the various facts and pieces of information that are coming around you." (Audit firm)

- **Sector and business knowledge;** the importance of auditors being curious and gaining knowledge of the business, as well as the wider sector, in order to better assess the accounts, spot any concerns early on and provide 'added value' by sharing best practice from the sector. Many believe that senior auditors from the Big Four do have high levels of valuable knowledge. However some worry that mandatory re-pitching and rotation, will lead to auditors having less business knowledge which could lead to issues being overlooked or misinterpreted (see Independence and Transparency section).

“I think they’ve got to invest enough time to understand the business, so they have to have the curiosity and intellect to be able to do that.” (ACC)

“I think it’s vital that auditors have a really, you know, pretty deep sector knowledge. I think it’s really difficult to be effective as an auditor if you don’t. You can skim along the surface, but I don’t see how you can effectively audit something unless you have that pretty deep understanding of what it is you’re actually auditing. Not just for that organisation, but if you have a wider understanding of the broader risks in the sector, I think you need to have that full understanding of risk to be able to carry out your audit properly.” (Investor)

“They need to have some expertise in subject matter, so they need to be able to understand what they are auditing” (Civil servant)

- **Challenging;** while part of the communication skills, a number of respondents on how an auditor must not be afraid to challenge management and confront any issues which may arise. This could be to the detriment of the strength of any personal relationship an auditor may have developed or be something which the auditor may feel could prevent the development of a wider relationship, but it is thought to be a central requirement for a successful working relationship.

“I think they have to have the appropriate challenging way of going about their business. I think they have to probe and challenge judgements that management will be putting forward. They have to be capable of putting the pressure on, if need be. So, they have to have, as a consequence of that, a reasonable working relationship with management, not too close, but also not too distant” (ACC)

“They also need to be brave, to challenge excuses or explanations that are given to them by the managers and controllers of the company, because that can be the weak link in audit, that when you’ve found an anomaly that may or may not be correct, you go to the managers and the directors and say, ‘What is this?’ and you’ll get an explanation. The auditor needs to be very brave to challenge that explanation against who is effectively paying their bill” (Journalist)

Auditors as a trusted adviser

Stakeholders have mixed views on whether an auditor can be a trusted adviser as well as being an independent auditor. Some stakeholders, especially regulators, journalists and politicians, believe that it is not possible nor is it a role that should be aimed for.

“No, we won’t accept that, we want independent everything” (Investor)

“I thought they are supposed to be more independent. They can talk to the CFO and the CFO has to trust the auditor because they are ultimately checking on his

accounts... if they were being a trusted advisor, that would have an impact on independence” (Politician)

“I think there’s a risk that if you become an advisor, you’re no longer performing your role as an auditor. An auditor should be objective about the way that they look at the company, and if they become an advisor to the CFO then they’re almost reviewing their own work.” (Civil Servant).

Those closest to audit (auditors, ACC’s and CFO’s) tend to be more confident that auditors can be a trusted advisers in the sense of them being an informal ‘sounding board’; a supportive yet independent partner. This is bolstered by the practical limit to non-audit fees. Those closest to audit are more likely to see the relationship as having the potential to be extremely positive and offering added value.

“I have to feel I can go and talk to my auditors about challenges without feeling that that then becomes a complete focus point for them... You need to see them as a supportive partner” (ACC)

“They are an independent sounding board... as long as they are not in the pockets of management!” (CFO)

“Internal auditors are my best friend. External audit firms are my second best friend.” (CFO)

“In my experience, the last three audit partners I’ve had where I’ve been a CFO, I’ve had very good relationships with the audit partner, and they have been accountable to me, but they have absolutely been very firm in applying the rules under the governance around decisions... I will generally contact the auditor ahead of time, ahead of the audit, and say, ‘We’ve got this situation, I believe it can be dealt with like this,’ and we will agree how they will interpret it when they come in, so that the dialogue is always proactive.” (CFO)

A few stakeholders note that the parties need to monitor the relationship and recognise its limits. To help maintain this balance, a few CFO’s and ACC’s speak of avoiding employing the same audit firm to be the auditors and the suppliers of consultancy services, while one respondent mention that the need for auditors to report issues to the regulator could make the trusted adviser role very difficult to cultivate.

“Yes... but it can be more difficult if auditing a smaller or owner managed business to avoid any conflict of interest.” (Audit firm)

“Some companies do see their auditor as a trusted adviser - they can help instill the right culture and direction...where I see the relationship working well it's because the chief executive and chairman, and board as a whole, are enthusiastic supporters of the work of the audit team. You've got the risk, or opportunity, depending on which way you look at it now of auditors being expected to report problems to the

regulator. Which has an extra dimension of encouraging independence.” (Business Association)

“Up to a point that is a nice-to-have idea but it also has a danger if it goes too far, and I think that once you start down the path of consultant or trusted adviser, you are already into the realms of, potentially, endangering that independence which is so critical.” (ACC)

Technology and audit

Those who are closest to the day-to-day workings of audit (e.g. Audit firms, some accounting bodies and CEOs) comment on the increased use of technology, and increased automation, in the audit process. Largely, this is felt to be beneficial. It is believed that increased use of technology is shifting the focus away from the compliance or ‘box ticking’ approach, to look at the strategic direction of organisations, and the challenges and risks involved. By using technology for the more ‘routine’ elements of the audit process, auditors’ skills can be better used at the most critical points of the process, such as making judgements.

“One of the things that technology can be used for, is actually to free up time for people to really get into the strategic direction of organisations.” (Audit firm)

“That’s a whole different set of more digitally able individuals to achieve that, rather than your traditional ticking and bashing” (Civil servant)

Another benefit of this tech-enabled approach is that it addresses the current industry challenge: the relevance of the ‘retrospective’ audit. With increased technology, real-time information can be processed more quickly and easily, enabling smarter, ‘real time’ reporting. Not only would this give stakeholders immediate access to audited information, but it would allow them to gain a greater sense of the strategic direction of their organisation, and of its fit within the industry as a whole. While ‘real-time’ auditing is expected to be the next big trend in the industry, most feel that it will take some time to fully bed in.

“One of the big debates has been about the relevance of an audit that looks backward if you like. Whereas if there was more real-time information available and then I suppose that’s going to be the next big trend.” (Audit firm)

“I think that discussions around... auditing or continuous assurance of data, big data, and data analytics and what have you, it’s a bit further away, I would say.” (Regulator)

Some negatives points are, however, raised. Firstly, given the increase in technology, it will be essential for auditors to have a good understanding of the IT systems used in

organisations, and to be adequately trained and able to use these. It will also be important for there to be controls in place at organisations, which could include an element of regulation.

“That would be a much more substantive type approach, but given the fact that there's so much reliance placed on IT systems and other things, so auditors should always have some kind of view to that. Where they place more reliance on things where they're doing analytical type procedures, then yes, I think it's very important to have a good understanding of the IT systems and controls in place at the entity, and that could be sort of regulated” (Regulator)

“I think they're having to think how they go from what was an old-fashioned audit of sampling things to actually trying to get underneath the data. They're going to have to become better at data analytics, there's no doubt about that. I'm not sure real time auditing offers much. I mean, it's a nice idea but, I suppose, firstly what value do we think it will give, over and above today's audit? Secondly, from my point of view, if I've got constantly auditors working with me, I haven't actually got time to run a business.” (CFO)

There are also some concerns about the ability of the regulatory and supervisory framework to cope with the changing nature of audit, in this new technological era. It will, therefore, be key for regulators to keep up with the pace of change in an arena where technology is constantly evolving, and to ensure that it is adequately invested in.

“So, what I would say is that the pace of change now, in the ability to interrogate systems through data analytics and predictive data analytics as well, the regulators need to keep up with that... So how do the regulators invest and how do the regulators keep abreast of the technology.” (Audit firm)

Regulators will also have to address standard setting. Standard setting, which has several current challenges, is expected to be even more difficult in the light of technological change. Respondents say they expect it to be impacted by rapid market developments, which will threaten the effectiveness of the audit regulatory framework as a result however they do seem to have confidence that the FRC is sophisticated enough to deal with this within its regulatory framework.

“There's a bigger issue about the nature of the regulatory framework and standard setting for example. Standard setting is a rather unwieldy process and as technology changes very quickly, standard setting process could be completely blindfolded by very quick market developments. So those are definitely potential risks or threats to the effectiveness of the audit regulatory framework. Technology, big data, data analytics and all of these things, have the potential to really change and not just audit, but the whole of corporate reporting...” (Civil servant)

“Let’s face it, even if we all believed it wasn’t, it’s going to happen anyway, so we’d better make sure that it develops in a constructive way rather than a destructive way with auditors and regulators trying to catch up.” (Audit firm)

Data and non-financial reporting

Across the three groups of interviewees, non-financial reporting is considered to be an important aspect of the audit process, with wider data beyond the ‘basic figures’ playing a strong role. As the use of technology, systems and process in organisations increases, more data points are being generated than ever before and being incorporated into reporting. With more in-depth reporting (that includes broader contextual data), stakeholders can gain a much better understanding of how a business is being run.

“The non-financial aspects should be equally important particularly when within Reports and Accounts to describe how a business is being run. Auditor must check non-financial data to ensure reporting in Reports and Accounts is fair.” (Business Association)

However, some challenges around the use of data in non-financial reporting, are raised. Firstly, there are concerns about relevance; given the vast amount of data available, there needs to be a clear framework about what to include and what to exclude. Without this there is the danger that irrelevant material will be included in reporting, which is expected to dilute the usefulness of documents.

“They’re probably mining more data than I would have thought is actually entirely necessary to enable them to report. So I think they go wide enough, possibly too wide, for what they need to report on.” (Investor)

Individuals also comment on the skillset required of auditors in a more data-focused age. The ability to analyse ‘big data’ requires a greater focus on data analysis and data mining, which goes beyond the skillset of the ‘traditional’ auditor. Some feel that data scientists and researchers are better placed to conduct analysis, and will take on a stronger role here. Individuals are concerned that the role of the auditor may diminish, and question the level of objectivity or even scrutiny applied to the auditing process as a result.

“There’s another thing I’m thinking about, just in terms of skills, that seems particularly apt at the moment. I mean, we’re thinking a lot about how we use-, as we move towards digital approaches in all the data analytics and so on. So some of these, I think that’s more-, rather than quality, its more skills, I think. It’s kind of the ability to analyse and work with some of these sorts of key big data sets, and so on, as well.” (Civil Servant)

“Whether it’s sensible for auditors to do too much of that research themselves, I’m not sure whether they are the ones best placed to do this, whether it’s something

that the research community might step in on, I don't know, that's a more complicated one.” (Academic)

Finally, there are some concerns around cyber-security, especially amongst audit users and audit providers. With greater use of technology, the need for secure systems becomes ever more important; cyber-security, therefore, must be assured.

“If you ask most boards ‘What is your single, biggest, number one risk now compared to three years ago?’ cyber would be right up there. If you can’t invest in the technology and the ability, and just the sheer scale of resources that are necessary, how can you be sure as an auditor that there’s not a big cyber-security type issue as well?” (Audit firm)

“Cyber-security actually is interesting and actually it probably is a good thing. There’s a lot of high focus around the relationship in the business. Certainly find the assurances we get around the data security pieces are useful.” (Investor)

FRC

Strength and Weaknesses

Almost all stakeholders agree that over recent years the FRC has gone through changes and that these have resulted in a positive impact on the organisation and the role it plays in audit. The FRC is seen as open and engaging with stakeholders and it is recognised for introducing some useful developments in auditing standards and communication.

“I think they do engage with us as shareholders increasingly which is useful, and doing things like we’re doing now I think is good to get some feel for shareholders and how it works.” (Investor)

*“For me, the FRC website, it’s well done. I’ve seen one paper from Melanie McLaren the Executive Director dated the first of April 2016, a response to the Head of Unit from the European Commission, Werner Hoyer and ... auditor responses seem to be there. Whoever wants to look for those communications, **they are transparent, they are on the website, and you could not do more than that.**” (Politician)*

Compared to other organisations with similar roles, stakeholders from outside the UK in particular, believe that the FRC compares very favourably and has a role to play as a standard setter.

*“Well I think the FRC, first of all, it’s a very well-resourced organisation, there is no other audit supervisor in Europe that has access to the kinds of resources, purely in budgetary terms, that the FRC has, it has a far larger budget than its closest rivalry, if I can put it that way, across Europe....**I have a very, very high opinion of the FRC and the work that it does, because it is able to engage with companies.** The level of the data is just that much higher in the UK, I think the way that the FRC deals with audit committees is a very good example of that.” (Civil servant)*

Within the UK however, a few stakeholders refer to the FRCs resources as being limited, particularly when compared to some of the larger firms the body must deal with. Despite this, stakeholders still acknowledge that the FRC uses the resources at its disposal very well.

“I think they’ve been like any regulator, they’re limited in the resources that they’ve got, they have to put the priorities where they can but we found them engaging and I think there’s been a noticeable difference over the last few years” (Audit firm)

Although not necessarily expressed as criticism of the FRC, one area of weakness expressed was the failure of regulation to deal with the dominance of the ‘Big Four’ firms. This is clearly viewed as a failure in the market with direct consequences for many stakeholders and so is seen to fall within the remit of the regulator.

*“I see lots of emails come through from them on different initiatives, etc. I still think, though, **the big elephant in the room, which everyone has failed to, sort of, tackle is this Big Four dominance I think.** I've seen a lot of talk over the years.... No one's done anything about it, really, to be frank. I think that's, sort of, a failure of regulation.” (CFO)*

At the same time, stakeholders also understand that the FRC is limited in what it can actually do, for reasons already set out in this report. Of those stakeholders who considered what could be done to reduce the dominance of the Big Four, the answer was more likely to be found in the market itself, and outside the control of the regulator.

*“I think the other approach where they may be successful is what they need to do is operate on a boutique basis, which is decide what sectors they are going to become experts in, buy in that expertise and then start making inroads on the audits in that sector. **I think that's obviously a commercial decision** that they have to take. **It's not one really that can be influenced by people like the FRC.**” (ACC)*

Best practice examples

Specific examples mentioned of initiatives and developments put in place by the FRC that are mentioned, particularly by investors and ACC's include:

- audit quality review
- viability statement
- enhanced audit reporting

1) Audit Quality Review

Helping to support communication between auditors and audit committees is praised by a number of ACCs. Some ACCs also add that generally they do have good professional relationships and communication with auditors, however FRC outputs such as reviews can be useful devices for opening new discussions.

*“[Audit firm X] had a review published on their file reviews. There were a number of critical comments and I went and saw my audit partner, with the head of the audit practice at [audit firm X]. We discussed the findings of the review, considered what impact that had on the quality of the audit, for which I had some responsibility. I think these sorts of things **provide opportunities for further engagement** so that we can provide ourselves with the assurance that we need to be able to rely on the work that's being done.” (ACC)*

“I think those have become more enlightening as well and more challenging for the auditors, which I think is good as well. I think they are doing stuff to try and raise the standards and raise the trust in audit firms and I think indeed auditors are trying to

do it as well. This sort of discussion is that it's a journey that we're still on."
(Investor)

However there are some voices of criticism who feel that in some cases the AQR can just be another level of red tape.

*"We've gone through a period with our auditor and the FRC in the background looking at some work that they did for us. We don't have an issue with them doing it but actually, I'm not sure what they're hoping to find from it and **actually all its done is wasted everyone's time**. You know, these things take up an awful lot of time and it just means that people who should, in reality be running the business, get sucked into the stuff."* (CFO)

2) Viability statement

The viability statement, often mentioned spontaneously by respondents in discussion, is seen as a useful tool and some clearly associate it with the FRC.

*"What lies behind that in terms of the way it's upheld in business management, I think has been very, very good. It's really focused the minds on making sure that everything that's done relating to risk dovetails into the business plans and with the way that the business looks at its viability. **I think that's one of the most valuable things the FRC has done in years.**"* (ACC)

3) Enhanced audit reporting

The changes that the FRC have brought in through the enhanced audit report also receives strong praise from a number of stakeholders. Interestingly not all stakeholders mention the FRC directly when discussing this but others see it as being part of wider FRC improvements (see earlier sections).

"I think that the majority of the communication [with stakeholders] comes through the audit report and therefore the changes in the new report format are very helpful." (CFO)

Need for Strong voice, global collaboration and more outputs

Several people have asked for the FRC to take a greater international role, either via more international leadership or via collaboration, particularly as those outside the UK see it as a leader and something of a test bed.

“I don’t think there’s any other audit supervisors in Europe that have the level of engagement that the FRC has with audit communities, for example. If anything, I would be trying to encourage the spread of the FRC’s best practices to the rest of Europe, because I think they do very good work.” (Civil servant)

But among some stakeholders there is a concern about the level of clout the FRC does wield in Europe.

“I don’t know how visible it is to the EU institutions, which is not a euphemism for saying it’s not visible. I just genuinely don’t know how well the EU institutions know or understand the FRC.” (Business association)

Building a stronger presence through engagement activities in Brussels has been called for, even developing a platform to share and disseminate thought leadership:

“So in Brussels, a specific communication environment, people are doing events at the European Parliament, or at the European Commission, or nearby at one of those think tanks or NGOs. I would like to see a European association connected with a university or a think tank, which would be great.” (Politician)

Indeed, thought leadership and being open about how the FRC views the state of the market is seen as a strength.

“Well I think the FRC is, in general, I don’t know about all the specific examples, but they are very good in terms of thought leadership. So they have this, I can’t remember what it’s called now, financial reporting lab or something like that, which tries to think about things coming up, forward looking agenda. They are very good in terms of, not necessarily micromanaging the market but at least providing a clear guidance to the market about what’s expected, at least that’s the perception I have of the FRC, anyway. So on the whole, I’d say I have a rather positive perception of the FRC.” (Civil servant)

What is their role? Where is it going?

Stakeholders also want to see the FRC be more of a champion of good audit work, make the move to focus on improvement and not fault finding. Those more familiar with the FRC are likely to have picked up either on the effectiveness review that the FRC commissioned on its monitoring work or are heard of sounds about moves focus on and highlight good audit practice

*“I think the changes with the FRC have recently announced following the effectiveness review that took place last year, to become an improvement regulator, and that’s to be welcomed ... On the AQR side, the recommendation that the effectiveness review made is the FRC needed to decide what sort of regulator it was, and ... **the FRC should***

transition from becoming a fault-finding regulator to becoming an improvement regulator. So ... they should actually be looking at how things could improve rather than telling them what they have done wrong and not looking to then make suggestions to how that could be better.” (Regulator)

“I would say, from what I’ve seen of recent engagement, I think the FRC will talk about more carrot as well as stick, and I think they’re getting better at sharing, you know, they have a view across the whole profession and I think they’ve improved how they share that.” (Civil servant)

At this moment however there still remains dissatisfaction with what is perceived as too strong a focus on what firms are not doing well. Some audit firms and CFOs voice concerns that this can have a negative effect on wider stakeholders’ views of audit and undermine trust.

*“I’m sitting here waiting for the publication of the audit inspection reports on the large firms. That will come out in the middle of May, and that will be a list of things that the firms are not doing well and what we’ve been criticised for, **and that is not helping that trust equation.** We all recognise that there is a need for continual improvement and we all recognise that there are things that we can do better, but it would also be helpful to get balance in those kinds of things. That if the majority of jobs and things that they review audit firms are doing a good job on, eg 80% of cases, well shouldn’t 80% of the report be about the good stuff? **Because what will happen is that the journalists will be all over the deficiencies and that’s what that gets right out into the market and it does undermine the general tone.**” (Audit firm)*

Looking forward, a number of stakeholders feel that, following changes and new processes being introduced, there now should be a period of time where this settles down.

*“The FRC themselves promised that they’re going to now be quiet for a few years because they’ve done a lot of things in recent years with the Corporate Governance Statement... **One of the challenges when it comes to the annual reporting cycle is, you know, every year there’s a new tweak.** There’s a new set of guidance to do this and do that and I just think a period of reflection, where there isn’t too much tweaking, I think will be a valuable thing.” (ACC)*

Appendix

A full outline of the stakeholders that were interviewed can be found in the table below.

	Interviews Completed – 49 in total
<u>Tier 1</u> 12 completed	Regulators x 5 (UK x 2 (policy), 2x Basel Committee, 1 US) Politicians x 4 (2 x UK MPs & 1 x Peer on relevant committees, 1 MEP chief of staff) Civil Servants x 3 (2 x UK, 1 x EU)
<u>Tier 2</u> 11 completed	Academics x 2 Journalist x 4 NGOs x 2 Business Association x 3 (1 x PIEs)
<u>Tier 3</u> 26 completed	Audit committee chairs x 7 Audit firms x 5 (1 big four, 2 just outside, 2 smaller) Accounting bodies x 3 Investors x 4 (3 x investment funds, 1 x trade body) CFOs x 7 (5 x FTSE350, 2 x small cap)

A list of project participants who have agreed to be named in this report:

Name	Job Title	Organisation
Lisa Easton	Technical Manager	Association of Investment Companies
Sue Meech	Executive Director of Finance	St James' Place plc
Mark Armour	Chairman of EMEA	Perpetual Income & Growth Investment Trust Plc
Mike Everett	Governance & Stewardship Director	Standard Life Investments
Razvan Hoinaru	Chief of staff to Vice Chair	European Parliament Economic and Monetary Affairs Committee
Joseph Carcello	Member	Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group
Alain Deckers	Head of Unit, Audit & Credit Rating Agencies	European Commission: DG Financial Stability, Financial Service and Capital Markets Union
Nigel Mills MP	Vice Chair	Associate Parliamentary Group on Business, Finance and Accountancy
Lord Robin Hodgson	Member	Associate Parliamentary Group on Business, Finance and Accountancy
Kate Mathers	Director, Financial Audit Practice and Quality	National Audit Office
Xavier-Yves Zanota	Chairman	Basel Committee on Banking Supervision
Nik Van der Ende	Member	Basel Committee on Banking Supervision

Jon Grayson	Deputy Director of Finance	Cabinet Office
Martin Shaw	Chief Executive	Association of Financial Mutuals
Tim Ward	CEO	Quoted Companies Alliance
Paul Stephenson	Director of Group Reporting and Corporate Functions Controller	Vodafone plc
Ian Fraser	Journalist and broadcaster	Freelance
Alisdair McIntosh	Policy and External Relations Director	Chartered Institute of Internal Auditors
Rebecca Cave	Journalist	Freelance
Professor Chris Chapman	Professor of Accounting and Finance	University of Bristol
Dr Atul Shah	Senior Lecturer	Suffolk Business School
David Walker	Journalist	The Guardian
Neil Martin	Chief Finance Director	RM plc
Carlos Martin Tornero	Journalist	The Accountant
Ron Stewart	Audit Committee Chair	Ted Baker plc
Charles Anderson	Finance Director	Ted Baker plc
Claire Ighodaro	Audit Committee Chair	Lloyd's of London
Guy Elliot	Audit Committee Chair	Royal Dutch Shell plc
Nick Land	Audit Committee Chair	Vodafone plc, FRC Codes & Standards Committee
Steve Wilderspin	Audit Committee Chair	3i Infrastructure plc
David Cook	Audit Committee Chair	Alliance Pharma plc
Chris Ward	Chief Financial Officer	Shaftesbury plc
Dr Brendan O'Neill	Treasurer	Institute of Cancer Research
Helen Weir	Chief Finance Officer	Marks & Spencer plc
Phil Holland	Deputy Managing Director, Finance Director	Nexus Group Holdings Ltd, Primary Health Properties plc
Ian Powell	Chairman and Senior Partner	PricewaterhouseCoopers
Michael Izza	Chief Executive Officer	Institute of Chartered Accountants in England & Wales
Sue Almond	Head of Audit and Assurance	Grant Thornton
Charles Tilley	Chief Executive	Chartered Institute of Management Accountants
Sundeep Takwani	Director of Regulation	Association of Chartered Certified Accountants, Global
Aleem Islan	Technical Manager	Association of Accounting Technicians
Steve Gale	Head of Professional Standards	Crowe Clark Whitehill
Ian Durant	Non Executive Director	Institute of Chartered Accountants in England & Wales
Paul Druckman	CEO	International Integrated Reporting Council
Simon Jeffreys	Non Executive Chairman	Aon UK