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Financial Reporting Council

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Dear Shamima,

CONSULTATION DOCUMENT: FIRM-LEVEL AUDIT QUALITY INDICATORS

The above consultation document is a very useful development. The FRC should be commended for the work carried out on this document and its preceding thematic review on this subject. However there is more work to be done.

My answers to the consultation questions are as follows:

Q1. Do you agree that the firms reporting their AQIs should be aligned to the scope of the (revised) Audit Firm Governance Code?

Yes.

Q2. Do you agree the AQIs should include all audit engagements but segmented between PIE and non-PIE audits? If not, what scope would you prefer and why?

No.

The AQIs should include only PIE audits so as to be relevant to the public interest and to eliminate unnecessary burdens.

Q3. Do you expect any additional costs to be incurred by firms reporting over a period which is not aligned with their financial years? Are there ways to minimize these costs?

Reporting on the proposed indicators will of course add to the bureaucracy and cost of individual audit engagements. It is important that the information gathering process does not add unnecessarily to the workload and time pressures of group engagement partners and managers particularly during the crucial closedown period of audits and in the busy season.

The proposed period of 1 April - 31 March is supported. It is beneficial to avoid selecting a 31 December date or another date in the busy period as this would add further burdens when there is already too much auditor workload and time pressure. For the same reason firms should be given at least three months to provide their AQI information after 31 March.

The costs can be reduced by only reporting on PIE audits.

Q4.Do you agree that it would be useful to include supporting narrative. Please provide suggestions to ensure that the information is concise and useful to users of audit services.

Yes, but put a cap on the number of characters that can be used and a ban on alternative performance measures being referred to.

Q5.Do you agree with the proposed AQIs? If not, or in addition, do you prefer some of the alternatives presented above? Please explain using the reference numbers.

No.

AQI no.3b' Average percentage of audit hours spent in the two weeks before sign-off' is highly questionable as a measure of audit performance. A high percentage would probably arise from poor audited entity performance in terms of information supplied to auditors late or of poor quality. Other factors would also distort this percentage such as geopolitical developments and changing economic circumstances when a high percentage could indicate a particular set of effective responses to late developments.

The meaning of 'audit leadership' within AQI no.14 requires some definition. Does it mean an audit board or is it about audit management?

Q6.Do you think there are any other firm-level AQIs that we should consider? If so, please explain.(If relevant, please refer to the list of AQIs we have considered but not proposed on Appendix 1).

No but there is also a strong need for 'Regulator-level workload and time pressure indicators' as explained below.

It is notable that the extensive and compelling US research by Persellin et al (2019) showed that auditors most often cited PCAOB(the US equivalent of the FRC and ARGA) pressure as the most significant external workload driver. The respondents at all levels and at all types of audit firms felt much more negatively about working in the auditing profession than they remember feeling at the beginning of their careers largely due to the presence of excessive workloads. They also believed that the demands placed on auditors were high with workloads significantly exceeding what the respondents perceive to be the point at which audit quality begins to deteriorate.

Key takeaways included that 85.63% of the current auditors responding perceived the workload effect as being a decrease in audit quality. The specific negative effects in order of ranking were:

less diligence in performance of audit procedures, inadequate staffing/staff turnover; impaired judgement and equally: forced to take short cuts; insufficient documentation and lack of professional scepticism (Table 3).These outcomes are worryingly similar to the outputs of FRC audit inspections.

It is also significant that a leading audit academic and former member of the PCAOB (Brown 2019) has raised concerns that time compression may cause auditors to skip procedures, pay less attention to matters discovered during the audit or otherwise fail to exercise professional judgement. In the UK, as it is in the USA, this is against the background of mountains of financial reporting, ethical and auditing standards which are increasingly similar. This has involved the setting of increasingly detailed and demanding standards which have resulted in the firms adopting the 'airline risk management approach' of lengthy checklists and thereby in longer and longer audit programmes and checklists. This in turn has result in more box-ticking and a fill-in-the-blank mindset (see Guy 2008) and not enough time particularly during audit closedown on: thinking differently, imaginatively,skeptically and past the numbers which is how frauds are from my experience actually found; checking what should have been done has been done properly and in ensuring that the professional judgements have been properly carried out and documented.

These time compression issues affect preparers as well as auditors, and alleviating them would reduce the problems impacting audit quality arising from late delivery of information to auditors and from the provision of poor financial information to auditors which gives rise to a ' garbage in garbage out' problem.

The past twenty years have also resulted in much longer annual reports and accounts which for FTSE 100 companies appear to have on average trebled in length (see Jones 2022). The leading accounting and financial reporting academic, Lev (2018) has also concluded that there is a wide-spread and growing dissatisfaction with the relevance and usefulness of financial report information particularly among investors and corporate executives. He also referred to the study by Bonsall et al (2017) that concluded that financial reports are outright 'unreadable'. Lev also points out that surveys show that many financial executives believe that " financial reporting has degenerated into an ever-more-burdensome 'compliance exercise' rather than an endeavour to inform stakeholders". Increasingly valuations have become based on cash flow forecasts and therefore on judgements about the future. These judgements have become more complex and demanding particularly given the extent of economic, business and geopolitical uncertainties . Financial statements are therefore much more difficult to prepare, evidence, approve, audit, understand and analyse.

It is therefore not surprising that Sir John Kingman recommended that the Regulator should promote brevity and comprehensibility in accounts and annual reports, engage meaningfully with users and asset owners about their information needs, and ensure the proportionality and value of reports. There is also evidence that, despite the huge increase in the length of annual reports and accounts for FTSE 100 companies, their reporting timetables (between the balance sheet date and the date of audit sign-off) seem on average to have slightly reduced (

see Jones 2022). All in all this would appear to be a clear sign of much greater workload, time pressure and stress not only for auditors but also preparers.

It is therefore recommended that ARGA should publish annually the following ‘Regulator-level workload and time pressure indicators’ and take action to improve them as I would suggest that such pressures are very significant root causes of what has been going wrong:

*For different constituencies of the FTSE and of other PIEs the length of the financial statements and of the annual reports and accounts

*For the same constituencies the reporting timetables

*The number of pages of financial reporting, ethical and auditing standards applicable to PIEs and less complex entries

*The number and proportion of PIEs with 31 December year ends which just add to time compression problems

*The number and length of new or replacement financial reporting and auditing standards coming into force in year

*The number of topical issues being identified for special attention by the Regulator in the run up to each busy season

*The level of stress, burnout and mental health problems in the accountancy profession bearing in mind that there is a very strong link with audit quality problems. More on this follows below.

It also needs to be borne in mind that increased standardisation is not a panacea. It acts as a barrier to challenger firms and to innovation in the PIE audit market place and puts intolerable stress on small practice firms and on individuals at all levels. Anecdotally I have been told that compliance with ever-more-complicated and sometimes ridiculously detailed standards, let alone the rise of ESG, puts a massive stress on the audit. Perhaps the medicine being dished up by the standard setters in ever bigger doses is actually killing the patient.

A leading audit academic has recently expressed the view that it is unreal that ARGA should cause a problem for a stakeholder (excessive standards) and then levy the stakeholder for the cost of addressing the problem. It is also puzzling that there is not a substantial discount given under the disciplinary scheme for auditors to take account of the standards overload that the regulator is itself creating under a regulatory impact assessment process which does not seem to have taken sufficiently into account the overall workload, time pressure and mental health issues at the individual level. See more on this below. The academic has also expressed the view that ARGA needs to understand the interconnectivity of what it is doing, and that there is no sign of that. Clearly this situation needs to be changed.

Q7. Are there any other comments you wish to make about these proposals, including concerning costs, benefits or impacts not discussed above.

Yes.

To achieve the right impact, the finalized document on AQIs should make it crystal clear that it is intended to be part of the process of moving beyond the notion of audit firms being expected by companies to compete primarily on cost and instead more towards true audit quality.

Low fee quotes are of course a recipe for poor audit quality as they are more likely to result in heavy workloads, high staff turnover, low experience levels, low supervision, skimped procedures, poor judgements and dysfunctional audit outcomes.

The subject of audit quality indicators is so important that it should be subject not only to an ‘ex ante’ but also a ‘post implementation’ impact assessment. Clearly in doing so, full regard should be paid to HM Treasury’s Green Book on Central Government Guidance on Appraisal and Evaluation which extends to regulatory impact assessments. This should be applied fully given the Regulator’s very wide private sector interface, the extensive levy raising powers that it will be given and its potential impact on the competitiveness of the UK as a place to do business and of UK capital markets.

The Green Book indicates the need to deal with subjective wellbeing approaches and with life and health effects which do not seem to be addressed as part of the information gathering for this project. It therefore follows that the impact assessment relating to firm-level audit quality indicators should take account of, and ask specific questions on, these matters. This is highly relevant given the recent publication (2022) by CABA, the wellbeing charity, entitled ‘ ‘Shining a light on mental health: Issues for the accountancy profession’. That publication is a wakeup call for all of us including the body regulating the accountancy profession.

CABA says that of their survey of accountants 55% of its respondents admitted that they were suffering from stress and burnout. 79% of them believe that stress and poor mental are a problem within the industry with the most common reasons for this being being heavy workload (87%), long hours (72%) and complex work with no room for error(63%).

There is also strong research evidence that excessive auditor workload gives rise to negative audit effects. See again the extensive study by Persellin et al (2019) and many other research studies(see Jones 2022). It is therefore recommended that all current and future FRC and ARGA impact assessments disclose the impact on auditor and preparer workload, time pressure, stress, burnout and other mental health issues at the individual level particularly during the busy season. This needs to be on a cumulative basis and not just on the particular item being considered in isolation.

It is also important that in creating meaningful impact assessments that the questions of consultees be directed not only towards the impact on stakeholders but also towards the individuals at different levels within preparer entities and audit firms. Such questions should include the extent to which a proposed standard or reporting requirement would in the context of the existing requirements impact workload, time pressure, stress and burnout and create dysfunctional reporting and audit outcomes and unintentional mental health consequences.

It is appreciated that there may be laudable reasons for a proposed standard, guidance document or a reporting expectation. However it needs to be borne in mind that there are already mountains of existing requirements , an avalanche of potential burdens on business and audit firms arising from a variety of sources including the Government's response to its consultation on restoring trust in audit and corporate governance, climate-related developments, and the extensive work programmes of various standard setters.

For the reasons set out above, it is also recommended that a separate team or body be created for the development of ARGA's impact assessment separate from those drafting standards or other reporting requirements who clearly have an ' independence self review threat' that would promote the ignoring or downplaying of the unintended consequences of what they draft. This would prevent the standard setters from effectively 'marking their own homework' . It would also be advisable that members of that team have no prior background in standard setting and therefore can act, and be perceived as acting, independently and objectively. This would also help overcome what HM Treasury describes as 'optimism bias' in the development of impact assessments.

The main arguments against this may be that it would slow down standard and guidance setting processes and divert some resources away from detailed standard and guidance setting per se towards more effort on impact assessment. I would suggest that these would actually be sensible developments as currently the accountancy profession and businesses of different sizes seem to be struggling with the existing and growing mountains of standards and guidance, the constant churn and addition and with excessive levels of stress at all levels.

Anecdotally I have been told that the pressure on all firms and corporates is huge. I have also been informed that the life of smaller practitioners is being made unnecessarily stressful by the various regulatory and professional bodies in terms of standards overload and overzealous regulation. There are also problems at the other end of the spectrum given the level of inflationary and geopolitical challenges hugely elevating business risk. It is therefore also important that those producing impact assessments should direct enough focus to the risks arising from the standards and disclosure overload and from unintended consequences.

Another key Regulator-level workload and time pressure indicator is the number of days between the date of the auditor obtaining sufficient appropriate audit evidence and the date of auditor sign-off. This important gap enables the group engagement partner to think calmly and properly and in a detached manner about: the overall package of the annual report and accounts and the auditor's report; the significant professional judgements and to ensure they are well documented; the quality of the evidence obtained; and whether the work that should be done has been done properly. (See Jones 2022).

Unfortunately in the UK this Regulator-level workload and time pressure indicator is zero and therefore suboptimal as, under ISA (UK) 700 and in particular the UK ISA plus paragraphs, the date of the auditor's report must be the date of physical signing. This is done so as to avoid back dating. However this key gap can be obtained by having in the UK the inclusion of two dates in the report - the date when the sufficient appropriate audit evidence was obtained and separately the date of physical sign-off. This would put the UK more in line with the rest of the world under international ISAs and thereby create important audit quality benefits. (See Jones 2022).

The time has come to use 'Regulator - level workload and time pressure indicators' and Firm - level audit and financial reporting quality indicators to push against longer, more detailed and excessively demanding standards. There is also a strong need to move towards smarter standards, subtraction and simplification rather than constant addition. This would establish a more successful and less burdensome form of financial reporting, ethics and audit standard setting and of regulation.

Conway(2021) makes the key point that year after year many express concerns about the (accountancy) profession's ability to attract and retain high quality professionals. He also says that it is important to fix the human capital management issues that exist today, not only to improve audit quality in the near term but also to secure the pipeline of future professionals needed to sustain the audit profession into the future. I agree with his call that, " Forward progress is long overdue" and recommend that view to you.

SOURCES

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DECLARATION OF INTEREST

The author is Chair of the Advisory Board to the Department of Economics and Finance at Brunel University London. He is also a retired partner in Deloitte LLP and therefore has financial connections with that firm. He had UK national and global roles in that firm. He is also a past President and former Chair of the Board of the ICAEW. However the views he expresses are personal and not necessarily shared by those bodies.

I hope that you find my responses constructive. Please let me know if you want to discuss them.

Yours sincerely,

Martyn E Jones