AQIs-consultation@frc.org.uk

Credentials
Response by Professor Krish Bhaskar, August 2022 who is providing views as a researcher.
My recent publications include:
The four volumes of the Disruption in Financial Reporting series are (all by Routledge):
Volume 1: Disruption in the Audit Market: The Future of the Big Four, 2019
Volume 2: Financial Failures & Scandals: From Enron to Carillion, 2019
Volume 3: Disruption in Financial Reporting: A post-pandemic View of the Future of Corporate Reporting, 2021
and
Volume 4: Disruption in Auditing: in draft form, possible 2023 publication

Volume 1 to 3 had Professor John Flower and Rod Sellers OBE, FCA as co-authors. In volume 4, I am joined by Professor Christopher Humphrey (Alliance Manchester Business School) and Rod Sellers (OBE, FCA, and President 2022/23 of ICAEW Manchester).

However these replies are my own personal views based on my day-to-day observations, my knowledge, and my research.

Question 1
Do you agree that the firms reporting their AQIs should be aligned to the scope of the (revised) Audit Firm Governance Code? If not, what scope would you prefer and why?
Which audit firms should be included?
If the FRC's intention is to bolster mid-tier and challenger firms, then it would seem appropriate to include all 31 PIE audit firms or whatever number this becomes. The switch from the Big Four and the challenger companies is hastened by the fact that all the 31 audit firms are at capacity and struggling to recruit trainees and qualified staff. You recent key statistics reinforce this.[1]

In another response to Consultation on funding the Audit, Reporting and Governance Authority, I make father comments on the scope of audit regulation in general. I would like all concerned to have a fundamental rethink of auditing as a positive force, holistic rather than box-ticking, and less 'comply-or-explain' rather than what audit is at the moment which is a necessary evil. And auditing to become a process that is assumed to be beneficial to the audited entity. The increasing regulation envisaged and currently progressing by the FRC/ARGA seems to be against government policy[2] which wants to eliminate EU regulations. The current direction of the FRC/ARGA is to end up with stricter and more regulations than under the EU.

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[1] https://www.frc.org.uk/news/august-2022/frc-publishes-key-facts-and-trends-in-the-accounta
[2] Many possible references but see this Financial Times article of the 10 August 2022. https://www.ft.com/content/fa52b076-2642-4c48-acfd-3ba45fe7c79d

Question 2
Do you agree that the AQIs should include all audit engagements, but segmented between PIE and non- PIE audits? If not, which engagements do you think should be included?
Which audits should be included?
If these tests are undertaken then I would feel more comfortable if it was based on the entire audit practice. As an example, I was examining the accounts of a non-listed engineering company audited by the one of the larger challenger firms. The accounts were not qualified (given a true and fair view) despite statements such as:

> 'In respect solely of the limitation on our work relating to stock, as described above we have not received all the information and explanations we require for our audit we were unable to determine whether adequate accounting records had been maintained'

That stock was actually located in Eastern Europe, India, and Australia. The stock and most of the overseas assets were laid claim by separate non-associated private companies in overseas accounts with a completely separate set of shareholders and management. This also applied to the fixed assets which were all owned by other companies. So the UK reported accounts were, in my opinion, grossly misstated the company's actual financial position. I came to learn of this as I was acting as an advisor to a possible purchaser of the company (period 2011 to 2017). In my earlier publications, we have criticised some of the annual reports of the FTSE100 as being misleading.

Question 3
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 minimise these costs?
No opinion. It would seem common sense to allow a greater transition period for the smaller firms – probably not the Big Four or so.

Question 4
Do you agree that it would be useful to include supporting narrative? Please provide suggestions to ensure that the information is concise and useful for users of audit services.
The danger is that such textual material would not be informative or provide boilerplate narrative. In our research, we found this to be the case in many of the narrative sections of the FTSE350 annual reports in recent years[3]. However, if there was some method of trying to ensure that such narrative was germane and relevant that would be good. That said the FRC has, in my opinion, not had a good reputation for changing narratives sections of annual reports so far. In that respect we found that some shorter annual reports of private companies were more neutral, relevant and informative in explaining the financial statements that followed[4]. Those shorter narrative sections had a much better tone.

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[3] Bhaskar et al, *Disruption in Financial Reporting: a post-pandemic view of the future of corporate reporting,* Routledge, 2021.
[4] Ibid.

Question 5
Do you agree with our proposed AQIs? If not, or in addition, do you prefer some of the alternatives presented above? Please explain, using the reference numbers.
No specific observations. However, I acknowledge that the FRC has moved towards such metrics but I would like to see some of Conway's metrics considered[5]. Examples are provided below.

Attribute	Relevant Metrics
General Experience	Average years of experience weighted by the hours incurred by each audit professional on the audit.
Knowledge of Client	Percentage year-over-year continuity (percentage of personnel retained from last year's audit for the current year audit; losses would include voluntary resignations, reassignments to other audits, and transfers to other offices).
Workload	Percentage of hours incurred over 40 hours per week as a percentage of total hours incurred.
Supervision / Leverage / Expertise	Ratio of staff time to partner time
Use of Specialists	Actual specialist hours as a percentage of planned hours
Industry Specialization	Narrative supplemented by years of specialized industry experience for managers and partners.

Conway also provides an example shown below:

THE TRUTH ABOUT PUBLIC ACCOUNTING[6]

Attribute	The Audit Promised	The Audit Delivered
Workloads	3 hours of overtime per week per professional	20 hours of overtime per week per professional
Staff continuity (year-over-year)	80% staff return rate	50% staff return rate
Weighted average years of staff experience post-CPA licensing	3 years	1 year
Ratio of staff hours to partner hours	7 to 1	10 to 1
Actual specialist time as a percentage of the 60 hours of specialist time planned	100%	70%

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[5] R A Conway, The Truth About Public Accounting, 2020. See Page 92.
[6] *Op. Cit.* Page 101

Question 6
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, in Appendix 1.)
See answer to Question 5.

Question 7
Are there any other comments you wish to make about these proposals, including concerning costs, benefits, or impacts not discussed above?
In another response to Consultation on funding the Audit, Reporting and Governance Authority, I make the following general comments.

Groundhog Day effect
From Enron onwards, we have seen financial crises and scandals lead to a tightening of reporting and auditing regulations. There have been several main government sponsored reports:

> Parliamentary Select Committee into the failure of Carillion[7] (May 2018).
> Competition & Market Authority report on the audit market[8] (April 2019).
> Kingsman Report into the workings of the FRC.[9]
> Brydon Report into the quality and effectiveness of audit[10] (December 2019).
> ARGA[11] to be created as a result of the Kingman report,
> White Paper and a Revised Government White Paper[12]

What we are seeing is the Groundhog Day effect. Scandal followed by regulations. Nothing ever seems to work. Meanwhile the concept of 'audit' is becoming what may be described as a dirty word. Comments by the FT reinforce this:

> Stop complaining about audit fines and improve your work, UK regulator tells firms
> Comments by FRC's Sir Jon Thompson come after complaints that clampdown by watchdog was putting off new recruits.[13]

In all these studies and comments by our academic peers, very few examine audit with a fundamental rethink and holistic concept which may lead to positive benefits to the entity being audited.

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[7] House of Commons. *Business, Energy and Industrial Strategy and Work and Pensions Committees. Carillion.* Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19. HC 769. Published on 16 May 2018. by authority of the House of Common
Available at:
https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf
Accessed April 2022.
[8] Competition & Markets Authority. Statutory audit services market study. 18 April 2019.
Available at:
https://www.gov.uk/cma-cases/statutory-audit-market-study
Accessed April 2022
[9] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf
[10]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf
[11] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf
[12] https://www.gov.uk/government/news/audit-regime-overhaul-to-help-restore-trust-in-big-business
[13] https://www.ft.com/content/ac6cce71-aaf2-485b-b8b9-bbe701dd7414

Question 7 Continued

Audit redefine?
Audit is seen as a necessary evil and not something that helps a company. There ought to be a fundamental rethink. However, all of the recent publications (of which there have been many) continue to support the necessary evil doctrine.

I believe we ought to rethink the guiding principles behind the FRC/ARGA. I also think the number and size of the FRC publications is impossible to follow and leads to more box-ticking rather than any fundamental purpose. In many ways, auditing and the audit market are now facing disruption with no positive or beneficial signs emerging.

The FRC fines seem to be written-off by auditing fines as the cost of doing auditing business. It has had a knock-on effect as for example EY wanting a complete divorce of auditing from its growing consulting divisions. What is more than proportionate is the threat of sanctions on individual auditors and partners. That has a dramatic impact. For the general public fines in millions of pounds may seem large but for the auditors it is either insured against or written off as an expense – as said above as the cost of auditing. Frequency of fines means the press treats these as almost reported as a routine or not reported at all.

Reputational damage:
There is little sign that any reputational damage has occurred because of the fines, sanctions or auditing quality commentary from the FRC. KPMG should have been the auditor to have suffered most and yet they seem to have only slightly suffered a dip in turnover. As for the public, these fines and quality comments are made so often for all the Big Four and now also for the mid-field challengers, that any reputational damage is not spread to any individual firm but to the process of auditing and the audit market in general.

This is reinforced by all the Big Four and many smaller firms reporting record profits (as of 2022). These fines are treated as below the line costs. However, the real impact is on the staff and partners and their career prospects. An exclusion or fine could and has ruined many careers.

Impact on UK capital markets
I think the current proposals will make it more difficult to attract foreign investors and budding entrepreneurs who want to list or form companies in the UK. As such the current thrust and strategy of the FRC/ARGA seems directly opposed to the ostensible statements of the current government (both Liz Truss and Rishi Sunak have suggested less red-tape and less regulation).

Audit market
At the moment the Big Four and the other top 27 audit firms are at capacity. The industry has trouble in recruiting trainees and qualified staff. This has been made worse by the expanding scope and width of audit at a time when all companies are under intense commercial pressures from supply-line shortages, red-tape associated with Brexit, and higher than normal inflation. The situation will further deteriorate by the expanding PIE definition which is estimated to involve a further 600 companies.

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Question 7 Continued

Audit market/Continued
If there are no new entrants, this lack of capacity is going to be made worse by increasing quantities of reports, guides and publications by the FRC. I would like to see the new ARGA as a helpful force and with the ability to help and smooth the reporting and auditing function and also to represent audit as a positive impact on companies – not the negative one that is current and growing at the moment.

The audit of riskier companies
As the FT article reported (quoted below), the FRC sees mid-tier challenger firms as growing too fast and taking on the riskier audits that have been rejected by the Big Four:

> "These firms have been growing too fast, picking up higher-risk audits being dropped by their peers, without adequate controls to ensure high-quality audits," the regulator said in its report.[14]

This leads to the Big Four cherry picking their audit clients whilst not tendering for the more risky audits. This leaves such audits to the smaller firms who perhaps have less resources and experience than the Big Four.

Proposed governance code
Several people have questioned the proposed governance code. Credence should be given to some of these criticisms in revising the code. For example. Brian Griffiths, Professor of corporate law at the University of Cambridge, argued against strengthening corporate governance. In this article[15] he argues that the proposed code is too long and complicated, is irrelevant in material aspects, he does not like the 'comply-or-explain' elements of the code and believes the code fits poorly with its operation and other criticisms Some credence should be given to such views before revising the proposed governance code.

FRC Publications
There are too many and they are too long and almost impossible to follow or comprehend. Sometimes these publications make up their own nomenclature as they proceed. These publications become increasingly divergent form the mainstream global reporting and auditing publications.

Government's objectives
If the government's objective is to have less regulation post-Brexit and fewer EU regulations, the ARGA proposals have actually led to more regulations and more form filling than exists anywhere in the EU. So instead of reducing regulation the government has succeed in tightening and increasing regulations. If a company has a choice of where to list it will be less willing to list in the UK because of the increased regulation. This is turn will impact on hastening the decline of the UK stock markets in relation to our EU counterparts or emerging Asian ones.

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[14] https://www.thetimes.co.uk/article/challenger-audit-firms-on-back-foot-as-big-four-drop-riskier-clients-snj06hntz
This refers to the FRC publications:
https://www.frc.org.uk/news/july-2022/frc-publishes-latest-audit-quality-review-results
[15] https://www.ft.com/content/057accea-5135-4a26-a5ed-e428184bc209