4 things that could reshape the future of audit

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20 Jan 2021

After three critical reports, the prospect of a new regulator and the break of the Big Four, audit could be on the cusp of meaningful change.

Financial auditing is frequently in the news, thanks to a growing list of court cases and fines. Public perception of auditors is low due to failings; while the regulator faces constant criticism. Misgivings are not removed by the fact a handful of firms handle nearly 100% of the FTSE 350's audit work (as well as a great deal of its non-audit work).

There is a mood for change in the air – to overhaul the system, loosen the Big Four's grip, encourage second-tier firms to grab a slice of the pie, decouple audit firms from their advisory and tax arms, and breathe a new lease of life into the regulator.

Three key reports have landed in the last year, providing a catalyst for change:

- Competition and Market Authority (CMA)'s Report,
- Brydon Report, and
- Kingsman Review.

The Financial Reporting Council (FRC) transformation into the Audit Reporting and Governance Authority (ARGA) could also provide momentum.

We spoke to several leading commentators for their views and opinions of the likelihood of change in the UK's audit sector. They are:

- Lord Prem Sikka, professor of accounting and finance at University of Sheffield and emeritus professor of accounting at the University of Essex.
- Emile Woolf FCA, a retired chartered accountant, non-executive director and a well-published audit commentator.
- Sunil Bhavnani, a technical director at Blick Rothenberg.
- Philip Shohet, a senior consultant at Foulger Underwood.
- Chris Biggs FCA, a partner at chartered accountants, Theta Global Advisors.

1 The reports

Emile Woolf: "The Big Four audit firms are the creators of their own crisis. They have steadfastly refused to face up to the reality of conflicts of interest. They have totally failed to understand the true meaning of independence in the context of audits. While I firmly believe that public interest enterprise (PIE) audits are crucial for instilling faith in financial reporting, I don't believe the Big Four will ever grasp the nettle."

Philip Shohet: "There's a huge opportunity if somebody can actually grasp the nettle to get some really quality reporting done. I think conflicts of interest are less of a problem; it's what they're producing as accounts and information and how useful this is. My fear is they're going to go for relatively simple solutions. There'll be increased regulation, which will fall to everybody, even the smaller firms, and there'll be more dependence on the company to produce accurate and absorbing information internally."

Prem Sikka: "None of these reports will really achieve the aim. There will be cosmetic changes, one of which is changing the FRC to ARGA, but that won't really achieve much. The possibilities of major reforms have disappeared with the Johnson government."

Sunil Bhavnani: "Audit market reform should not be seen as the saviour of future corporate collapses. As Sir Donald Brydon pointed out, businesses fail because of the actions of directors. Audit remains fundamentally backward-looking, although more focus on robust and enhanced work on going concern is the subject of a revised auditing standard effective for December 2020 year ends."

2 Big Four breakup

There are fairly diverse views on breaking up the Big Four's grip, such as Woolf's belief that auditing should be entrusted to a public body like the National Audit Office (NAO) or, as he refers to it, the Public Company Audit Office (PCAO). The Big Four would still have an important role, they could be engaged to perform audit work, but their client would be the PCAO, not the individual plc.

"While I believe this contains the essence of the solution, I doubt the government has the will or the skill to see it through," he says. "Ministers are too close to Big Four alumni and don't understand why audits continuously fail to deliver. Separation of audit and other services is absolutely essential, but in separate entities under totally separate ownership, otherwise it will be just another facade. Audit firms should be engaged by the PCAO to audit – and nothing else."

Tentatively in the pipeline is the operational separation of audit firms, which while not currently legislated for, has been given a deadline of 30 June 2024 by the FRC and firms must have outlined their plans to the FRC by 23 October 2020. It's underway with a number of firms starting to make changes to their structures.

"Operational separation need not be legal separation, but the audit practice must be ring-fenced with measures such as transparent transfer pricing of services from the advisory arm, standalone audit firm financial reporting, and remuneration of the audit partners not exceeding the audit practice's profits," Bhavnani says.

But this is not a separation enough for some. "You're either auditors or you're advisers. You can't have your cake and eat it. You can't just compartmentalise your business into audit and advisory," notes Shohet.

So then, just break themselves up, perhaps. Which, given audit forms less than a quarter of Big Four revenue, is not such a stretch of the imagination.

"In the not too distant future, they will probably say it's something they can jettison. Consultancies are more lucrative," Sikka says.

Indeed, Biggs has heard talk of how the lucrative advisory/consultancy sides of the Big Four would actually prefer to be split from audit because they see their brands being dragged down by audit failings in the headlines.

"I don't think it will take a lot to persuade the non-audit side of the business to happily split, because they've got probably far more to gain than to lose."

3 Can the mid-tier break through?

The main concern is that there is a vast drop off in size, resources and experience beyond the Big Four, while some of the larger mid-tier firms have also come under the scrutiny of the regulator and the press. Nevertheless, there may be ways challenger firms can penetrate the FTSE audit club.

"There will be a natural trickle-down of public interest entity audits to the challenger firms, but mid-tier firms will need to demonstrate to audit committees that they have the skills and resources to undertake audit work on large and complex businesses. That will require investment," Bhavnani explains.

This concerns Biggs. The mid-tier firms face a catch-22, where none of them are going to invest in hundreds of specialist staff across hundreds of countries unless they've got the pipeline, but they can't get the pipeline until they have the investment.

"So it may be best that they start to break in on the sorts of clients and risk profiles they're absolutely comfortable doing. I think there will still be a population of companies where in the short and medium term it will only be the Big Four that can physically manage them. But hopefully over time, the balance will change."

A good example of a firm playing to its strengths is MHA, suggests Shohet. Connected globally through
the Baker Tilly international network, it’s an example of a progressive mid-tier firm that understands culture to provide better reporting.

“They do a lot of their work under a sector umbrella, for example healthcare or banking. They understand the culture of the sectors, as opposed to viewing clients as just another limited company. If you understand the culture, you’re going to have fewer mistakes, because you’re going well beyond merely looking at accounting standards and ticking boxes.”

4 The (not so) new regulator and possible Public Company Audit Office

Woolfe is optimistic: “As the FRC is so badly tainted by failure and scandal, its role will be taken over by ARGA, which should be mandated with a constitution that prohibits membership of Big Four alumni. Its role will be purely supervisory and much smaller than FRC, provided reforms are implemented. Again, if a Public Company Audit Office (PCAO) akin to the NAO is in business as the overarching audit controller, it will be free to appoint the best of the second-tier firms to audit public interest entities (PIEs), and will give them a chance to break into this market.”

While not completely behind a public sector-led audit office, Biggs thinks we need a very diverse regulator, that reflects all elements of the audit profession, so that includes ex-auditors, but also more from the side of the shareholders and the companies.

“I think you need that wide view. I don’t think you’ll get that if you just make it a public sector one
as well. Because I think you’ve got to have the commercial element, otherwise you could argue it would become almost like a quasi-public sector kind of thing.”

This is a concern for Sikka, who worries the new regulator will lack independence, given Kingman doesn’t specify how to make ARGA responsible to the people.

“Are we going to get 50% of stakeholder representation? No idea. Are all its meetings going to be in the open, its minutes publicly available? Don’t know.”