A FOCUS ON QUALITY

The ability to more accurately measure audit quality was identified as a pressing issue facing the profession at the first Value of Audit roundtable, hosted by economia, in association with KPMG.

LIST OF ATTENDEES

Paul Boyle, chief audit officer, Aviva
Tony Cates, head of international markets and government, former head of audit, KPMG in the UK
Richard Cree, editor-in-chief, economia
Alan Ferguson, NED and audit committee chair
Robin Freestone, Non-executive director, Pearson
Robert Hodgkinson, executive director, technical, ICAEW
Melanie McLaren, executive director, codes & standards
Peter Montagnon, associate director, IBE
Will Pomroy, policy lead, governance and stewardship, NAPF
Mark Vaessen, global head of IFRS, KPMG International

Paul Boyle, chief audit officer at Aviva, welcomed improvements in audit (recognising there is always more that can be done), and said that the mere fact of having an audit was often enough to make executives behave.

“The value of audit isn’t to be measured by the beauty and elegance of the financial statements that are produced,” he said. “It’s the unseen difference between the financial statements produced and what would be produced in the absence of audit, due to errors, over-optimism in the absence of effective challenge and in some cases, manipulation. That difference is important.”

Tony Cates, head of international markets and government and former head of audit, KPMG in the UK, agreed. He pointed out this highlighted the role audit plays in building trust. “We’ve been involved in the debate around restoring trust. The public has lost trust in business. Part of that debate is trust in auditors and what we do and what else we could bring to bear.”

Melanie McLaren, executive director at the Financial Reporting Council (FRC), added that audit plays a central role in fostering a positive investment environment. “The FRC’s mission is to encourage high-quality reporting and corporate governance, to foster investment. The annual report and accounts is key. We believe audit is a fundamental underpin of that and is fundamental to markets. Our role is to make sure there’s justifiable confidence in audit.”

For his part, Peter Montagnon, associate director at the Institute of Business Ethics, agreed trust remains an issue. “It is worrying to read that over half of the public think the government should crack down on business. There is a problem and we need to fix it.” But he was less clear what role audit played. “I’m not sure how far audit is central to this, because audit has to do with the health of the capital markets, rather than public trust.”

Alan Ferguson, a serial non-executive director and chair of four audit committees (which between them employ all of the Big Four) added that audit quality has risen up the agenda. Having been a finance director and audit committee chairman for 16 years, he reported being contacted by an investor last year to discuss an audit. “I had my first ever shareholder meeting where a shareholder wanted to come and talk to me about audit. Something’s stirring out there, which is interesting.”

Boyle pointed to the impact of developments in audit reporting, and the expanded audit report now required by the FRC. “With what is required, the UK is a leader in terms of what the audit report says about the most important factors the auditor thought about.”

Boyle referenced KPMG’s audit report for Rolls-Royce, which has since been acclaimed as best-practice for this new approach. With Rolls-Royce, KPMG described the big issues it had to deal with in relation to that audit. It also described the particular conclusions it came to in relation to those issues. “For the first time, ever, audit reports are actually worth reading, because they say something different and interesting,” he said.

Cates admitted that there had been a determined effort to make sure with Rolls-Royce (and other pilots) that the firm reported the stones turned over,
One of the perceived problems was how to ensure independence in the things they’ve looked at is regulation of markets and confidence in them. There needs to be a backstop, that you must rotate after a period of time. “The relation between the auditor and the audit committee becomes more cosy the relationship becomes. This is why we alighted on re-tendering of the audit firms. Having a longer tenure of the audit if it’s not tested regularly, the audit quality is going to drop. But we need a mechanism for dealing with the perception or reality that the longer the tenure of the audit, if it’s not tested regularly, the audit quality is going to drop. Therefore, we need a mechanism for dealing with the perception or reality that the longer the tenure of the audit, if it’s not tested regularly, the audit quality is going to drop.

Ferguson agreed the challenge is to keep things interesting. “You do it once and the second year it will be similar, that’s the reality of these things.” Ferguson was concerned about crossover with other reports. “We also have to think about the audit committee report. I’ve spent a lot of time on it and there’s a danger of overlap. Companies and auditors have to work hard to try to differentiate. But I’m hoping shareholders are genuinely going to read it.”

Robin Freestone, CFO at Pearson, agreed. “The differentiation of audit reports is something to be welcomed,” he said. “It will be interesting to see where the debate goes. There’s a debate to be had around materiality. When a big company talks about plus or minus £100m in their accounts, that’s an issue. There are more debates to come. I worry that differentiation in year one is easier than in year five, when this becomes more boilerplate and we come to the same space. It is difficult to assess quality, other than by the quality of the audit report at the end of the process, even when one’s being audited let alone as an independent reader of a set of financial results.”

Ferguson concurred, adding that the debates so far on issues such as reporting standards audit market competition had forced the profession inward. “The goal of having one global standard made everybody introspective, and I’m not sure it moved the needle other than in a negative sense. The competition debate, so far, has made the profession introspective, because everybody is asking what it means for them. There are an awful lot of game theories in terms of plotting and who is going to go out to tender.”

Montagnon suggested the debate on IFRS had led auditors to use standards defensively. “I agree we are in a better place than when everybody was pushing IFRS and it seemed, to shareholders and investors, that audit firms were using this to promote standards that would limit liability. In a way, the failure of convergence has created an opportunity for more discussion about how decisions have been made. We can do this in a way that opens up the debate with shareholders, opens our understanding of differentiation and makes the choice more interesting when it comes to rotation. Through this process, it should be possible for shareholders to get to know more about what they’re buying.”

For Freestone, the idea of mandatory rotation remains problematic. “I have always felt there was a danger rotation would have the inverse effects it was designed to achieve. Rotation has a fantastic effect, from a perception point of view. While that was a problem some were trying to solve, in terms of new audit teams turning up every five years, I don’t think that will stimulate quality. And I don’t think we’re going to see costs come down. In fact, costs will go up. We’re going to have less choice than we’ve had. As a result you’ll see more concentration of the Big Four in the FTSE 350 and below. We’re going to see things go the wrong way.”

McLaren was clear that the FRC had never been in favour of mandatory rotation. “We focus on things that improve quality, but we’re realistic. The audit market is concentrated, and we’ve never been persuaded that in a market where you’ve got limited choice, taking away the incumbent was going to help. But we need a mechanism for dealing with the perception or reality that the longer the tenure of the audit, if it’s not tested regularly, the more cosy the relationship becomes. This is why we alighted on re-tendering and we’re pleased it has been swept up into the EU solution with a 22-year backstop, that you must rotate after a period of time.”

But Will Pomroy, policy lead on governance and stewardship at NAPF, said this still presented problems for some investors, who had picked up the idea of rotation to address issues of independence. “Innovators were partly blamed for the financial crisis and to some extent they were to blame. One of the things they’ve looked at is regulation of markets and confidence in them. One of the perceived problems was how to ensure independence is maintained and auditors are serving their interests? A number fell on rotation as a quick fix because they didn’t have confidence in the audit market to ensure tendering would be satisfactory. There was an assumption that rotation would see firms going through the motions and not much change.”

Ferguson, having been both a finance director and audit committee chairman, offered the analogy of a triangle to describe the idea relationship between the key parties. “The audit committee chairman has more responsibility and a clearly defined role these days. I compare it to the three points of a triangle: it used to be that the FD and the audit partner were the two outer points, with the audit committee chairman off to the side. Ideally it should be an equilateral triangle. We can’t afford to have the triangle skewed either way. No one wants the FD over one side and the audit partner and audit committee chairman closer together. That doesn’t work, either.”

Pomroy said the triangle had to include shareholders. “What it alludes to is that we are a long way to one side, and shareholders were skewed off from the others. Some of the solutions focusing on rotation will probably resolve concerns.”

Throughout the discussion it was repeatedly stated that public trust in business, and by default audit, had broken down and rebuilding it will take time. The policy approach to this breakdown has started to have a positive impact, with movements in areas such as audit reporting. And yet more needs to be done to get a grasp on what we mean by audit quality and what good looks like. There was acceptance that a somewhat aimless call for more transparency across public life and greater competition in markets has been the standard approach to trust building. As McLmiren pointed out, it was important for the profession to avoid falling into making “lazy policy” for the sake of it. But the biggest question remains how the role and scope of audit should be defined to be of value. This requires work on how audit quality is measured and what expectations are placed on auditors to identify future risks. Is it achievable from a backward look at the previous year’s accounts? Should auditors be required to also offer assurance on wider elements, such as the viability of the business model over the longer term?

Ferguson was supported when he said that modern audit sometimes leaves him a little cold. “As chairman of the audit committee I find auditors sitting in a room on a computer. I’ve no idea what they’re doing. It could be like my son doing his revision. Audit quality is an area where there’s a way to go to peel the onion back a bit, where everybody would benefit.”

Freestone concurred. “Audit quality is something we’ve got to pin down, in terms of how we measure it, otherwise these debates are difficult. We can’t say we’re definitely moving forward, as it becomes judgemental. We are moving forward and the quality of audit has got better over recent years in a more complex environment. But the issue of public trust is more complex, because it is easily undermined by very small things.”