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11th February 2019

Response to Post Implementation Review of 2016 Ethical and Auditing Standards

This is a joint response from UKSA and ShareSoc on behalf of individual investors. UKSA and ShareSoc represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Our view is that:

1. We welcome the FRC's decision to hold a post-implementation review of the 2016 Ethical and Auditing standards.

2. The audit profession and audits are in a state of crisis. The recent cases of Carillion, Conviviality, Patisserie Holdings, Flybe and Interserve make investors very worried as to whether they can trust accounts. It is not just the high profile cases. The FRC itself has rated 70% of audits as needing improvement. Yet this consultation from the FRC fails to recognise fully the terrible situation we are in.

3. The review focuses on processes rather than outputs. Whilst we agree that ethics and culture are important, they must not be looked at in isolation. It is no good having great ethics, if the results are awful.

4. The FRC states *"In taking forward this Post Implementation Review, the FRC's principal concern is that the standards used in the UK support the delivery of high-quality audit, by demonstrably independent auditors who act in the public interest."* The Big Four auditors are each a small part (c25%) of a larger multi-professional services firm. This questions the ability of the auditors to be independent, when most of their firm's business is dependent on selling professional services assignments to executive management. For the same reason they do not act in the public interest but in the interests of management. The cultures needed for audit and professional services consultancy are different. This can only be achieved if these businesses are separated.

   Our answers to your specific questions are shown below.

Feedback Questions:

Over-Arching Questions

i. How well do you think the 2016 revisions to auditing and ethical standards have met the objectives set out in our September 2015 consultation 'Enhancing Confidence in Audit' and summarised in paragraph 3 of this consultation document?

The objectives have probably been met to some extent. To what extent is hard to say because the objectives are unquantified and unmeasurable as they stand. What is very clear is that investor expectations have not been met.

ii. In carrying out this review of effectiveness, should the FRC consider any additional objectives as being relevant for ethical and auditing standard setting. If so, please state what they are and why?

Objectives must include that accounts are accurate (meaning they do not contain any material misstatements). If auditors are in any doubt they must qualify the accounts. They should not give management the benefit of the doubt. In rare cases where they do give them the benefit of the doubt they should state explicitly (in the Independent Auditor's Report) why they have decided to do so.

iii. Do the current ethical and auditing standards drive the auditor to deliver work that meets the expectations of users within the current scope of an audit? If there are expectations that are not being addressed, please state those along with your proposals as to how they can be addressed.

No. The expectations of users are still not being met. Simply introducing ethical rules to be followed by auditors does not tackle the basic problem that many audits do not identify false or misleading financial accounts.

The FRC also needs to take account of the fact that:

- Many users probably cannot articulate what they are legally entitled to expect from an audit;
- The 'scope of an audit' is probably unclear to many investors;
- Some popular expectations by users, such as some form of duty of care by the auditor, are not actually a legal requirement of any audit;
- Auditors will seek to limit their own liability by, for example, stating that it is not their responsibility to check for sophisticated fraud on the part of management.

There is a serious mismatch between the expectations of many audit users (i.e. <u>investors</u> – an important distinction because custom and practice (and participant behaviour) might lead one to believe that the audit committee and the company's management were the clients and users) and those of the auditors themselves in terms of the service they believe they have undertaken to provide.

This mismatch of expectations and the convenient vagueness about who the true audit client is must be addressed if progress is to be made in setting ethical and auditing standards that have meaning and value for investors.

iv. Are there further steps that the FRC should consider as part of this review to ensure the delivery of high-quality audit? If so, please state what they are and why.

See **iii** above.

The FRC needs to identify why fraudulent accounts can still be produced by companies and not be identified as such by auditors. In other words, they need to look at what rules or procedures could be put in place to identify such failings as:

- false balance sheets (e.g. reported cash not being available or undisclosed overdrafts as in Globo and Patisserie Holdings),
- incorrect revenue recognition (Quindell, Redcentric et al),
- excessive risks being taken and poor internal controls (Conviviality, banks in 2008, etc), and
- other examples of overly aggressive reporting practices being adopted by companies.

The FRC also needs to consider what to do about financial reporting practices by companies which, although not strictly illegal, are nonetheless designed to mislead investors and flatter the performance and financial strength of the company primarily to ensure that management targets appear to have been met and bonuses are achieved.

Questions Relating to the Ethical Standard

v. Are the ethical principles and supporting specific requirements sufficiently clear? If not, please explain the issues and how you believe they could be resolved.

They may be clear but they focus on rigid rules and procedures, not on outcomes. Indeed the ethical 'principles' appear to be defined in terms of rules and procedures which, if followed, allow a tick to be placed in the box. There is no requirement to be able to demonstrate that audit quality itself or the users of audits have benefitted from the application of the standard.

There are two elements of good news:

- this consultation by the FRC is an opportunity to identify shortcomings that were never foreseen in the original application of the ethical standard;
- recent audit disasters demonstrate beyond any shadow of doubt that this is not an academic issue. Current standards of audit are failing everyone – investors, auditors, companies and their management, employees, customers, suppliers, pension fund members and regulators. It doesn't get much worse than this!

vi. Based on experience, do you believe the ethical principles and supporting specific requirements are sufficiently proportionate for PIEs and non-PIEs? If not, please explain your view, including what you would consider the proportionate position to be, having regard to the need to address threats to independence, objectivity and integrity viewed from the perspective of an objective, reasonable and informed third party.

We are unable to comment on this.

vii. Do you believe that user confidence would be strengthened if the FRC required the application of the independence requirements of FRC Ethical Standard to all components of a group audit?

It is not clear what the exact implications of this requirement would be. The problem is that auditors are fundamentally not independent at present. They are appointed by the audit committee who are heavily influenced by the executive directors. They often see their primary allegiance as being to the audit committee and the directors rather than the shareholders.

viii. For practitioners, what difficulties, if any, have you encountered in complying with the ethical principles and supporting specific requirements? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

We are unable to comment as we are not practitioners.

ix. Do you believe the current restrictions on non-audit services are sufficient to address threats to independence, objectivity, integrity and audit quality, and address stakeholder expectations? If not, please explain why, by providing examples where audit quality has been compromised as a result of non-audit services being provided by the auditor.

They do very little to affect the objectivity, integrity and audit quality or to address stakeholder expectations.

We also find the logic behind some of the current restrictions hard to understand. Services which one might have thought that an auditor should to be able to provide such as tax advice and other tax-related work is apparently 'off limits'. On the other hand, audit firms, via their consultancy businesses, can provide plenty of IT implementation and upgrade work, corporate restructuring advice, M&A services, new product development and business strategy work. These are all highly profitable – more so than audit work. The drive to acquire this type of business provides no less conflict of interest that doing tax work.

We believe that a fundamental review is needed of the type of work that auditors should be able to do for their clients. This should also take account of the range of skills and experience that audit firms require to be able to:

- provide a comprehensive range of services to companies and investors;
- provide a stimulating, satisfying and appropriately rewarding environment within which work and develop.

x. Do you believe there should be further restrictions, or even an outright prohibition, on non-audit services?

b. Should any further restrictions or prohibitions also apply to "audit related" services, that the auditor is not required to provide? If so, please explain your views.

b. Should any further restrictions or prohibitions also apply to services required by law or regulation (i.e. permitted by the Audit Regulation)? If so, please explain your views.

We are uneasy about auditors providing non-audit services – particularly the provision of what might be termed 'mainstream consultancy services'. However, we also recognise that banning the sale of non-audit services:

- Could be difficult to achieve outside of the UK – particularly where auditors are operating in overseas territories;
- Could have the effect of lowering the range of skill available within existing audit practices and limit the attractions of audit as a career.

Instead of forcing firms like the Big Four to split their audit and consultancy practices, an easier and probably more effective way of achieving better auditor independence would be to adopt Sir John Kingman's proposals on auditor appointment. This would involve switching the purchasing decision from the company to an independent regulator (by implication a 'reformed' FRC). This would create a shift in the commercial incentives on auditors, since as a purchaser the regulator's only interest would be to see challenging and high-quality audits.

xi. There is currently a derogation in the Ethical Standard allowing for the provision of certain non-audit services where these have no direct effect or an inconsequential effect (where indirect) on the financial statements. Should this derogation be maintained in the Ethical Standard, and if so why?

See our response to **ix** and **x** above. Any conflict at present occurs primarily because f the way in which auditors are appointed and the dependency link that this creates with the client company's management. It is first and foremost this link that needs to be broken if auditor independence is to be ensured.

xii. Do you believe there could be adverse consequences from imposing further restrictions on some or all non-audit services that may outweigh any actual or perceived benefits? If so, please explain your views.

None in addition to those mentioned in our response to Question **x** above.

xiii. The FRC included reliefs from certain FRC ethical requirements for non-PIE audits for the audit of small and medium-sized entities. Should these reliefs be maintained, and if so why?

It depends on the extent to which these reliefs could compromise audit quality. No-one should expect a lower standard in the quality of audits of smaller firms.

Questions Relating to the Auditing Standards

xiv. Are the relevant auditing requirements of the Regulation and Directive as integrated into the revised ISAs (UK) sufficiently clear? If not, please explain the issues that are currently of concern and how you believe they could be resolved.

We are unable to comment on this.

xv. For practitioners, what other difficulties, if any, have you encountered in complying with the revised ISAs (UK)? Is there anything the FRC could do to help alleviate these (e.g. further supporting guidance)?

As non-practitioners we are unable to comment.

xvi. Is the work required of an auditor on an entity's compliance with laws and regulations, and those procedures to identify irregularity, including fraud, sufficient to meet the needs and legitimate expectations of users? If not, what additional work would you require and why?

The case of Patisserie Holdings suggests that fraud can easily go undetected and, as in the case of PH, remain undetected until it is too late. It raises worrying questions about the extent to which sophisticated fraud goes undetected by auditors in other businesses.

It might be helpful if in future auditors were to:

- Carry out more thorough checks to identify fraud. This could be possible using modern sophisticated data analysis systems to check all transactions going through a company's ledgers. The objective should be to look for suspicious patterns in the data prompting a more detailed investigation by the audit team or forensic accounting specialists.
- Identify and assess the scope for fraud to take place; the fact that fraud is not taking place at present provides little reassurance that fraud will not be perpetrated in future. As part of the audit report the auditor should report to shareholders on the scope for fraud.
- Review the debt and cash balance each month and insist that the company discloses to its shareholders the average monthly debt and cash (at present the requirement is for opening and year end), the interest paid on debt and the average interest rate %. Auditors should review this for 10 years and review any trends.

Where cases of fraud emerge it should not be possible for auditors to defend themselves by saying that they could not possibly have spotted it for whatever reason. The crime of fraud will always be that of the fraudster/s, not the auditor. However, shareholders have a right to expect that the auditor, as their agent, will carry out thorough checks both to ensure that fraud is not taking place and to deter would-be fraudsters.

Finally, an underlying principle for preparers of accounts should be that they must not believe they can abdicate responsibility for the quality of their accounts to auditors. In this context they should also look beyond the absolute legal requirements of the audit.

xvii. Should the FRC take further steps to increase the value of extended auditor reporting to users of financial statements? If you agree, what material would you like to see included in auditor's reports?

It would be helpful if the viability statement were to be auditable and to be audited.

xviii. ISA (UK) 720 sets out the auditor's responsibilities in respect of other information – do you believe the current requirements are sufficiently responsive to the needs of users of financial statements? If you disagree, please set out what additional work you would like to see auditors undertake.

We have no comment on this.

xix. For going concern, auditors are required to assess whether management's use of the going concern basis of accounting as required by IFRS or UK GAAP is appropriate. How could auditors make their assessment of greater value to users of financial statements? Please set out what steps you believe should be required to better underpin confidence in audit and audited financial statements.

Something more is needed to support the going concern assurances in the Independent Auditor's Report. Many Auditor's Reports simply say: 'We have nothing to report on going concern'. Like so much else in the statutory audit, the wording looks like auditor's code for: 'It is a formality. Don't worry. We have given it a cursory glance. Everything looks fine!'

Many investors will have no idea what checks the auditors carried out or were required to carry out to arrive at their 'going concern' conclusion. Something more is required – although it is difficult to say exactly what would strike the right balance between bland reassurance and eye-glazing overkill. Maybe going concern reporting should be the subject of a Reporting Lab project.

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