Audit – is it fit for purpose?

by Peter Parry

On 3rd July UKSA and ShareSoc members met at PwC's Embankment Place office for an event which PwC had offered to run and host for us on the role of internal auditors, external auditors and audit committees. Since last September when we first started talking with PwC about a possible event, few would have foreseen the cataclysmic implosion of Carillion, the failure of Conviviality or the reprimand from the FRC over the Quindell audit. Nine months later, the issue of audit and the role of the external auditor were hot topics for investors.

The event was chaired by an audit quality partner at PwC. It was divided into two halves, the first being a panel session looking at different aspects of audit including the external audit, the internal audit and the role and perspective of the audit committee. The second looked at the how audit is evolving to include the use of emerging technologies in conducting the audit.

For the first session, an external audit partner and an internal audit director were joined on the panel by an Audit Committee Chair at a FTSE 250 company and a charity. After a short summary from each of the panellists of their own perspective on key audit issues, the debate was opened up to the audience. Some of the key themes to come out of the debate were:

- Auditor independence. Some members asked why it is very rare that annual reports are qualified by the auditor. The accounts are nearly always signed off. Are there never any issues over which an auditor might qualify the accounts or, in some cases, resign? Does this suggest a 'cosy' relationship between the auditor and the directors? Quite the opposite, as the external auditor partner pointed out. He said that the role of the auditor is to raise any concerns with management and, when necessary, persuade them to change their minds over the way in which the accounts are being presented. If the auditor qualifies an audit everyone loses.

- Report of the external auditor. One member pointed out that the audit report is utterly dull, there are never any exceptions to be addressed and everything is always compliant. In view of this, it is hardly surprising that many investors spend little time reading it. A further concern was raised that, unlike doctors, lawyers, surveyors and other professions, auditors do not give meaningful opinions. The surveyor tells you whether your house is likely to fall down; the doctor tells you that you will end up with Type 2 diabetes if you don't reduce your weight. The majority of members in attendance felt that the auditor simply tells you that the company's financial statements give a true and fair view of the state of the company's affairs at a given date. However, the external audit partner noted that the extended auditor's report now includes much more detail, such as information about the risks, materiality and audit procedures performed.

- Report of the audit committee. Questions were raised about the work of the audit committee and its report. One key area that members noted receives scant coverage in the audit committee report is the work of the internal audit team. How are their priorities set? What issues do they uncover, and what action is subsequently taken? Shareholders would benefit from more information about this.

- Dialogue between investors and audit committees. A member asked if there could be more direct input to the audit committee by shareholders. After all, the audit is performed for the benefit of the shareholders. The external audit partner said that he would like this if a suitable mechanism could be devised. An audience member suggested having an independent audit board which the external auditor would work to instead of reporting to senior management. The external audit partner agreed that this was an interesting idea which might ultimately point toward the system of supervisory boards which is used in some European countries. However, the panellists noted that by involving shareholders there is a risk of insider information being shared with only some, and not all, shareholders. Shareholders do have the opportunity to and could engage more with audit committees and auditors at AGMs, but currently this is very rare: a polling of the attendees before the event suggested that 75% have never asked a question at an AGM. Engagement with audit committee chairs is something which UKSA is discussing with PWC.

- The annual report. There was a suggestion that auditors should audit the front end of the annual report as well as the financial statements. The external audit partner said that this could be done but it could significantly increase the audit fee as a result. Shareholders in the audience were of the view that this would be worthwhile if it provided greater rigour in the way in which the narrative elements of the annual report are compiled. The external audit partner noted that the Companies Act currently requires the auditor to check that the front half is not inconsistent with the financial statements or knowledge obtained in the audit. He added that in some instances companies feel that the numbers required by accounting standards do not give the full picture. Hence companies will provide alternative performance measures (APMs), which one should be able to reconcile to the financial statements and which should be consistent from year to year. However, there is no regulatory requirement to audit these APMs, which creates a mismatch of expectations on the part of many investors and those of auditors with regard to what the audit can realistically achieve.

The overwhelming impression of the attendees was one of a serious mismatch between what investors want and what is being provided by financial reporting, the audit process and audit outcomes. Huge amounts of time, money and effort are being wasted providing information and assurance which is failing to meet the needs and expectations of, at the very least, many private investors and possibly professional investors as well. This is not for any lack of commitment, goodwill or expertise on the part of auditors. It simply reflects a system that is not fit for purpose. Too much of the work of the FRC focuses on technical and tactical improvements to accounting and auditing while overseeing a flawed system. Serious strategic thinking is needed. It is to be hoped that the Kingman Review will take note.

The second half of the afternoon focused on the use of technology to improve and streamline the auditing process. PwC pointed out that humans are good at:

- Understanding how businesses work;
- Making judgements of materiality and scope;
- Interpretation of data and understanding risk;
- Professional scepticism.

They also highlighted how technology can support human auditors in their endeavour by:

- Automating routine processes;
- Overlaying multiple data sets;
- Identifying unusual patterns and detecting anomalies in large data samples;
- Enabling the testing of all available data rather than just a sample.

A number of insightful questions were raised by members about:

- Problems of compatibility of different systems and platforms for analysing data;
- The problem of data accuracy and reliability – also known as GIGO (garbage-in-garbage-out);
- The risk of over-emphasising audit efficiency at the expense of providing useful insights;
- The cost of investment in new technology and the impact on audit costs.

PwC responded that the first two points are indeed areas that need addressing before technology can be used entirely across all audits, and noted that progress is being made. On the second two points, PwC noted that human judgement will always be required, with technology allowing the auditors to focus their attention on specific areas. They also noted that the cost of an audit depends on many factors, including the complexity of a business and the outcomes of risk assessment procedures.

The day finished with an informal networking session over drinks and canapés. It was the ideal opportunity to talk in more detail with our hosts and to catch up with other members of UKSA and ShareSoc.

Both UKSA and ShareSoc would like to thank PwC for running this excellent event and for their generous hospitality. There is plenty here for us to build on in terms of future events and a constructive on-going investor dialogue with PwC.