Audit and Accounting – The Provocations

Issues to be considered when appraising the government's next suggestions for audit reform

1. Background

The future of audit is being debated in the UK[1] [2]. Whilst audit is not just an issue for what the government calls public interest entities (PIEs)[3], the focus of their concern is on such entities because they are the ones whose failure might cause greatest disruption within the economy, and loss to those involved with them.

The Corporate Accountability Network believes that audit does need reform within the UK[4]. However, it is our belief that the audit of a set of accounts or financial statements[5] cannot be considered as an issue that can be addressed independently of those accounts. It is our opinion that audited accounts are ultimately an inseparable whole. As such we suggest that the success or failure of auditing and accounting in meeting the needs of the users of those accounts cannot be separately appraised.

In this briefing we review the history of both accounting and auditing and how they have developed together, in tandem, and inseparably. As we noted a consequence, the conclusions underpinning the current proposals for audit reform are entirely misplaced, and unless the government takes notes of this in its forthcoming proposals anything that it might suggest will not be fit for purpose.

[1] https://beisgovuk.citizenspace.com/business-frameworks/audit-and-corporate-governance-review/

[2] The consultation papers relating to this process are noted in the references noted at the end of this Briefing.

[3] The Corporate Accountability Network has issued a separate Audit Briefing on what it considers an appropriate definition of a PIE might be.

[4] See our separate Audit Briefing on the reasons why audit might need reform.

[5] We treat these terms interchangeably.

2. Purpose of this note

This note is being written in February 2022 at a time when it is anticipated that the government's response to its consultation paper on the future of accounting and auditing in the UK (BEIS 2021) will be issued shortly.

The first draft of this paper was written before that BEIS consultation was published, which explains the focus of attention in what follows on not just what the government proposed in 2021, but what was proposed in earlier consultation papers. Those earlier consultations heavily informed proposals that the government made.

The likelihood is that any new suggestions to be made by the government might embrace not only its own 2021proposals, but also those which were made in earlier consultations, and those which have arisen as a result of responses provided to it during the course of 2021, including those submitted by the Corporate Accountability Network. Details of all these consultation documents are included in the references noted at the end in the references noted in Section 4.

The purpose of this note is in that case to go back to the fundamental underlying assumptions implicit within all the government consultation documents that have been produced to date with regard to accounting and audit reform to demonstrate that many of these proposals are implausible given the reality of the state of the accounting profession, its history and its relationship with auditing.

The intention is to lay out a series of what are described as provocations. These are intended to be the basis of appraisal for whatever proposals the government might now make, which suggests the timeliness of producing this briefing at this moment.

3. The Provocations

In an earlier discussion paper[6], entitled 'Joined at the Hip', the histories of auditing and accounting were reviewed and the suggestion was made that with regard to any one entity the two issues are not independent of each other, and cannot be. The observer and the person observed will always change each other's behaviour, and that is true of the relationship between the auditor, their client and the accounts that they are mutually concerned with. It was also suggested that this conclusion is not particular

[6] https://www.taxresearch.org.uk/Blog/2022/01/19/corporate-accountability-network-audit-briefing-accounting-and-auditing-are-joined-at-the-hip/

to any one set of accounts: the evidence is overwhelming that the separation of the auditing and accounting professions has not happened because the relationship between the two is inevitable, and indivisible.

In this note the consequences of that observation are explored. In particular, the current proposals for audit reform are appraised and it is suggested that two of the three proposals that have been made are, on the basis of this conclusion, implausible. The Kingman and Tyrie recommendations both presume that audit and accounting are separable. Furthermore, they presume that an auditor can form an opinion on the accounts of an entity without considering whether or not the accounting framework used for reporting by that concern is appropriate to its needs. It is suggested that these assumptions are wrong and that whilst there are elements of what they propose that makes sense, particularly with regard to enhanced regulation, the relationship that they propose between an auditor and the audited entity is one that cannot exist if accounts showing a true and fair view are to be created. The opinions of those two reviews are largely reflected in the government proposals made in 2021.

To consider these issues in more depth the strengths and weaknesses of the current audit reform proposals are considered in this note. That review, when coupled with the conclusions of the previous paper, is then used as the basis for a number of evidence based 'Provocations'. Each of these is intended to highlight a reason for an auditing problem having arisen, and to then suggest why current proposals do not address it. The aim is to seek feedback on these suggestions.

1. Provocation 1 – The assumptions of the audit reform debate have been wrong

This Provocation suggests that the assumptions that underpin the existing proposals for changes to the audit in the UK are:

1) That there is such a thing as an audit independent of the accounting of the entity to which it relates;

2) That in a commercial environment an auditor can form an objective opinion upon the accounts of their client;

3) The auditor can report without asking whether the accounting framework used by the entity on whose accounts they are offering opinion is fit for purpose;

4) The quality of an audit can be appraised independently of the accounts to which they relate;

5) A structured form of audit opinion reporting can meet the needs of the users of accounts;

6) The main stakeholder to whom the auditor need address themselves are the shareholders of the entity even though they comprise a subset of just one of the, at least six, stakeholder groups that can be identified for any entity.

It is suggested that these assumptions are wrong. They are, in fact, of the problem that audit reform is encountering because they are false. As a consequence they are not a basis for the solution of the audit problem. It is alternatively suggested that:

A. There is no such a thing as an audit independent of the accounting of the entity to which it relates;

B. In a commercial environment an auditor cannot form an objective opinion upon the accounts of their client;

C. The auditor cannot report without asking whether the accounting framework used by the entity on whose accounts they are offering opinion is fit for purpose;

D. The quality of an audit cannot be appraised independently of the accounts to which they relate;

E. A structured form of audit opinion reporting does meet the needs of the users of accounts;

F. The stakeholder to whom the auditor needs address themselves are all those of the entity i.e. its:

   a. Suppliers of capital, in all its forms;
   b. Trading partners;
   c. Employees, whether past, present or future;
   d. Regulators;
   e. Tax authorities;
   f. Civil society partners, known and unknown to it.

The discussion that follows in this note is based upon these alternative premises.

2. Provocation 2 – The Kingman and Tyrie audit reform proposals, plus those put forward by Department for Business, Energy and Industrial Strategy in 2021 are not fit for purposes because they are based upon the assumptions detailed in Provocation 1

The assumptions noted in Provocation 1 underpin, to some degree all three currently proposed UK audit reform proposals plus many of those presented by the government in 2021. These fall into two camps.

The first group is made up of the Kingman Review of the Financial Reporting Council (the main audit regulator in the UK) and Tyrie Review of the audit market for the Competition and Markets Authority, which might be considered together whilst making quite different proposals. Both are largely process based or represent incremental changes to existing regulatory or market-based arrangements.

In summary the Kingman Review suggested that:

i. Changed regulatory environments can address the quality of the audit process;

ii. As a consequence a new regulator is required

iii. Revised remuneration bases for the auditor regulator might enhance its independence, empower it to recruit better staff and so increase the effectiveness of its regulation;

iv. Audits should retain a strong shareholder focus.

These proposals are worthy. In the current audit environment they make sense. But they do not address the very obvious failure of audit to meet user expectations. This review is the most limited of the proposed reforms , but despite that it has not been acted upon, at least as yet.

The Tyrie Review for the Competition and Markets Authority was more radical, but is still process based. It suggested:

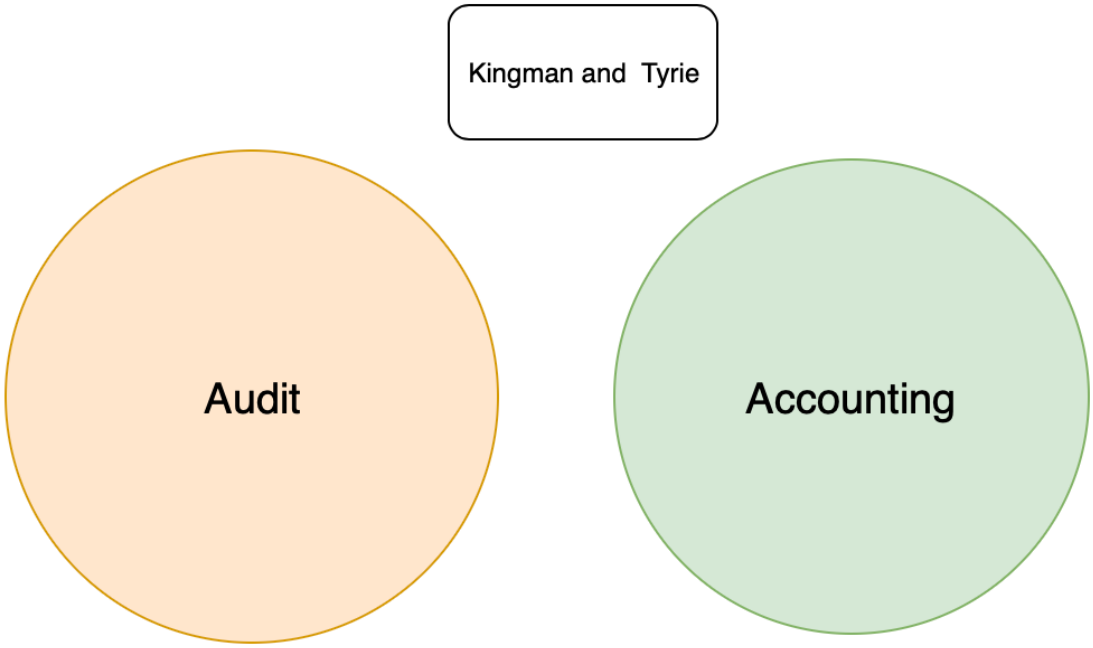
i. There should be a split between audit and advisory businesses. Auditors should not sell consulting services. To achieve this outcome the audit and non-audit businesses of audit firms should be split into separate operating entities, each with their own separate governance and reward structures. To be effective this will also require separate management, accounts and remuneration policies.

ii. The process of audit appointment should be improved to make sure those appointing auditors are held to account and independent enough to choose the most challenging audit firm to suit the needs of their entity.

iii. The choice of auditors should be expanded because competition in the market is weak. It was proposed that most quoted company audits should be carried out by at least two firms, at least one of which would be from outside the Big Four.

The Financial Reporting Council is now acting on the first of these recommendations. The proposals they have made do not, however, seem to create the so-called 'Chinese Walls' within firms that the recommendation requires, and nor do they prevent the audit function within firms from selling significant values of consulting services.

These proposals are not fit for purpose as a comprehensive solution to the audit problem that the UK faces because they are based upon assumptions that are themselves an inappropriate reflection of the current state of audit in the UK, as noted in the first Provocation. If the assumptions used as the basis for recommendations are themselves wrong the solutions are, inevitably, not fit for purpose. They assume that the audit / accounting relationship is as follows:



As Provocation 1 suggests, this cannot be the case.

To the extent that the proposals made by the government in 2021 adopt this approach – and that is very largely the case – they too are unrealistic.

3. Provocation 3 – The Brydon audit reform proposals are much more appropriate than those of the Kingman and Tyrie reports but still fail to recognize the appropriate relationship between accountants and auditors within the audit process

The Brydon Report is much more radical in its thinking than either the Kingman or Tyrie reports, and is harder to summarise as a consequence. It can be argued that its principal recommendations are that there should be:

i. An expansion of the scope of the audit e.g. to include non-financial data and secondary reporting;

ii. An extension to the range of stakeholders to whom the auditor is responsible beyond shareholders, and that there should be a duty to make to ensure that the needs of those stakeholders are met;

iii. A duty on the auditor to ensure decision useful information is supplied by accounts, and to provide it in the audit report if it is not otherwise available;

iv. A new audit profession, distinct from the accounting profession;

v. The reintroduction of auditor judgement into the audit process;

vi. Improvement to the wording of audit reports and the end of 'boilerplate' language;

vii. Enhanced transparency on the appointment of auditors;

viii. A duty to report the focus of audit attention;

ix. A requirement to report on resilience, which will be subject to audit scrutiny to support the opinion offered on the applicability of the assumption that the entity is actually a going concern;

x. Enhanced capital maintenance reporting;

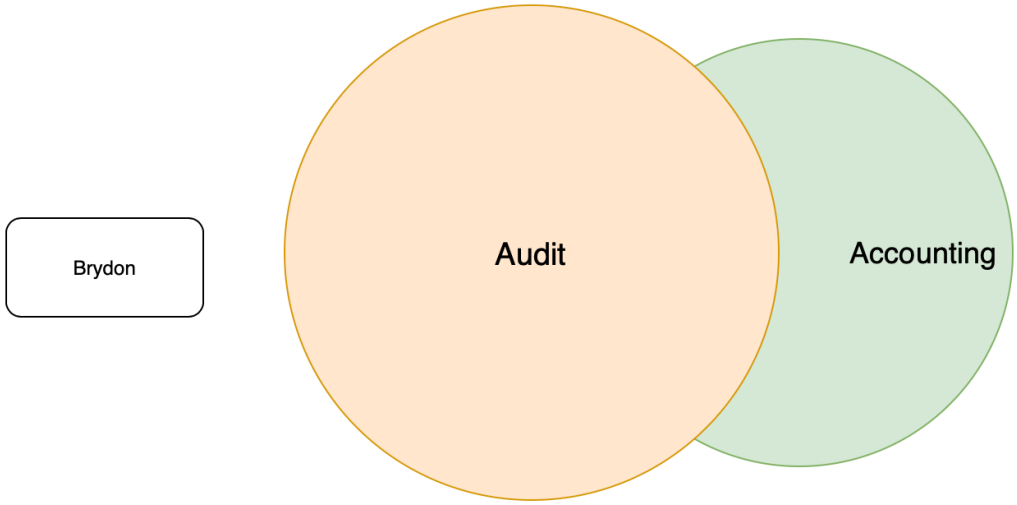
xi. New reporting requirements on fraud.

These radically change the potential approach to audit, and so far there has been a muted response to these proposals. They are, however, easily the most important of the three sets of recommendations made. They have, to some degree, and most

especially with regard to the creation of a separate audit profession, appeared to win some degree of government favour to date.

However, Brydon also adopts the same broad set of assumptions noted in Provocation 1, and has not noted the history of accounting and auditing in making the recommendations. The result is that the framing of the recommendations made does not reflect the reality of the past and present nature of auditing and the split of responsibilities within the audit process is accordingly inappropriately allocated.

Brydon summarises the audit / accounting relationship as follows:



The audit is deliberately shown as dominant: Brydon gives the auditor the right to add accounting data that has been omitted from the accounts, and this is the necessary consequence. However, the interactivity implicit in the auditor / client Relationship is hard to represent in a diagram of this sort: the balance of responsibility is not clear and that is the problem that is implicit within Brydon. The respective obligations between the parties is unresolved. Brydon says that the reports aim is to make 'audit more informative to its users and therefore, by improving the cost and allocation of capital, adding value to the economy as a whole' (Brydon 2019, 6). The objective is sound but, it is suggested, not possible unless the auditor is given greater responsibility for reporting. The idea that Brydon also notes 'that it is for directors to communicate about their company and, within limits, for auditors to confirm what is communicated' conflicts with this goal. As such Brydon is eventually conflicted in its objectives. So too have the resulting government proposals been conflicted where they adopt this approach.

4. Provocation 4 – Brydon mis-stated the purpose of an audit in the 21st century

The Brydon review suggests that the purpose of the audit in the 21st century might be 'to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements' (Brydon 2019, 7) . It is suggested that this is an insufficient definition given the points noted in Provocation One.

If that Provocation is read in association with the timelines in 'Joined at the Hip' it is apparent that what Brydon does is take auditing back to its roots. Quite literally it restores the nineteenth century relationship between the auditor and their client, with the auditor in the dominant position. There are a number of reasons to suggest this.

Firstly, what Brydon proposes is a new professional body of auditors, with skills quite distinct from the those used by their clients. This has happened before, as the timeline makes clear. In the 19th century those clients who did employ accountants expected them to have quite different skills from those that the auditor had. What was, however, quite clear was that the auditor most definitely had the upper hand when it came to financial reporting. It was only as the 20th century progressed that accountants began to switch from training with an audit firm to working for that firm's clients in a great many cases. Before this happened the audit profession had skills quite distinct from those of any commercial accountant. Brydon is proposing that this be the case again. There are good reasons for thinking that this is appropriate. The skill of the company accountant is to report within the entity. The skill required of the auditor is to ensure that the needs of stakeholders for information suited to their needs is met. There is no logical reason why the internal company accountant should have those skills and every reason why they should not.

Second, in the 19th century (and in many cases thereafter, with the practice still being well-known among small audit clients today) it was commonplace for the auditor to decide the accounting policies of their client, determine what information was included in the client's accounts, and still use their judgement as to whether the resulting disclosure was true and fair. Far from being seen as presenting a conflict of interest, it is likely that many auditors thought that this element of control provided them with the means to ensure that a true and fair view was presented by the accounts that they signed. The powers that Brydon suggests replicate this: the suggestion that the auditor have the power to use their judgement to provide additional information, not otherwise available in the accounts, within the audit report makes clear that the judgement that was used by 19th and early 20th century auditors is something that remains of relevance in the 21st-century.

Third, this notion, that the auditor determines what actually represents a true and fair view of the accounts of the entity that they are auditing, upturns the balance of power in the auditor/client relationship. Just as has been the case throughout audit history, although of late only with regard to smaller clients, the auditor would now be given the explicit power to determine the information that they think should be supplied for the benefit of all stakeholder as Brydon re-interprets the duty of care that an auditor has. The ability of the company to present a 'front' and to hide what they would rather the world did not know is removed from them because the power to expose is given to the auditor.

Fourth, the element of judgement that this will require within the audit process fundamentally changes the nature of accounting. The audit will no longer be a mechanical process confirming compliance with an agreed, imposed, and uniform accounting framework. It will, instead, require that a true and fair view be presented irrespective of the framework in use. In other words, if International Financial Reporting Standards do not, and even cannot, by themselves deliver the information that stakeholders require from the company, or alternatively, if the view that they give is considered by the auditor to be misleading, then that auditor has a duty, if the Brydon recommendations were to be implemented, to either require that their client present their accounts in alternative ways that the auditor thinks necessary or, that auditor must alternatively provide the necessary information within the audit report to ensure that view is presented. The result is that Brydon quite explicitly threatens the hegemony of the Big Four firm driven accounting and auditing narrative implicit in the lowest common denominator standards that the IAASB and IFRS imposed and replaces them with a new true and fair view.

Fifth, what that new true and fair view means is that uniformity of presentation will not be the priority within financial reporting anymore. Of course, some consistency will be essential for the purposes of compatibility and so some basic common denominator information may be necessary. So too most basic principles exist (but prudence, consistency, accruals and going concern worked well for a very long time, it should be noted). Thereafter, however, the priority must not be the presentation of data in a format intended to reduce perceptions of difference, but should instead be focussed upon the highlighting of what those differences mean. This, of course, should be precisely what shareholders and other stakeholders want to know. If shareholders want to actively choose investments because they believe that there might be better or worse companies to whom they might wish to entrust stewardship of their funds, then differentiation in reporting must be their desire. That is also true for other stakeholders. Existing accounting, with its clear desire to create uniformity in reporting only serves

the interests of the index investor: it does not suit those who actually want to decide how capital should be allocated.

Sixth, Brydon necessarily encourages the creation of new interpretation methods as a consequence of these potential changes. Some, such as country-by-country reporting, are already known but are not in use. Others, such as enhanced tax reporting are implicit in standards from the like of the Global Reporting Initiative. New initiatives will however be required on trade relationships and employee reporting requires considerable advances. So too does environment reporting where sustainable cost accounting may well have a role to play. The important point to make is that none of these are peripheral are additional to financial reporting: each should be a key part of it but has been excluded from consideration by the IFRS / IAASB view of financial reporting. And yet that view conflicts with audit history. In the early days of auditing it was the auditors who fought for better and more relevant standards. That is what is required now as well. An independent audit profession could promote these new types of reporting standard for the sake of all stakeholders.

Seventh, that then requires rethinking the nature of the audit firm. It would be a multi-disciplinary, independent, and stakeholder reporting focussed entity. The auditor could not be paid by its client: a levy would have to be the basis for its remuneration. Appointment would need to be open and transparent, but firms could be from the private sector. Their terms, priorities and decision-making processes would have to be on public record. Revolving doors would have to be banned. Whole new skill sets would have to be learned. But the gain would be a whole new lens into the corporate world, where the auditor provides the critical appraisal of the data that a client present to ensure that a true and fair view of what it really does is provided. The result would be a new view on markets and how their participants work.

5. Provocation 5 – a new role for the auditor

As a consequence of the arguments in Provocation 4 it is argued that there should be a new role for the auditor. The logical conclusion of Brydon's own arguments are that the audit role defined by Brydon as 'to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements' (Brydon 2019, 7) is wrong. The audit role should instead be that the auditor has 'the duty to ensure that the stakeholder of a company has the information that they need to establish and maintain their confidence in a company and its directors'.

This would require a division of responsibilities, as follows:

Company responsibilities	Auditor responsibilities
To prepare and deliver for public scrutiny accounts prepared in accordance with an agreed accounting framework subject to those exceptions required and explained by the auditor to ensure that a true and fair view is presented by those accounts.	To ensure that the information that might reasonable be required by the stakeholders of an entity is available for their use in a form on which they can rely as to its truth and fairness.
To provide the auditor with such information and explanations as required by the auditor to enable them to fulfil their duties.	To explain how they determine what information they think that the stakeholders of a particular entity might need has been determined.
	To ensure that the data supplied by the company might be understood by a reasonably informed stakeholder who has concern about the activities of the entity, with such concern being interpreted by the auditor to ensure comprehensibility but against a background that assumes that: • The stakeholder is risk averse, requiring that prudence be applied to all interpretations and that risks be highlighted; • The stakeholder recognises the conflicting goals of those who might engage with the entity and requires that such conflicts be highlighted if imbalances of risk are perceive to arise; • The going concern principle is of paramount concern to all stakeholders, and that all risks to its applicability should be identified;

	• The interpretations offered provide comparability where possible so that effective decisions can be made on the allocation of whatever resources the stakeholder has to engage with; • That professional standards shall apply to such disclosures, the length and scope of which shall not be limited by the reporting entity or statute; • The auditor shall have indemnity from the entity with regard to the audit observations that it makes, but not from stakeholders, biasing opinion as a consequence in favour of stakeholder concerns.

As Brydon implies this would require a new audit profession.

It would also require new, and separated, audit firms, but these will nonetheless require accounting skills because it will be their task to communicate the critical information on the interpretation of the data supplied by a company within its accounts that the auditors thinks is of relevance to the stakeholder. The supply of any other services to the audit client is incompatible with this goal.

The role of the audit report will then be an exercise in risk appraisal undertaken on behalf of the stakeholders to whom the auditor will be liable, with a presumption of prudence over-arching all interpretation supplied. This role will necessarily require the auditor to account. The auditor will, therefore, have an accounting responsibility for their client as they have always done, but in an explicit and transparent fashion.

This, it is suggested, is the audit required for the twenty first century.

4. References

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