Developments in Audit event – 25 October 2017

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Ladies and Gentlemen, thank you for being here today.

As I said in my opening remarks, high quality audit is essential to capital markets, to financial stability and to trust in business. You have heard our views on audit quality in the UK from Melanie and the international perspective from Brian. I will mainly cover the challenges for the future, but it pays never to forget what happened a decade ago.

So, let's look back to the lessons from the financial crisis and the reforms that have flowed from it.

The financial and social cost of the crisis frankly was horrendous:

£106 billion: the financial support required to nationalise Northern Rock and Bradford & Bingley.

£532 billion: the financial support required to recapitalise RBS and Lloyds.

£1.1 trillion: total financial support provided for UK banks since the financial crisis.[1]

The figures are astonishing, and often more than people realise. They also do not include the impact on GDP, productivity and costs of additional regulation, and the impact on individual lives.

The financial crisis shone a light on many false assumptions about how markets work and how people behave.

It challenged perceptions about the role and approach of financial regulation.

[1] https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/

And it illuminated the unacceptable behaviour and lack of judgement of some in the financial services industry.

But what, in particular, are lessons for regulators? And I want to focus on three:

1. The need to avoid group think and to have genuinely independent minds.
2. The need for dialogue and for the regulatory system to be joined up.
3. And the need to look forward to new challenges and risks – not just fight the last war.

In terms of group think: in the first half of 2008, even after the failure of Northern Rock in autumn 2007, the received wisdom was that credit markets would remain open for business and that risks could be covered by selling them on. This received wisdom proved disastrously incorrect.

- The threat of systemic failure was not properly anticipated.
- Those who had concerns did not get a hearing.
- And controls did not offer adequate protection.

In the past, society has recognised and responded to the risks of group think on a periodic basis in the past, but only often after it has suffered the effects of markets out of control.

- the South Sea Bubble;
- the railway speculation of the 1840s after which audit came in, and
- the stock market crash of 1929.

Controls were put in place: notably the introduction of independent audit in the mid nineteenth century and independent securities and banking regulation during the last century.

By 2008 these external controls were well developed, including the role of non-executive directors, and yet they failed effectively to challenge the received wisdom of the day.

Most regulators regret that they did not do more to challenge group think, and the FRC is no exception in that regret.

How did this come about? After all, the purpose of market regulation is to provide challenge and curb excessive risk or poor conduct.

It requires an independent mind-set.

It must have the curiosity to explore the unlikely and the courage to speak out.

And be prepared for the unexpected.

Since 2008 all regulators have been significantly reformed, including the FRC. With the Government's support in 2012, we restructured our organisation, elevating key decisions on codes and standards – but not enforcement – to board level and creating an integrated body to address risks rather than being a set of unjoined-up semi-autonomous entities.

Second, regulatory regimes need to have clarity about who is responsible for what and each part must play their role rigorously in dialogue with the others. In the run up to the crisis the different parts of the system placed too much reliance on each other without really testing whether they should be doing so. And that was as true of regulators as it was of banks and their counter parties.

The Bank of England and FSA placed reliance on auditors without adequate dialogue with them.

And at the same time, auditors made assumptions about the health of the financial system because regulators were not raising a red flag as far as they were concerned.

This has been addressed. Dialogue between auditors and regulators has been established and on a regular basis the FRC meets the executive members of the FPC.

Third, the system was not sufficiently forward-looking. Audit is not completely retrospective – audited financial statements have forward looking information and modelling embedded in them, but in 2008 and still today audit provides a snapshot at a certain point in time. As a result, audit and audit regulation did not plug the gaps in this lack of dialogue either.

- The accounts of the banks closed at the end of December 2007;
- the auditors' decision on whether they needed to qualify those accounts were finalised in the first 2 – 3 months of 2008, and
- under the legislation, auditors have a period of time to get the documentation of their work finalised before closing the file and opening it to inspection.

As a result, not until well into 2008 could the FRC have seen potential inadequacies in the audits. And by then the picture in the audit file was frankly out of date and irrelevant.

But what does that say about the real value of the company's going concern judgement and the audit of it? Why was there no requirement for the company, the auditors and the regulators to look further out and to say what the risks were?

Regulators and auditors are not immune from the tendency to fight the last war. That war in accountancy had taken place in the 1980s and 90s when banks and other companies padded their provisions in good times in order to have the capacity to run down their provisions and report they had maintained profits when the company's position turned down.

Smoothing profits in this way is bad practice and accounting standards developed to stop it with good intent.

The means adopted to reduce smoothing, the introduction of a requirement for companies to value their assets and liabilities at current market values, despite being more transparent, imported a degree of market volatility into their accounts in real time. That "market knows best" thinking that lay at the heart of the crowd's wisdom, but it needed greater context and sensitivity analysis.

The lesson is clear: we must consider both present market experience AND future risks.

This is necessary in particular because calling out a risk when it is imminent and when doing so could have catastrophic consequences is pretty tough.

How does an auditor qualify the accounts of a bank in the face of a consensus that markets support it, when to do so could trigger the bank's failure and a crisis of confidence in the whole system?

In practice, the consequences of systemic risk in banking make it extremely difficult to call out the risk late, even if it had been fully perceived. It is vital therefore that challenge is strong and sceptical <u>before</u> the matter reaches a crisis point.

The seeds of failure in the crisis lie in the lack of robustness in tackling risk in 2006 and 2007, as much as in the errors of judgement of 2008. With hindsight, neither the banks, their internal risk managers, directors, financial regulators, nor the audit profession exercised the level of scepticism needed in this earlier period.

This was not good enough and regulatory change was needed.

So we, as well as financial regulators, have therefore enacted a programme of change to introduce significant additional safeguards. In particular, to create a more forward thinking risk-aware mind-set in companies and the accounting profession, more innovation in risk management and audit, more risk transparency for investors.

We introduced new requirements in relation to the setting of internal controls and reporting of their effectiveness in risk mitigation.

We required audit committees to report fully on significant matters they have discussed, including concerns raised with them by regulators.

We set up and implemented the recommendations of the Sharman Inquiry introducing the requirement for companies to make a longer term viability statement, forcing them to look beyond the one year going concern judgement.

And we pressed for accounting standards to take account of expected future losses and for prudence to be part of the conceptual framework used to determine the nature of standards.

We shook up audit by introducing regular retendering of audits to encourage innovation.

We led the way in the introduction of extended reports by auditors on their concerns about risk to their audit.

And we have greatly increased the transparency of our own views on the firms.

Overall, to a greater extent than elsewhere in the world we have enabled boards, audit committees, auditors and the regulatory regime to pull together – the unity of purpose that Brian talked about just now.

To give one example, being aware of our views, audit committees of major companies have put audit quality – not price at the top of their agenda in audit retenders. Knowing this has happened, auditors have increased their efforts to secure a reputation for quality.

Through this triangle of audit committees, auditors and the FRC working together, reinforced by transparency to each other and investors, I think we have seen a sea change in effective consideration of risk and in that feeding into audit.

That said, there remains room for improvement in both reporting and audit.

I mentioned the viability statement, but companies have been tentative in choosing how far forward to look in their viability statements – three years is now typical and better than one, but a company that has invested for growth over a much longer period ought to report about its longer term prospects. It may be nervous of a statement of viability over a long period but why not give much the same statements to its shareholders that it has given to its bankers or its pension fund trustees. So we continue to press for improvement and our Financial Reporting Lab is working to help companies do so.

On audit we also need a more forward looking perspective.

We have introduced a requirement for the auditor to report on risks to the audit of financial statements, not just give a black or white opinion on the accounts. And these extended audit reports are a great step forward and are valued by investors. However they focus on the current audit and the financial statements of the previous years' performance. Past performance and a selected point in time continues to be the focus of audit.

That is not a criticism of auditors. They are doing what the law says they should do. Auditors are required to look at the company's statements on risk and identify any inconsistencies with the accounts, but that is not a forward-looking audit.

It is time for lawmakers and standard setters, whether at international level or through bodies like the FRC at national level, and through the profession, to ask whether audit should be fitted with front-facing halogen spotlights as well as reversing lights. The FRC will lead debate with the profession, with lawmakers and international bodies, to explore and embrace that idea and to respond to that challenge.

We are in fact already working with international standard setters and other regulators to bring the voice of investors and regulators more strongly into their deliberations, and hope that will prove a good basis for them to address future strategic challenges in the future.

We should also address the opportunities of digital technologies. For example, in relation to the concept of materiality in the audit: the amount of error in the accounts that the auditor and the company can live with. Materiality is accepted in audit because to capture every transaction has been costly. But we know that today's immaterial irregularity sometimes becomes tomorrow's great hole in the accounts.

Technology should enable this to be reduced as all transactions can be digitally captured and automatically tested at a more acceptable cost. However, even with such data capture, judgement has to be exercised about what anomalies it makes sense to investigate.

But even there digitalisation can help. Audit firms are investing in data analytics to gain better insight into patterns and connections in data. And we are also working with the profession to ensure regulators enable the benefits of AI.

I should now like to turn to audit quality and the leadership of the audit firms, picking up on the themes that Brian and Melanie mentioned.

We have set audit firms a target that 90% of their audits of FTSE 350 companies that we inspect should be satisfactory by 2019. The average for those we regard as satisfactory has risen to 81%; two of the six major firms exceeded 90% last year, but one remains, I’m afraid to say, at 65%.

The 90% target is a way point not an end point. We will increase it, paying particular attention to financial services audits. For the statistics to be significant, however, we must see a consistent, long-term trend of improvement.

As Brian noted, this is not just a UK problem. Globally financial services audits are not meeting regulatory expectations. IFIAR members – the International Forum of Independent Audit Regulators of some 50 countries – reported adverse findings in 2016 in relation to 49% of the audits of systematically important financial institutions (SIFIs).

IFIAR have set a target reduction of 25% in the findings of Public Interest Entity audits inspected by IFIAR's 9 Global Audit Quality working group by 2019. Progress in the past has been slow, but efforts are being made and we expect that when an interim update is published early next year progress will be shown.

And that's important because UK audits frequently rely on the quality of work overseas. The international networks of the firms must ensure that public interest entity audits and above all major bank audits are done to the highest standards by all national firms.

And I stress national firms because regulators like the FRC are nationally based and have no authority over the international networks at present. Nevertheless, we look through IFIAR to the international firm networks for cooperation in driving strong international performance on a consistent basis. We will explore how standards set by the International Audit and Assurance Standards Board can be used to hold global, as well as local, leadership to account.

The firms have established themselves as strong global entities and it's important that they are held to account.

As Melanie and Brian explained, great audit teams and poor audit teams sometimes exist side by side in the same firm. This may reflect that some clients do a better job than others. However, where good and bad co-exist, the quality of leadership, its ability to achieve consistent performance and a strong, consistent culture comes into question.

The quality of leadership and governance is a focus of the FRC's work, and we have made it a key component of the

Audit Firm Governance Code: a Code through which we have introduced independent non-executives into the firm ahead of the rest of the world. And we have done this ahead of the rest of the world and we encourage all to do the same.

Regulation creates a framework and expectation of leadership in the firm but it cannot succeed unless the culture of the firm set and driven by the leadership is strong. We are therefore conducting a thematic review of firm culture in the UK.

Effective leadership also requires clarity about who is accountable for what. The FCA’s Senior Managers Regime has helped establish such clarity in banking. And we need to consider if there are aspects of that regime that we could learn from to help create greater clarity about respective responsibilities in the firms. At the moment the law places responsibility primarily on the audit partner, but they cannot succeed without their own leadership’s support and ownership of audit quality in at least equal measure.

I’d now like to turn to enforcement for a little while.

Since we closed our investigation into the audit of HBOS, our enforcement approach has been questioned by some. We will shortly be publishing a paper on what we did and what we found in detail.

Today I want to focus on the lessons we have learnt from the HBOS audit and other cases in relation to enforcement. And I want to stress there are three main points.

First, the test of misconduct, formerly established in the previous statutory framework, is too high a bar for taking cases in relation to audit. The public expects that lesser inadequacies will be brought to book.

For new cases, under the new audit regulation regime introduced in 2016, the test of misconduct has been replaced. Now enforcement action can be taken on the basis that there has been a breach of the relevant requirements. This is a lower threshold test than proving misconduct. More potentially deficient audits will therefore be investigated, prosecuted and ultimately sanctioned to varying degrees. We hope this will underpin confidence in audit and in the public interest.

Second, for enforcement to be effective successful prosecutions and their sanctions need to be a genuine deterrent for poor performance. Over the past two years, tribunals have arrived at higher fines than ever before for audit deficiencies. Tribunals were imposing penalties of hundreds of thousands a few years ago. Now the penalties being imposed are in excess of five million.

Is that the right level though? We have asked the recently retired Court of Appeal judge, Sir Christopher Clarke, to lead a panel to review our sanctions; in particular, to consider if the range of fines and sanctions available are adequate to safeguard the public interest and deter wrongdoing. We look forward to his report and guidance for future tribunals later this year.

Third, we need to bring cases to tribunal much faster. Our new powers help in this regard, particularly in securing information from companies, and we will use them rigorously. We have also overhauled our internal processes and built a new and stronger mostly legal team of 30 – four times the size of a few years ago. And we will build this further as necessary.

But robust enforcement procedures and thorough investigations are, on their own, not enough to ensure public and stakeholder confidence in our work as a regulator.

We must also be more transparent by communicating our role and work in a way that is accessible to all of our stakeholders, including employees and the wider public.

We have listened to the concerns of our critics, and are concluding a review of our own governance structures and processes. As part of this, we are publishing a register of interests for all members of our Board and key decision-making Committees.

The FRC is a far stronger body now than it was in 2008. We have stronger powers. Government brought forward legislation to enable us to restructure in 2012.

We have a record of innovation in audit regulation that is second to none in the world. No audit regulator is more transparent about its assessment of the firms, both in working with audit committees and through public reports. Very few have consistently imposed tougher sanctions on poor work.

Nevertheless, group think remains a risk, for us as well as those we regulate. We are determined to challenge it.

We must all cultivate innovation and diversity.

We must all embrace technological change.

We must not be inward looking and only talk to ourselves.

At the FRC, we are reaching out:

- We have a strong group of people drawn from wider stakeholder groups, including employee representatives, to help us.
- We are to use citizens’ juries.
- And we are recruiting new members to our boards and committees to create diversity of background and thought.

Our mission is to promote transparency and integrity in business in the interests of the economy and the public at large. Not to do so just for investors, although they’re very important, or just for companies, or just for professionals. But to prod, provoke, galvanise and inspire them all for the public good.

So in conclusion, the FRC enacted an extensive programme of change after the crisis:

- strengthened UK corporate governance, empowering investors, including through the annual election of directors;

- strengthened the role of audit committees and Boards in addressing risk;
- set up the Sharman Inquiry;
- introduced audit retendering;
- introduced extended auditor reporting, and
- worked with international standard setters to strengthen the accounting and disclosure framework.

But despite these significant measures, there remains work to do:

- to establish high quality audit on a consistent basis;
- to ensure firm leadership drives culture in the firms in ways that enables quality to improve and consistency to be achieved;
- to bring together international regulators to work to ensure that the firms' own international networks seriously drive strong performance on a consistent basis.
- And to work with government and the profession on whether the audit of today is suitable to cope with tomorrow's challenges – both in terms of changing business models, technological advancements and

shifting public expectation about what role audit should fulfil – to refocus that rear-view mirror into a forward-facing beam.

I invite you all, whether you come from the professions, from business, investment or represent non-financial interests, to help us shape these reforms.

Thank you.