

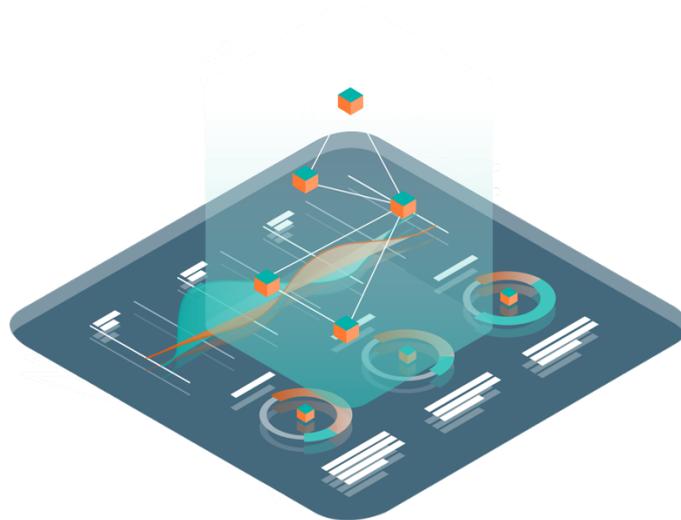


FRC AAT Consultation

Technological resources:

Using technology to enhance audit quality

July 2020



The Engine B Response

Question 1

Do you agree that the increasing use of technological resources, including AI and other advanced tools, enhances the quality of audits, beyond the benefits derived from efficiency gains. If so, what are the indicators of enhanced quality?

The CMA chairman declared that “more than a quarter of big company audits are considered sub-standard by the regulator”, which indicates that the need to increase quality of audit across the entire industry is critical.

The majority of arguments presented by the Big Four against encouraging competition is the idea that the high-quality service they provide cannot be provided by the smaller firms. However, this has been disproven by reports from the FRC and instead, the industry should now open to the idea of using competition as a means to increase quality in the industry rather concern over impending collapse. Further examples include 72% of total audits needing “limited improvements” in 2017/2018 which clearly show these large firms are not performing well enough to justify their monopolistic power.

The lack of quality in past audits also has effects on the industry: they leave the Big Four vulnerable to scrutiny from the FRC and CMA and also work against the suggestion that “if you want public financial records that investors trust, you must use a Big Four accounting firm” (Christian Wolfe). Yet, if the Big Four are seen to be the only audit firms capable of carrying out complex audits, and these firms claim immunity from regulators, due to the scale of infrastructure required to undertake such audits, the undisputed failures of firms in the last few years considerably weaken this argument.

The implementation of next generation technology, through a solution such as Engine B, can forge a way through these issues. The FRC

review, along with the Brydon Report, emphasises the need to strengthen audit data quality. Although there are various Data Quality Assessment Criteria, Accuracy, Completeness, Consistency and Timeliness are generally agreed as key criteria.

Technology should bolster the quality of audit data by adhering to these criteria within a commitment to principles of transparency, equality and universality. An intelligent data platform should be able to analyse structured and unstructured data together, and therefore remove the need to rely on preselected data sets. Established auditing methods with a limited efficacy, such as root-cause analysis, will be implemented more rapidly, completely, consistently and accurately without an artificial barrier between the data lineage and its source; in other words, data quality is greatly improved where it is not pre-selected by the audited client or defined to include only structured data. As Brydon notes, the benefits of gathering a full range of data are best secured by an industry standard method for data analysis and extraction.

One approach would be to establish an industry standard platform and method for gathering and analysing audit data, improving the transparency, efficacy and overall quality of the auditing process. It also brings auditing closer to realising the long-stated ambition of “100 per cent testing.”

Question 2

Do you believe that challenger firms are currently at a disadvantage in the use of new technology? If so, what remedies would you suggest?

The Big Four exhibit a level of market share that is difficult to find in many other industries and this brings significant benefit particularly relating to data. Digitisation will naturally level the playing field, as the margin for human error associated with smaller, less renowned, firms is

effectively eliminated by the digitisation of tasks completed by lower ranking, billable staff. However, such innovation can often be blocked by inherent structural issues, as partners are not incentivised to reduce their team's billable hours.

In addition, the obstacle for Challenger firms is that they are unable to make the same level of financial investment in technological transformation as the larger firms. Should one of the Big Four or Six make significant steps forward in their technology innovation and transform their audit practice, this would mean that smaller firms would be unable to compete and will eventually fold.

Audit technology must overcome rather than entrench the challenges that have driven the need for industry wide transformation. Client data is too often kept away from small companies and start-ups by large firms able to build competitive moats with their own data extraction tools. While a common data model implemented across all firms will go some way to overcoming that issue the solution must work across the entire industry, be open source for all firms and be supported by legislation and regulation.

Ultimately an industry wide approach should remove barriers to entry, innovation and competition. This can be done by:

- Encouraging more technology innovation by increasing the use of data standards
- Levelling the playing field by introducing the equivalent of Open Banking for corporate data. If a standard data access approach is created then the large costs associated with having to tailor to client specific systems is removed and innovation is unlocked.
- Leverage regulation to force change and implementation of technology. By removing sampling and forcing complete audits

the firms would have to implement these regulations using technology.

- Ensure that the data platform verifies client data with 3rd party feeds where possible. As one example: Cleared Cash as a feed of data from Open Banking would have exposed many of the recent audit scandals before they became unsurmountable.

Question 3

Other than investment, what do you believe are the key challenges auditors face in the increasing utilisation of automated tools and techniques within the audit process? Again, what remedies would you suggest to overcome these challenges?

There are a variety of challenges which are creating resistance to using automation in audit. Large scale transformation is a daunting task for any organisation. Currently, although the Big Four invest a great deal in transformation, firms simply adopt the improvement method of the day, often taking a simplistic approach to reform, by incrementally changing their current business and audit practices, while still entrenching them to historic ways of managing audit. However, it is becoming evident that it will be necessary to address both technological changes and the impacts this might have to business models in parallel. The latter poses a significant threat to firms, and Partnerships are understandably reluctant to relinquish their position to effect real change, creating a dynamic of active inertia across the top levels of larger firms.

In turn, firms facing changes in their environment often fail to respond effectively and defend themselves from competitors inhabiting innovation. In the future this could well be the case for the Big Four. With many years of disproportionate market share, success becomes an ingrained and assumed part of the culture, and failure as a result of complacency becomes a greater risk.

An alternate solution to initiate digitisation which also incorporates automation will enable firms can invest in the change through realignment of their business model. This will simultaneously enhance and disrupt the firm by developing new technology to increase the value derived by both clients and the firm itself. By creating the equivalent of Open Banking for Corporate Data across the audit, tax and legal sectors, an open architecture can be achieved, enabling vendor access, client control of their data and regulatory assurance in a controlled and consistent environment.

If firms could recognise the need to be more forward thinking, and more freely ambitious, moving away from archaic and siloed methods of audit, true transformation is possible. However, ingrained cultural dispositions and traditional models which underpin the way firms operate will need to be relinquished in order to foster adoption.

Conversely, smaller firms lack the financial means to create technological transformation which could, and does, leave them at a significant disadvantage. By leveraging a single source solution that works across all firms and clients, the playing field across the Big Six, challenger and independent firms is levelled, opening up competition – as demanded by the CMA, the FRC and the Brydon review - and providing increasing levels of value and service excellence for end clients.

In addition, there is a perception that a range of technical skills are required. It's imperative that any technological solution must have simplicity and ease of use built in. Firms must also be willing to invest in their staff, ensuring reskilling and creating a business model around the use of automation to benefit employees as well as provide enhanced value to clients.

With COVID-19, the audit industry faces an unanticipated and unpredictable convulsion in the global economy. The innovation many

workplaces have implemented in order to adapt to the Coronavirus landscape, with online and remote environments suddenly a part of the “new normal,” are not going to be unwound.

Instead, the rapid adaptations thrust on the Professional Services industry have accelerated trends already underway: for example, the widespread adoption of electronic signatures in mid-tier firms had been impeded by cultural barriers now eroded by the new necessity of working at home. The same drivers underpinning the thrust of change in accountancy, auditing and legal firms also determine the rapid shift towards digitisation in key sectors of the wider UK economy such as estate agents, universities and local councils.

As the texture of the workplace transforms from a paper-chain approach to technology, with information manually inputted into spreadsheets and emails held on workplace servers, to a dynamic model of cloud-based, algorithmic data streams, the need to embed digital systems into accounting and auditing only strengthens.

Question 4

Does the current assurance model or the auditing standards represent an obstacle to technological innovation? If yes, then what specific standards, objectives, requirements or guidance cause practitioners particular difficulties?

Currently, there are systems in place to increase the quality of audit. However, these systems have implemented a move from sampling of audit records to full checks, and this brings with it a variety of issues around speed of service. While at present, regulatory requirements mandate only sampling to assure audit quality, so clients are able to insist audit providers only engage with audit sampling, rather than full assurance.

In providing an automated service solution, the issues around speed and accuracy of service are dramatically reduced and audit firms could provide a higher level of accuracy, quality and assurance at vastly increased speed. By implementing this change, clients will accept the tools that drive quality.

Question 6

What firm-wide controls do you believe are appropriate to ensure that new technology is deployed appropriately and consistently with the requirements of the auditing standards, and provides high quality assurance which the firm can assure and replicate more widely?

To improve the efficiency and efficacy of finding solutions to problems existing in more places than one, a single solution could be created by a single team and distributed as required. As such, by recognizing opportunities which can be advantaged by identifying grounds for commonality, firms can share information and resources in some form of a non-competitive ecosystem resulting in mutual benefit all round – ideally at least.

However, firms risk cross-contamination of regulatory restrictions if they overlap too much. This combined with the fact that as of 2018 the Competition and Markets Authority deemed choice in the audit industry to be too limited, with the Big Four conducts 97% of audits for the FTSE 350 (Financial Times, August 2018). This makes regulation a challenge especially with regards to commonality, which can lead to reduced product differentiation. However, should proposed future changes aid open data sharing and greater levels of innovation – as will be achieved by a single data solution, like Engine B – this will bring efforts back within recommendations approved of by the CMA.

Alternatively, rather than accepting that some form of a cross-sector partnership will possibly make any endeavour more difficult in

understanding the relevant regulation, there is perhaps also room, if not a need, for regulatory bodies to adjust their parameters in a time of endless new opportunities to cocreate change. This should be in recognition of the fact that with increasingly complex technology on the way, businesses will in turn have to increase the complexity of their own outlooks of future challenges, so that they are then able to craft solutions with the greatest potential for sustainable change.

In addition, the CMA recommendation that FTSE 350 companies must adhere to a Managed Shared Audit process, as well as the Operational Separation proposal for Audit practice, is a valid regulatory attempt to address the issues with Audit Quality. This understandably has been met with some resistance from larger firms. However, through standardisation of intelligent data, and a single version of the truth as part of an open source solution, the deployment of this innovation at each firm will ensure compliance to these proposals as well as current regulations and standards, with all necessary assurances inbuilt.

Question 8

What do you see as being the main ethical implications arising from the greater use of technology and analytics in an audit?

Both the FRC review and the Brydon Report discuss the challenges data-driven auditing raises for data protection, security and confidentiality. While compliance with GDPR partly addresses these areas, audit reform opens many questions about how and where data should be handled. The FRC therefore asks auditing committees to question “How does the external auditor store and handle the entity’s data? What data is retained and for how long is it retained? What steps are taken to ensure the security, confidentiality and privacy of data?”.

As a technology company, we have a crucial role to play in helping the auditing industry to address these questions successfully and

systematically. We provide the tools for auditors to trace the lineage of data to their source, but we will never move that data away from the client's systems. Clients audited through our open source API will retain control over their own data and where it lies. In other words, Engine B's common data model offers a standard auditing methodology capable of analysing unstructured and structured data sets without forcing that data to migrate into new systems outside the client's space.

Where AI ethics and regulations are concerned, being a rapidly developing yet still new practice, regulations are having to be formed and adapted at similar rates. In February 2020, the Information Commissioner's Office published a draft guidance addressing anticipated grey areas relating to AI governance, especially relating to auditing and risk management thereof, to ensure data protection compliance.

Currently, it takes the form of a conceptual framework, aiming to show early recognition of the benefits AI will and must bring, while introducing potential regulatory needs which will come alongside AI's wider use in the workplace. The ICO's work is still ongoing, and subject to discussion, and there will likely be no definite framework will be finalized for quite some time. An idea gaining momentum however is that audits could be the way forward for AI governance, reducing fears among CEOs that they will be accountable for machine mistakes in a way similar to cyber security audits.

Without a final decision on how AI governance will shape up, there are various theories as to the best way to go about it, as well as opportunities for auditors to position themselves in useful jurisdictions. For the moment at least, the ICO itself assures us that there is significant and ongoing investment into resources and effort, and that as a regulator they "will expect the level of governance and risk management capabilities to be commensurate and proportional to their AI data protections risks."

Question 9

Do you believe there is value in the UK having consistent data standards to support high quality audit, similar to that developed in the US Financial Reporting Council

We believe XBRL type, digital reporting would have great value. In addition, more importantly, data standards for technology interoperability should also be adopted.

As the EU's 2016 directive for mandatory auditing firm rotation in Public Interest Entities (PIEs) comes into effect, the need for industry-wide ADA standards and a common data model is stronger than ever.

However, it is evident that the technology is not sufficiently embedded in the industry to implement audit rotation durably and effectively. While the sector has long sought a standard Application Programming Interface (API) to deliver a unified method for gathering and analysing auditing data (notably through the xbrl API), a single solution is yet to crystallise.

This is partly due to a lack of industry-led compulsion or government regulation specific to the control of analytic data feeds. Furthermore, any reforms implemented now must be built to comply with the expected regulatory standards under ARGAs, and thus uphold with the underpinning principles and purposes of audit regulation under the proposed framework.

More broadly, the economic disruption and regulatory uncertainties produced by Brexit complicates any expectation of unified transnational standards, while COVID-19 has already upended the workplace environment and expected to lead the global economy into recession. This landscape only adds urgency to the need to unify, standardise and share auditing data models and implement consistent data standards.

Question 10

Do you agree that threats to auditor independence may arise through the provision of wider business insights (not as part of the audit itself) drawn from the interrogation company data? If so, what measures would mitigate this risk from crystallising?

The threat to auditor independence due to this provision is clear and the collective move of firms from cross selling services is prudent. The audit industry has been accused of resembling a closed shop in how it operates particularly in cross selling and blurring lines between providing and selling services, alongside insufficient regulation for increased accountability.

Transparent data sharing would provide less of an excuse for confusion between which services audit firms are actually selling. By increasing the incorporation of AI and cognitive automation in audit culture, our hope is to decrease this perception of a somewhat covert industry and instead provide sufficient public data for there to be real choice in the market.

As trust and confidence in the sector plummets and risk to reputations grow, there is a gap in the market for a technological solution which opens up the audit industry, showing that it isn't and doesn't have to operate in such a closed manner, using innovation to restore a beneficial working practice for all.

Therefore, not only should there be increased focus on the definition around the end client of an audit, but also the liability on the sign off of the audit and the relevance of audit to wider society.

Question 13

Do you agree that the use of third-party technology vendors raises potential ethical challenges for auditors and, if so, which potential safeguards would you see as effective in reducing this threat to an acceptable level?

There are potential ethical challenges in this case.

However, if there is a vibrant innovative marketplace of providers utilising standard data models and a robust certification process, then this would go some way reducing the risk.