



Improving Confidence in the Value of Audit

A Research Report
commissioned by the
Financial Reporting Council

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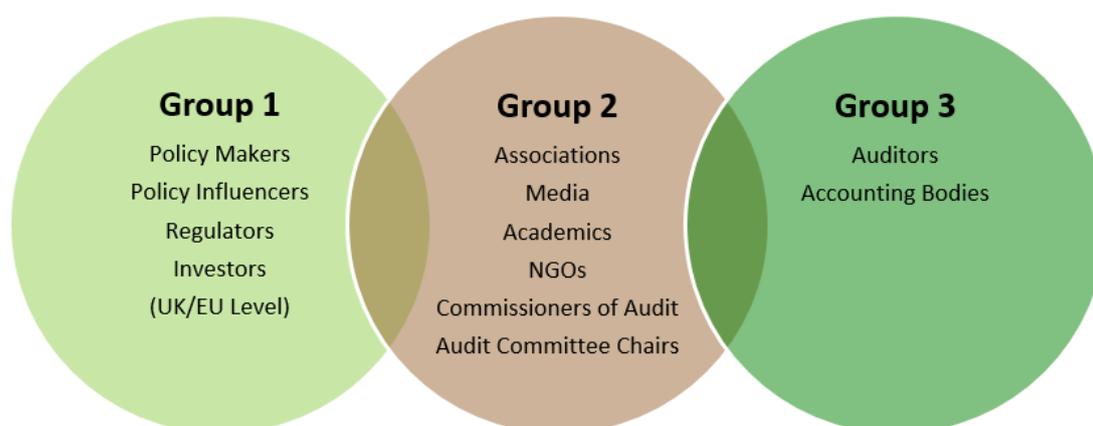
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Background and Methods

The FRC commissioned YouGov to undertake research into the current perceptions of the value of company Audit. The study is designed to provide the FRC with a clear assessment of current knowledge of, and attitudes to, Audit. The FRC believes confidence may have been on the decline for a number of years amongst key groups and now wishes to take stock of where Audit is exactly.

The project focused on primary research with influential groups to ascertain any differences and similarities across stakeholder groups. In total, 36 interviews lasting one hour each were conducted with stakeholders from across the Audit process and wider policy landscape.

Three groups were identified that broadly reflect the varying levels of direct involvement that stakeholders have in the Audit process. Respondents were recruited against these groups with the achieved samples represented below. Full details of the composition of the different groups are supplied in the appendix.



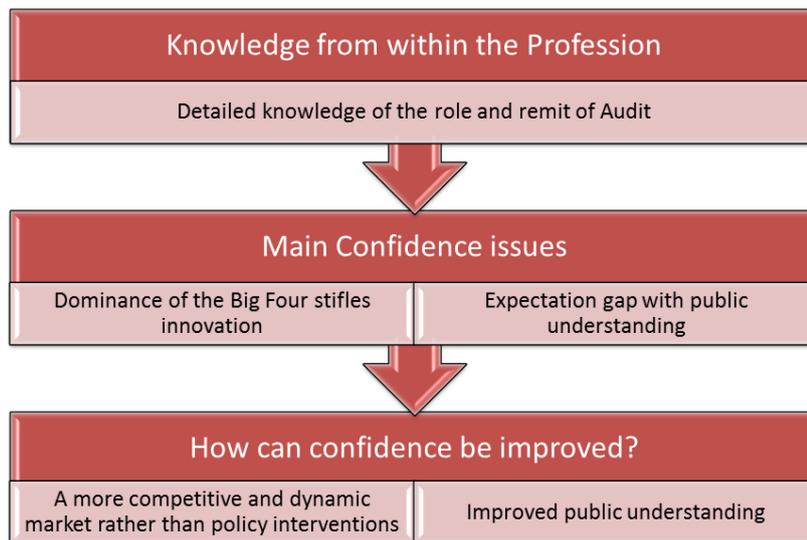
Group 1 – this is a policy and legislation-based group focusing on critical political committees or roles. Amongst the individuals represented were MPs (members of the Business Finance and Accountancy APPG), senior fund managers from the major investment funds, Senior Advisers to MEPs, as well as Regulators and Civil Servants from the UK and the EU.

Group 2 – this group included representatives of Business Associations, business/City journalists (from broadcast, print and online media), relevant academics (business schools etc.), and also relevant NGOs.

We also spoke to senior commissioners and users of audit in the form of CFOs, Audit Committee Chairs and FDs from a range of high-profile organisations.

Group 3 – this is a professional group including representatives of Audit Firms and Accountancy bodies.

High confidence stakeholder groups



This group is confident in the quality of Audit but are aware of significant issues regarding perception. They are happy with the current design of Audit but believe that there is an ‘expectation gap’ between what the public understands and expects and what Audit is actually designed to do. There is an entrenched belief that wider stakeholders, including the general public and media, do not understand the purpose and remit of Audit and so many feel that criticism is misplaced or inaccurate. They feel there is a need for the profession to better communicate its role both to the wider public and the business community.

They have high confidence in the Audit service and Auditor qualities. In general they are not supportive of policy interventions aimed at tackling issues of independence within Audit, such as mandatory rotation or Audit-only firms. Within this group Audit Committee Chairs were most supportive of the ideas of mandatory rotation or retendering. The dominance of the Big Four firms emerges as the most significant issue for most in this group both in terms of contributing to a negative perception of the profession and stifling innovation and choice, which ultimately affects quality. Financial Directors and CFOs are particularly frustrated by the lack of choice in firms with the capacity to Audit large multinationals. Audit Firms tend to have confidence in the value and quality of Audit as it currently stands. This group are more likely to discuss the role of Auditing and Accounting standards and the tension that overly prescriptive standards could have upon exercising opinion.

These stakeholders would like to see a more competitive Audit market and a better public understanding of the role of Audit and its purpose.

Medium confidence stakeholder groups



The largest proportion of stakeholders fall into the medium confidence group. A wider range of confidence levels are reflected within this group with some fairly confident overall and others having quite significant concerns. This is largely due to the varied roles and experiences that were reflected within each stakeholder group.

These stakeholders are generally content with the way in which Audit is designed but have confidence issues based around how services are delivered and the qualities of Auditors. Concerns vary across different interest groups but are focussed around the core issue of independence, which they understand to be vital to effective, quality Auditing. There is also a belief from some that Audit, as it is currently delivered, does not provide enough value to the key beneficiaries, namely investors and the public.

This group differs from the high confidence group in that they see the current independence of Auditors as a significant issue, which is exacerbated by the dominance of the Big Four. Consequently there is more support for policy interventions that aim to increase the independence and transparency of the Audit process, such as mandatory rotation, mandatory retendering or limiting non-audit fees.

There is a concern from some that the relationship between those auditing and those being Audited is too cosy to enable true independence and scrutiny. There is a further concern that many Directors are hiding behind the Audit when things go wrong at a company, yet at the same time these Directors are responsible for supplying the underlying company financial information to the Auditors in the first place.

Consequently there is support for readdressing the ways in which Auditors report to provide more value to investors and the public. Investors want to see more about the Audit process and operations, to enable them to engage with the process more and gain more value. Other stakeholders talk about reporting that offers more of a public assurance, potentially through future forecasting.

These stakeholders would like to see increased transparency and independence in appointment and processes as well as reforms in reporting.

Low confidence stakeholder groups



This group has significantly lower confidence than other groups, which is driven by their belief that Audit should be performing a more significant public interest role by protecting the public from failing institutions. They tend to perceive Audit as having a more pivotal role in protecting the public than other stakeholders. They understand the current statutory remit but feel that it does not provide sufficient protection to the public or benefit to shareholders.

These stakeholders share the service concerns of the medium confidence group but perceive the problems to be more structural and so are more likely to advocate more drastic intervention. Policies such as removing the statutory basis of Audit, external appointment of Auditors and Audit-only firms are suggested.

The journalists who we spoke to tended to concentrate their views on Audit of the financial sector, which drives their lack of confidence in the profession more broadly. The financial crisis was a significant influence upon their views of Audit, as an example of the profession failing to protect the public.

These stakeholders would like to see Audit redesigned to focus on delivering more public protection and more benefit to business, which again would be driven by the Audit Firm taking on a role that is more challenging to the business than is currently perceived by low confidence stakeholders.

Stakeholder views in detail

Through semi-structured in-depth interviews we analysed the ways in which stakeholders understood and assessed the value of Audit. Their views on these areas revealed the confidence that stakeholders have in Audit.

These conversations covered views of Audit in three principle ways, which has informed the structure of the report and the thematic analysis which we have undertaken.

- **Audit Design objectives** covering what stakeholders believe the overarching purpose of Audit to be, who the primary beneficiaries are, and how this should impact design including its statutory basis.
- **Auditor qualities** covering what qualities stakeholders believe Auditors and Audit firms should possess to fulfil the Audit remit. This includes views on independence and competence.
- **Audit service qualities** covering stakeholder views on the output and processes of Audit. This includes reporting, additional value added and the role of regulation in delivering strong service.

Audit design objectives

Stakeholder views of the role and purpose of Audit shape their confidence levels in it. There is consistent understanding of the statutory remit but an expectation gap does exist around how this relates to public benefit. This leads some stakeholders to argue for a widening of the remit to encompass forward looking information, which is the primary way in which some feel Audit could add more value. Reactions to Audit's role in the Financial Crisis highlight stakeholder views on Audit design objectives.

The overarching purpose of statutory Audit

An overarching theme that is identified by all those that have some experience of working directly in or with the Audit profession is the expectation gap that exists

between Audit and the general public. Wider stakeholders are less aware of this term.

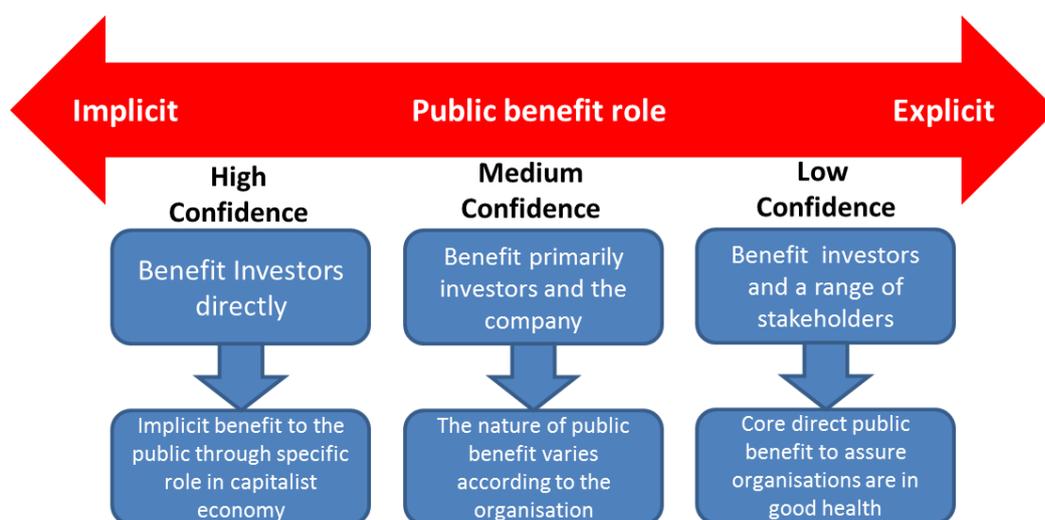
‘There is an expectation gap between what society thinks Auditors should do and what they are doing...the public need to understand what the Audit scope is.’ (Group 1, Global Regulator)

‘There is an expectation that Auditors turn up the drains, address problems and then sign off. The reality is they have a much more limited remit.’ (Group 1, UK Regulator)

‘Politicians and regulators still have an expectation that Audit does something it doesn’t do and this is the classic expectation gap that has been an issue since 1884.’ (Group 3, Accounting Body)

‘When I was taking my exams we talked a lot about what was known as the expectation gap, the gap between how our work was actually defined and how it was perceived to be defined by people who interacted with the audit profession. That expectation gap is as large now as it was when I sat my exams, which was several decades ago.’ (Group 1, UK Regulator)

In fact all the stakeholders that we spoke to have a good understanding of what the statutory remit of Audit is. An expectation gap does emerge between Auditors and wider stakeholders around the intended benefit of this remit. Those within Audit see it as one of many tools to protect the public whereas others see it as the primary protection that investors and society have against corporate malpractice and financial failure. There is a more nuanced view in between these positions that defines the public benefit of Audit by the extent to which the organisation being audited has a public interest remit. In essence there is more direct public interest in auditing a multi-national financial institution than a smaller retail organisation as the public has more interest in the stability and success of the former than the latter.



There is broad agreement that a statutory requirement is necessary as it establishes an external duty upon companies to assure their investors, instead of placing the duty of accountability with individual investors, who may have different needs and expectations. This is seen as protecting investors and the public. A minority of stakeholders argue that removing the statutory requirement could improve the quality of Audit. They argue that if the statutory requirement was removed it would be incumbent on companies to commission audits that gave sufficient transparency to attract investors in a crowded marketplace, which would have a greater benefit to the economy more broadly.

'If the statutory requirement were eliminated, it might create a market for audit that investors cared about. As it is, the statutory requirement creates a box-ticking culture.' (Group 2, Media)

'The compulsory Audit should be abolished and instead the Board should be solely responsible for the financial statements that they release.' (Group 1, Investor)

'Yes it should be statutory. These requirements go wider than the listed market and if you remove that within the private sector then you potentially have problems as you're leaving it up to more concentrated share ownership to decide whether it is necessary or not, when in fact it is essential' .' (Group 1, Investor)

Beneficiaries: Investors

There is a lot of agreement amongst stakeholders that the primary beneficiary of Audit as defined by law and regulation is and should be investors and shareholders. They are an interest group that are distant from the day to day running of the business, so the Audit reports perform a function of assuring them that the financial reporting and processes are correct.

'Auditors do not have a duty of care to individual citizens, just to the shareholders' (Group 1, MP)

'The responsibilities of Audit are clear. In the UK the beneficiaries are the shareholders' (Group 1, Global Regulator)

'Legally the shareholder must be the primary beneficiary...at the end of the day the shareholder is a distant owner of the business and they need somebody to reassure them that the executives working at the company are effective and that prompt control systems are in place to produce results which do show a clear and fair view' (Group 2, Audit Committee Chair).

Beneficiaries: Board members

Aligned to benefitting investors many stakeholders see Board members and the company themselves as beneficiaries of Audit. When speaking about the Board, stakeholders did not spontaneously offer distinctions between benefitting the Audit Committee as distinct from the Board. Overall this is largely understood as a secondary benefit through the work of a good Audit rather than something that should inform the way in which Audit is designed.

However a tension emerges from some stakeholders that the Audit process and reporting in particular is shifting to be of more benefit to the Board than investors. These views are particularly strong amongst investors as well as some academics. There is a feeling that the current statutory remit has created an overly prescriptive service that does not offer shareholders the information they require to make investments.

'Audit benefits the auditors themselves (nice fee), management, and the bank manager. We're in a society where everyone likes to hide behind someone else having checked things.' (Group 1, Investor)

'Companies themselves benefit, but also other interest groups – shareholders and the government themselves.' (Group 2, Business Association)

'There is supposed to be a triangle of beneficiaries – the company, auditor and shareholders. But the triangle is increasingly missing shareholders as Auditors and companies have got closer together.' (Group 1, Investor)

'The company themselves should be the first beneficiary as the audit process is valuable in itself to shed light on a company's processes and operations' (Group 1, UK Civil Servant)

Beneficiaries: Wider public

More widespread differences in opinion emerge when discussing the relationship between benefitting investors and the wider public. High confidence stakeholder groups feel that Audit contains an implicit wider society benefit by acting as a key part of maintaining a well-balanced capitalist economy, but it is really through investors and shareholders that this is achieved. For these stakeholders it is one of many levers in society to maintain the stability of business and so they are confident that it is fulfilling its role sufficiently. Audit fulfils its public interest role by verifying financial statements and not by publishing a clean bill of health or a future forecast.

The only significant conceptual difference emerges from those stakeholders within the Audit profession who have a continental European background. They argue that continental Europe understands Audit to have more of a public interest remit compared to the UK and USA where Audit is more designed for investors and shareholders

'Primarily the shareholders and investors and also the board. There is a broader governance and society role you could say but I see it as primarily for shareholders. I think it benefits society more generally as it gives a set of rules that you can judge companies by and that allows society to allocate resources.' (Group 2, Business CFO)

'There is a real society benefit to know that the financial statements are correct.' (Group 2, Business CFO)

'I strongly believe in adding value to the public in general as the public interest [of Audit], which will have to do with my Dutch background as I consider shareholders and investors as just one of the stakeholders in the group that need to have trustworthy financial information, but there are many others in the group like trade unions, labour employees, tax authorities...it's a much wider group and it would be a mistake if Auditors would act only on behalf of shareholders and investors.' (Group 3, Audit Firm)

'[Auditors serve] investors in the first place but they have a broader role considering the impact that wrong reporting could have on the economic health of the company and, globally speaking, on the health of financial markets.' (Group 1, EU Civil Servant)

'Although the primacy of shareholders is important, if you create confidence in the market that will create more efficient allocation of capital which is good for society...I wouldn't get carried away with benefiting other stakeholders. I think they need to get it right with shareholders first before extending to other stakeholders.' (Group 1, Investor)

Medium confidence stakeholders tend to see Audit as having a more significant public interest remit but still acting through investors or directly interested parties. Often a more nuanced explanation of the relationship between investors and the public is articulated with the idea that the extent of public interest depends upon the nature of the business being audited. So institutions such as banks are audited in the public interest because the public are key stakeholders. They are not necessarily key stakeholders in all private companies.

Essentially in some circumstances Audit needs to fulfil a role of assuring the public that an organisation is healthy and not just that the financial statements are correct. Recent corporate failures have led some stakeholders in this group to consider a redesign of Audit to concentrate more upon establishing a clean bill of health where that is in the public interest. There is a belief that the way in which Audit is currently designed is not offering sufficient assurance to the public and so a re-design should be considered.

'If their particular objectives are focussed on fulfilling the interests of shareholders then the Audit process will reflect that, but if it's clear there is a much broader responsibility then the Audit process will reflect that... Each organisation has its own stakeholders depending on the organisation and sector and their relative importance and that will determine who the Audit is for.' (Group 2, Business Association)

'[Audit is] primarily to benefit the shareholders, the markets as a whole and management in that it's an added control over the integrity of their financial information.' (Group 1, Investor)

'Companies themselves benefit but mainly other interest groups - shareholders, government. You could probably say the public interest too - I think it's in the public interest in terms that the public are receiving tax revenues from that company so that should be accurate' (Group 2, Business Association)

Low confidence stakeholder groups feel that the Audit process is probably the most important lever in society for protecting the public from failing institutions. Although they still see investors as the primary beneficiary they tend to see the role of Audit as a public assurance of a clean bill of health to the company. This is necessary to benefit society rather than just verifying financial statements. Therefore these stakeholders are more likely to want the remit of Audit to be redesigned and potentially broadened.

'We have created the corporate form, which is a legal compromise, a legal fiction in some ways, to allow for important things to happen in society, and above all, in the economy, so the audit clearly performs a central role in making that possible because it's for public companies, and therefore it's absolutely, unambiguously clear that its function is social and economic in a wide sense, or it has consequences that are social and economic, and are not restricted to simply reporting information for the business and the owners of the business.' (Group 2, Media)

'External audits are statutory and set by the Government - the Government represents the public/society. Thus there is an implicit contract between audit and society. Auditors are no longer delivering what society wants...they are too limited' (Group 1, Global Regulator)

Future forecasting and going concern

The primary area that all stakeholders identify as lacking in the current statutory remit of Audit is providing a view on the future health of the company. This is the key factor that needs to be considered in order to enhance confidence in the value of Audit for some.

High confidence stakeholders, who are all fully aware that the current scope of Audit covers historical financial records and some commentary on 'going concern', recognise the limited future forecasting that Audit provides as a significant issue. In general there is interest in the idea of Auditors reporting on future information but a number of practical issues are raised about how effective this is likely to be in practice. This drives some complaints against the inherent conservatism of the profession, with some believing that Audit should be more dynamic and develop a way to meet this need.

'There are areas like future prospects which are something that is very possible to be done but if auditors are to do that then they need protection around the liability.' (Group 3, Accounting Body)

'The big question is whether, if there would be an obligation on the auditor to present and produce more public facing information, we could reduce the risk of big corporate collapses...I think we need a debate about that. I would say for listed companies should publish more forward looking information on forecasts [in their Audit Report]. It's actually very difficult to do properly.' (Group 2, NGO, FD)

Medium and low confidence stakeholders are not always aware of the current remit of Audit focussing specifically on historical accounts and 'going concern', although most are. As they see Audit as primarily issuing a statement of health to society many feel this should involve an element of future forecasting. This is a key area where Audit could add more value for these groups.

'Auditors look at the going concern for next year, they check management's going concern assertion. But they can be misunderstood here..... e.g. should auditors do stress testing? We don't expect them to have a crystal ball.' (Group 1, Global Regulator)

'I think the tendency, for perfectly understandable reasons, is to be precisely wrong, that is to say to rely on historical figures to which you ascribe a certain precision. It can be, and often is, extremely misleading. I have no idea what the answer to this is - because I'm not an auditor, it's not my job to think about this - but I think it is clear, unambiguously clear, that across the western world, and it is not a uniquely British problem, that the valuation of financial companies, and the audits of financial companies, have turned out to be enormously misleading.' (Group 2, Media)

Broadening the scope of Audit

Widening the scope of Audit to include non-financial information is a less popular view across all stakeholder groups, but there are some that see it as falling within the remit of the Auditor. Many take the view that it is important that businesses are scrutinised for non-financial information but for most this is not and should not be the role of the Auditor unless it directly impacts upon the financial health of the organisation. There may be other mechanisms and organisations that may be better placed to offer scrutiny of non-financial information.

'Environmental and other audits are a complete waste of time.' (Group 1, Investor)

'On balance I'm in favour of keeping the scope as it is. I'm a fan of a true and fair view and get on with it rather than let's look at the health and safety report.' (Group 2, NGO, FD)

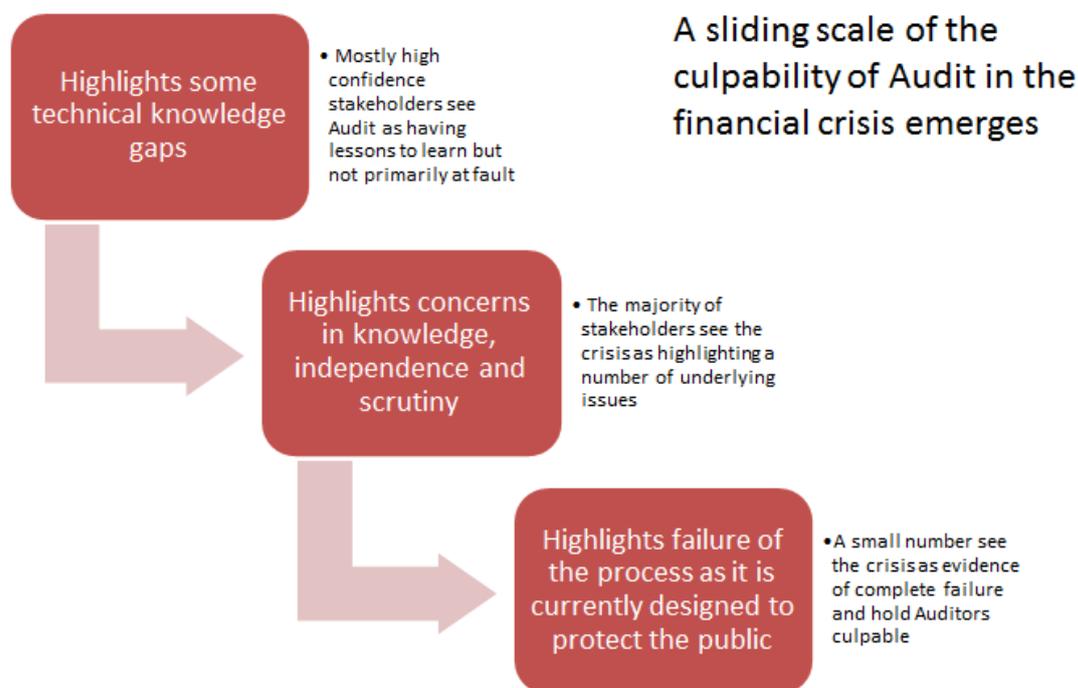
'There is room for other forms of Audit, to have audits for non-financial information that is relevant to financial performance.' (Group 2, Business Association)

'I would go nowhere near it [non-financially relevant information]. I don't need an auditor to do that - I have enough requirements on health and safety.' (Group 2, Business, CFO)

'The bottom line for the Auditors is that they are essentially financially based and they're very good at sorting that stuff out. There may be a case for having this other stuff (non-financial information and processes) checked but I'm not sure that Auditors are in the best place to do that and if they are I'm not sure it should be part of the Audit. It may be that it's a separately contracted service.' (Group 2, Audit Committee Chair)

CASE STUDY – The financial crisis in 2008

These differing views emerge clearly when discussing the financial crisis. As the financial sector is an industry where the public has a clear interest in stability, it works well as a reference point to explore issues of the current effectiveness of the design of Audit. All stakeholders feel that the financial crisis highlighted shortfalls in Auditor competencies in understanding the complex financial models being used by financial institutions. Furthermore, Auditors failed in their duty to apply sufficient challenge to the information which the companies were supplying to them.



High confidence stakeholders feel that the crisis does not necessarily reflect any failure in Audit and are satisfied that Audit fulfilled its function. They generally see the

largest share of the blame elsewhere and any blame laid on Auditors would need to be shared as part of an overall financial risk culture. Some are open to the crisis acting as a catalyst to discussing potential changes to Audit, but are clear that as it stands it does not of itself reflect a failure.

'I'm pretty sure that all Auditors ticked the boxes in those days, so to have a deeper, wider understanding of what was behind those products [complex financial products in investment banking] and all relating values and risks in order to know if the value represented by banks was an appropriate one [would be the key learning point for Auditors following the banking crisis]' (Group 3, Audit Firm)

'Well, it comes down to what you think an audit is there for. Is an audit there to stop a company going bust, or is an audit there to give an independent review of the information that's reported by the company? If you take the latter view, which is the view that I take, then I think you would probably say those comments might be a little harsh. It's not the auditor's job to tell either the company or the investors that what they're doing might lead to the company going into liquidation.' (Group 2, Business CFO)

Medium confidence stakeholders do see Auditors as culpable in the crisis, and as public interest institutions failed, it is fair to say that Audit failed in its remit. This tends to be attributed to process and service level factors rather than a re-thinking of the remit and design of Audit, although some are open to a debate about the remit and design. It has caused some to question what the real value of Audit is, leading to a rethinking of its role and remit.

'There is a need for auditors to be flexible on the sources they draw on and not rely entirely on the information from management. It makes sense for them to consult a wider range as a test for integrity and this is all part of being critical and independent, and not being spoon-fed.' (Group 2, Business Association)

Low confidence stakeholders are by far the most critical and use the crisis as a reference point to drive much of their lack of confidence in Audit. They are more likely to believe that the crisis reveals a fundamental weakness in the way that Audit is conceptualised and designed to give the public more assurance. Some see it as irrefutable proof that the current design is not fit for purpose.

'The question you have to ask yourself, because this is a core thing, did audit provide us with a reasonable early warning system? That's part of what it is supposed to do, for things to be clear, that's part of what it's got to do. The answer is, I think, very clearly no.' (Group 2, Media)

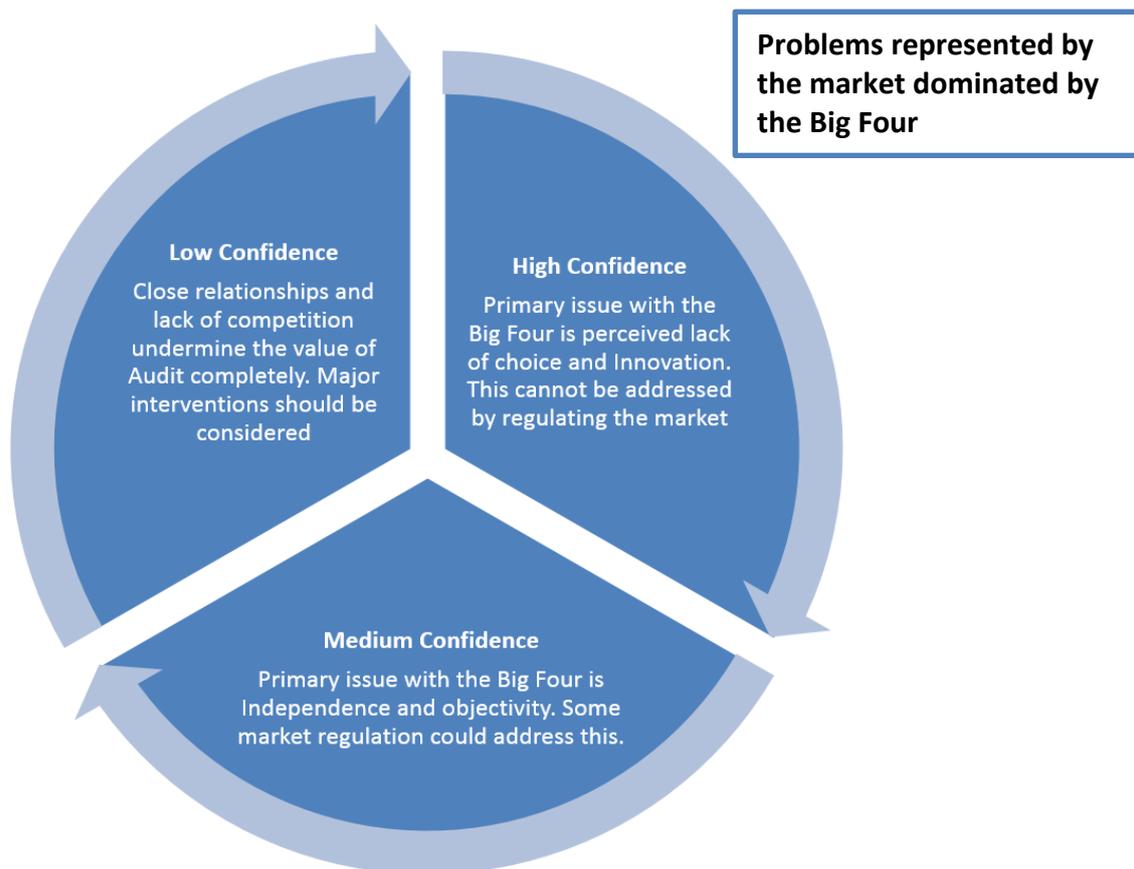
'Audit began to be legitimised when enterprises were small and manageable but in the era of globalisation that is not the case anymore, they are very large, places like banks have real time movements of money, vast assets, so conducting an audit is a waste of time.' (Group 2, Academic)

Auditor Qualities

There is agreement across all stakeholders that Auditors should be independent, sceptical and challenging and at the moment it is only those within the profession that have true confidence in this.

Amongst all other stakeholders there are significant concerns over independence that is driven by the close relationship between Auditors and companies as well as the current market configuration where the Big Four firms dominate. Those within the profession are more concerned about the lack of competition that the Big Four dominance has created.

Concerns over audit quality stem from these issues of independence and objectivity as a number of stakeholders feel that Auditors do not present a sufficiently strong challenge to management.



Independence and Objectivity

High confidence stakeholders largely fail to engage with concerns over the independence of auditors. There is a general feeling that this is not a real issue and just one of perception. Most feel that enough measures are currently in place through regular rotation of lead partners from the same audit firm, professional regulation and limits on additional services. Financial Directors are confident they have their own processes in place where there is no statutory requirement to ensure objectivity and challenge. They tend to be strongly against any interventions to increase independence, feeling it would often compromise quality. Most feel that Audit only firms could risk compromising on quality through restricting the ability of Auditors to have access to wider business knowledge and experience, which they feel is a vital quality of an effective Auditor.

'Appointment externally? I personally don't think that will make a difference, I don't think that's how markets should work - the company should choose and that won't tackle the problem. Rotation? I personally I don't think so..... it takes time to know a company and become familiar with those statements so if it was too short it would mean lower quality.' (Group 2, Business Association).

'Independence should not be overdone. I don't think it would be healthy to limit auditors to Audit only and not allow them to do any advisory work for the company. If you're able to do advisory work it will help you understand the client's business and allow you to do a better Audit; however, I agree there has to be limitations to what advisory work you are allowed to do and the amount...as long as your Advisory fee is not more than your Audit fee I'm still convinced that it doesn't influence your independence in such a way that it will impact your Audit opinion.' (Group 3, Audit Firm)

Medium confidence stakeholders feel that independence is a very significant issue in terms of quality and perception, but views are mixed on how to address this. Some present a number of practical objections to mandatory rotation and tendering. There is a sense that the problem lies within the configuration of the Audit market and these heavy handed interventions will not increase competition as long as there are only four firms with the capacity to do the work. In addition they feel that an Auditor needs to know a company's business well so there is value in having an established relationship. Overall mandatory rotation and tendering are accepted by some higher and medium confidence stakeholders as reasonable interventions provided that the length of time between retendering is at least ten to fifteen years.

'There's a lot of training and the firms spend a lot of time looking at who is doing their job well. A danger is that trying to mitigate the problems, which there surely are, can have perverse effects on quality in other ways. It's a trade-off – for example, the issue of mandatory rotation comes at a different cost.' (Group 2, Academic).

'We should avoid a situation where one auditor remains in charge for decades, but there is also a need to have educated people who know the company and understand its operations' (Group 1, UK Regulator).

'There is a cosy relationship between the Big 4 and their clients. I don't think a regulatory solution is the answer to that problem. It's more about companies asking the question [to their Auditors] "look, are our figures fine?" and the Auditors being a bit braver and saying "we've seen something here that if it continues may cause concern"' (Group 1, UK Civil Servant).

'Mandatory rotation is a possibility but there is a trade-off between independence and learning the ropes. Starting afresh on a big company audit could put the auditor at a disadvantage. The relationship can be too cosy.' (Group 2, Media)

'The problem is that changing your auditors is a tremendously disruptive thing.....there is a balance to be drawn and after 9 years a mandatory retendering could be appropriate but it would have to be on that kind of cycle' (Group 2, Audit Committee Chair)

Some common ground does exist between stakeholders through a desire to make the appointment of Auditors and their reporting more transparent. This is a far more soft-touch approach to tackling the issue of perceived independence than introducing any external market regulation. It is advocated by high confidence stakeholders and those medium confidence stakeholders that do not want more regulation.

'Companies should publicly advertise what they are looking for and then make a statement around why they go for that particular auditor - transparency around their decision.' (Group 2, Business Association)

As independence is such a key issue for medium and low confidence stakeholders there are many that are in favour of policy interventions. Audit rotation, mandatory retendering and capping of non-Audit fees are the most common solutions proposed. They feel that these interventions would help to break down the perceived close relationship between Auditors and the firms that they Audit. There is an overall sense from some stakeholders that the process is self-serving and some form of intervention is needed to increase independence and transparency.

'Auditors are appointed by the company's directors, remunerated by them, they'll even do some accountancy and say, "here, let me show you how you can dodge your tax, and how to prepare your accounts afterwards"... Auditors are not independent, they have all kinds of relationships with them and even worse we don't know what auditors get up to. What kind of public accountability mechanisms apply to accountancy firms?' (Group 2, Academic)

'I think the idea behind mandatory rotation is right but I would say mandatory tendering would work better if it was monitored to make sure companies made the right choice... it's about giving [Auditors] the opportunity to compete.' (Group 2, Business Association)

'The statutory requirement does lead to inertia to a certain extent; there is reluctance to change auditors and the tender process is not comprehensive enough..... Yellow cards for auditors, capping non-audit fees at 50% of audit fees,

and mandatory rotation after 15 years would be sensible measures that would certainly help transparency. Principles should be used to guide the audit process for the benefit of investors and shareholders. Companies should also use a good tendering process, possibly employing a tendering expert. Of all the interested parties the auditors are the one group who are pushing back most against change.' (Group 1, Investor).

'There is certainly room for improvement in terms of competition...there are EU proposals being discussed at the moment.' (Group 1, EU Civil Servant)

'It is a matter of concern that only 4 firms do the FTSE 100. It gives a bad perception if the Auditor becomes FD of the firm he was auditing. They should only do the job for a few years, so compulsory rotation would be good in order to demonstrate independence.' (Group 1, MP)

Some lower confidence stakeholders are in favour of more extreme measures such as Audit-only firms, external appointment and payment by external bodies. This stems from their desire to restructure the industry, as they believe that its current configuration makes it hard for Auditors to gain any significant independence.

'In the case of banks there is an easier solution which is that an auditor employed directly by the regulators e.g. FCA, should be doing the audit.' (Group 2, Academic)

'I think it (Appointment of Auditors) is a job for the state - it is not a job for organisations whose prime motive is to make money and make the client happy; by the client what the Audit firm means is Directors, not shareholders or the public. Delegating it to the private sector is disastrous' (Group 2, Academic)

There is a feeling amongst some stakeholders that the dominance of the Big Four is indicative of a lack of professional distance between different stakeholders within the Audit profession. Those conducting, commissioning and regulating Audit are seen to have close professional relationships, which causes some to question the level of independence and objectivity in the profession more broadly. Some stakeholders across all confidence levels express some concern that the profession is a closed shop, which can hinder independence, or the appearance of independence.

'Audit committees need support and what worries me at the moment is that they go to the Big Four for support. It feels too close. It could be a role for the FRC or professional bodies or the CBI. The cosy relationship between audit committees and the Big Four isn't good.' (Group 3, Accounting body)

'[There are problems with] the revolving door between the auditors and the finance function of their client and where auditors take up jobs with clients and clients move towards, go work at the auditors. That shows the relationship can cloud judgement and stop the auditor from being truly independent.' (Group 2, NGO)

Competition and Choice

Many stakeholders expressed some concerns about the current market configuration in terms of limiting competition and choice in the marketplace. Audit firms and Financial Directors express concerns that the dominance of the Big Four could stifle innovation.

Overall there is a fear that four firms with the capacity to audit large multi-national companies is too few and presents the risk of becoming three if one firm fails. No one expresses any concerns about the competence of any of the firms, which is seen to be very high. There is perceived to be a large gap between the Big Four and other Audit Firms in terms of global reach which significantly reduces choice for many multinational companies.

'There is also a lack of competition in audit - only 3 firms can do bank audits' (Group 1, UK Regulator).

'Then, there's a big expertise gap from the big four to the next, yes....it is by no means beyond imagination to assume that we'll wake up one morning and discover that one of the big four has fallen off their perch. It just takes some scandal, some problem, etc. So, whenever you have four of something you have to say to yourself, 'Could I actually live with three of them?' Because having four means that three is a real prospect at very short notice, yes?' That's problematical. (Group 1, UK Regulator)

'If a small number of firms dominate I think collusion is always a problem - prices could be manipulated and it is better to have a broad range of opinions and strategies so no one gets a competitive advantage' (Group 2, Business Association).

'There are a limited amount of big players and the [European] Commission is working to improve competition in the sector.' (Group 1, EU Civil Servant).

Competence

In terms of competence the Big Four can act as a positive factor in terms of perception of Audit quality for some stakeholders. There is a belief that the Big Four have high recruitment standards and working practices, which can drive high quality, competent Auditors. There is general acceptance of the value of multi-disciplinary firms from a quality perspective as it enables a broader business perspective, even if for some the risks to independence outweigh these benefits. CFOs in particular report a high level of confidence in the Auditors they use, which drives their overall confidence.

'Yes [the Big Four represent] high quality - I think they are generally better qualified and of a higher standard than the people who criticise them' (Group 2, Business CFO)

However despite this there are some isolated voices from within the Audit profession, investors and wider stakeholders that have concerns about the competence of Auditors. These concerns do not tend to dominate their overall confidence as those with low confidence overall tend not to raise issues over Auditor competence, since their concerns are at a more structural level.

In terms of competence the main issue that arises is based around wider business acumen and the ability to challenge management. Auditors often blame standards and regulations for this and there is a sense from wider commentators that the professionalization of Audit has restricted the ability of Auditors to acquire this wider business and economic knowledge. They feel that the professionalization of Audit has created intelligent 'box-tickers' rather than sceptical professionals. They do not know enough about the standards to link this to any specific regulatory policies or practices and instead give a general view from outside the profession. Some have a concern that Auditors are not strong enough to challenge companies they audit.

'An advantage of the Auditors in the 70s and 80s is that they had a much better understanding of business economics and Audit being too specialist is a concern for me, so they should have a better understanding of business economics to understand what the drivers are and the risks for companies.' (Group 3, Audit Firm)

'Auditors are not courageous enough in speaking out if they find an element of the company's operations that they are not happy with.' (Group 1, UK Civil Servant)

'Auditor should be trying to get behind the numbers, but now it is lots of bright people engaged in mere box-ticking.' (Group 1, Investor)

Audit Service Qualities

High confidence stakeholders feel that Auditors should and currently do provide considerable added value above their statutory remit. Other groups tend not to recognise this and see the profession as more process driven.

In terms of output, investors are particularly critical of the Audit report as it currently stands and there is a sense from some stakeholders that Auditors could provide more public facing reporting.

Those within the profession are most critical of the standards fearing that it is creating an overly prescriptive professional culture that stifles judgement. Other stakeholders are less aware of the standards and regulatory environment but do recognise a challenge to ensure international consistency in Auditing.

Added value outputs

Those that are particularly confident in the current quality of Audit feel that Auditors are already consulting very broadly in terms of the information that they audit and do not see the need for any broadening of their role. This view is particularly prominent

in CFOs and Financial Directors as it is something that they already expect from Auditors.

'Ours certainly do that [consult wider sources and intelligence other than financial statements] anyway. We have audit partners sitting in each market, they do draw on a much broader context of what they see as happening within the bank - how can you form a judgement without the contextual information? I would be amazed if my external auditor wasn't looking at context and industries.' (Group 2, Business, CFO Banking)

There are some stakeholders who feel that Auditors need to consult a wider range of sources. Some of these come from a European background and see the Auditor as fundamentally fulfilling a broader role than financial health.

'A triple bottom line reporting: people and planet as well as finances. I think that is going to carry on developing.' (Group 2, Academic)

'[Audit] can cover pension liability, social security, environmental - if you consider the public mandate role you will look at a number of different aspects as well, to act on behalf of the public.....Personally it feels too focussed on capital markets but I understand where they are coming from, but I wonder if they understand where we are coming from.' (Group 3, Audit Firm)

Audit Report outputs

Specific concerns emerge from investors regarding the way in which Audits are reported as well as the information that the reports contain. This is a significant issue for investors in terms of their ability to engage with, and feel confident about, the quality of Audit. The issue of the scope and content of Audit reports emerges more broadly through other stakeholders who highlight the need for more transparency in reporting.

'From our perspective the International Standard on Auditing [UK and Ireland] that was recently updated to improve the Audit Report for shareholders was a good step forward but we still feel that way the result of Audit is reported to shareholders is poor and we still don't really get what we need in terms of the key aspects to help form an opinion...it's difficult for investors to assess the quality of the audit and where the information actually came from.' (Group 1, Investor)

'More could be done on disclosing sampling, areas of focus and on subsidiaries. It would be beneficial to get more transparency on what the auditors have audited.' (Group 1, Investor)

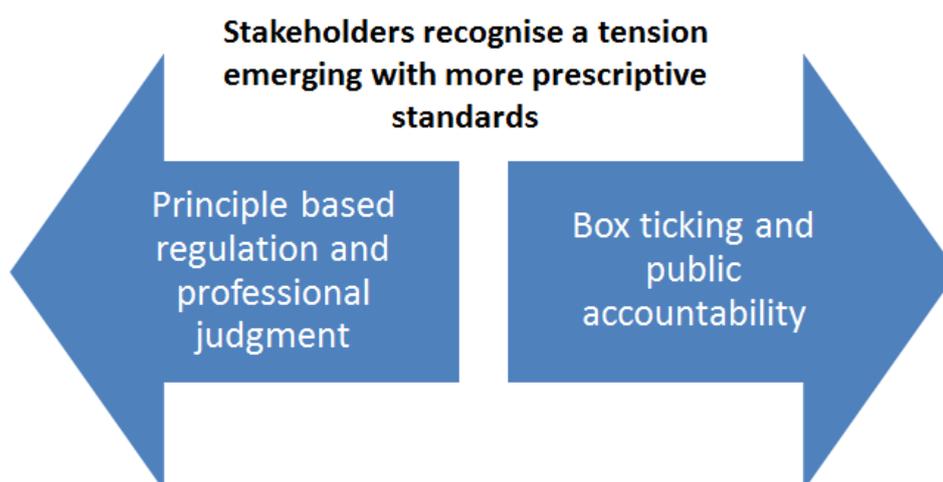
Some stakeholders do recognise that to improve the value of Audit reports the company and the investors need to engage with the process more themselves. There is a feeling amongst stakeholders across the confidence groups that the reports need to be scrutinised more and part of this involves investors and directors engaging more with the output.

'Confidence would be enhanced if directors show that they want to have an effective audit.' (Group 1, MP)

'As in many cases they [shareholders] don't have a long lasting relationship with a company, I think they have lost their previous position...they step in and step out as quickly as the weather changes.' (Group 3, Audit Firm)

'In the UK there is a balancing act in the role of the Audit Committee in overseeing the process and reporting on it and what the actual Auditor reports, so it's important to get a balance between the two.' (Group 1, Investor)

Standards and Regulation



A concern that is voiced across all stakeholder groups is the shift towards Audit as a box-ticking exercise. Auditors link this to overly-prescriptive Auditing and Accounting standards whereas wider stakeholders see it as part of the way in which Audit is currently understood, without direct reference to any standards. Wider stakeholders have a general sense that the profession has evolved to a process-led one but cannot pinpoint why this is or how to rectify it. It is possible that this is due simply to perceptions that statutory activity requires a bureaucratic and highly structured approach. This underpins concerns that some have that Auditors are currently not sufficiently sceptical and challenging

'The best system will be principles-based but with a stick. Ultimately a lot more judgement is required in the audit of a bank' (Group 1, UK Regulator).

'The process must be a risk-based approach rather than box-ticking.' (Group 1, MP)

There is a significant weight of opinion within the Audit community, and even with those that are generally confident in the quality of Audit, that Auditing and Accounting standards have become too prescriptive and need to move towards a more principles-based approach. Those within Audit see the professional judgment of the Auditor as the primary way in which Auditors perform their role and are concerned that an emerging shift to standards that are too prescriptive inhibits this.

I think we've gone too far with being prescriptive and perhaps have lost sight of judgment. (Group 2, Business CFO)

'Rules are important but principles are more important. It always makes me concerned when the profession becomes more rules-based and forgets there are more important overriding principles' (Group 3, Audit Firm)

'I think people get over enthusiastic about rules and regs so my plea would be for more simplicity and pragmatism.' (Group 2, Business CFO)

'I do have a genuine concern that the true and fair view has been overwhelmed by a standards based approach that is both technical and artificial...there is a danger that this [standards based approach] can give a misleading picture' (Group 2, Audit Committee Chair)

Those with less direct experience of Audit are not aware of standards and tend not to raise them as an issue, other than believing that they exist and assuming that they play a positive role. There is a feeling amongst some of the low confidence stakeholders that Auditors are not held to account enough, but this is a minority view and the issue of standards and professional accountability tends not to be the driving force behind their lack of confidence. These views are linked to the broader feeling that the Audit profession is a closed shop and that professional links between external regulators and current practicing Auditors are too close.

'The FRC is using its teeth to say that some audits are not of high enough quality. But the FRC also has conflicts, as a lot of the Board come from the Big 4.' (Group 1, Investor)

'The problems which remain to this day are that auditors are not really accountable to shareholders or to the public at large; shareholders can't see audit files, auditors have no duty of care to shareholders, there are no league tables indicating what their performance is.The first step must be big distance between the FRC, or whoever is regulating the auditing industry and the accountancy industry, they are far too close.' (Group 2, Academic)

Higher and medium confidence stakeholders feel that standards and regulation as it currently stands is sufficient, and that scrutiny has increased over recent years. If there are any issues it is in the way that firms and individuals apply these standards rather than the standards themselves or any missing players in the accountability framework. Outside of the regulatory community knowledge of standards and

regulation is low but there was a general sense that external scrutiny was not a significant issue.

I think it's more about the application of the standards than the standards themselves. (Group 1, UK Regulator)

'They (the FRC) seem pretty transparent on publishing their reviews. I remember being reviewed at PWC but I don't have a strong view on it.' (Group 2, FD, NGO)

It is generally recognised that regulation is important to ensure consistency but most stakeholders do not have enough knowledge of the regulatory environment to comment on how effect the current regulatory framework is. There are no significant voices calling for more regulation. A number of stakeholders identify the issue of global consistency and international regulation as a challenge currently facing the profession. Although global consistency is an issue for the profession with standards varying across countries and the EU, there is a lot of scepticism that International Standards are a viable way of tackling this.

'It would be a disaster to have a global body setting global audit standards as you would end up with the lowest common denominator. We need to reconsider what an auditor does when they scope and plan audits.' (Group 1, UK Regulator)

'Large businesses operate multi-nationally, so common international accounting standards make sense. Consistent regulation of the audit function also makes sense. EU regulations tend to take us down a road we don't want to go down, as there are accounting treatments for French and German firms that are not appropriate for British firms. A standardised approach does work, but it can go too far.' (Group 1, MP)

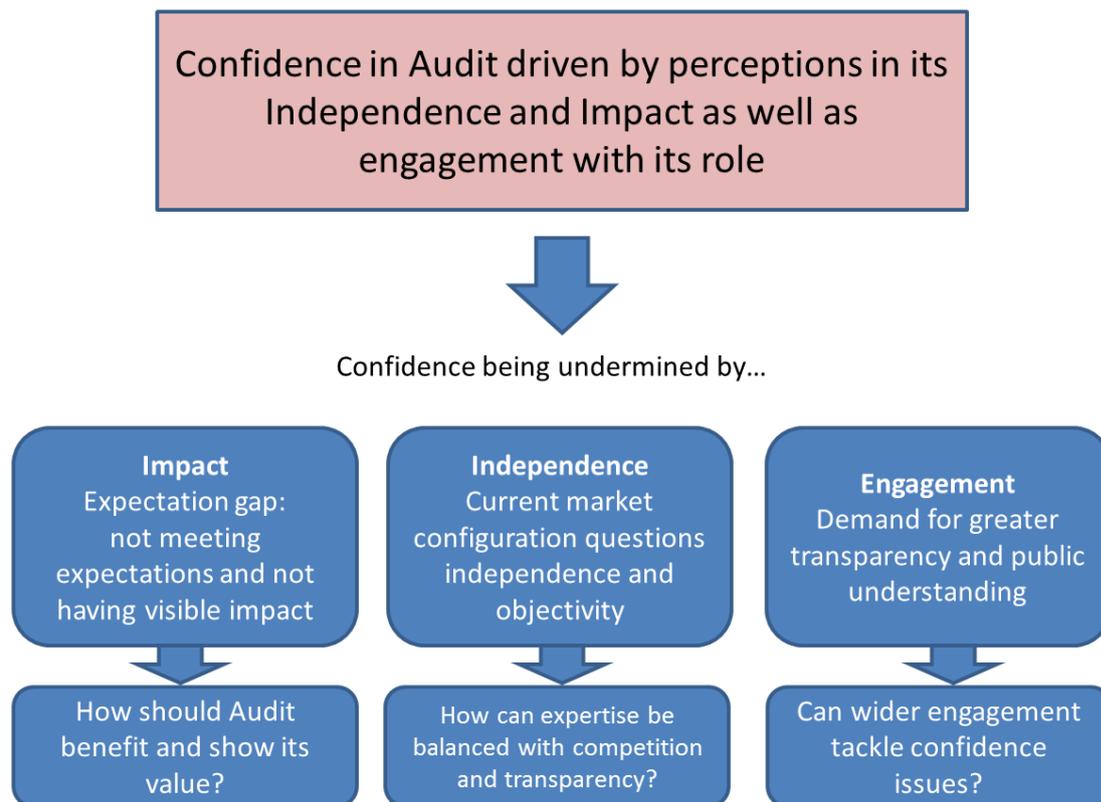
'The problem with current standards and IFRS is that they have tried to come up with a way of putting every number on the balance sheet, and it has become far too scientific. We should leave the European Union process and gain back control of our own operating standards.' (Group 1, Investor)

'International consistency is important but there should be leeway that says we have a standard in this area and if you think there is a reason to divert from this it is reasonable if you are exercising judgment.' (Group 3, Accounting body.)

Summary and conclusions

This research suggests that the level of confidence that stakeholders have in Audit has a very close relationship to their experience of the day to day audit process.

Their experience of the day to day Audit process ultimately impacts the extent to which they feel Audit, as it is currently configured, is independent and objective and has sufficient impact on the economy and society. These are the primary factors that drive perceptions of confidence as highlighted in the diagram below.



- **An expectation gap in end benefit and impact.** There is wide awareness of the role and remit of Audit but a significant gap in the end benefit of this remit. This leads to differing interpretations of the overall impact that Audit currently has. There is need for more public debate around what the purpose of Audit should be to achieve a more consistent understanding from stakeholders.
- **Independence and Objectivity.** The current market configuration is widely accepted as an issue for all stakeholders for differing reasons. Some feel this restricts innovation and dynamism through a lack of competition in the marketplace. Others feel it is at the heart of a structural problem of independence and objectivity. A number of factors contribute to perceptions of a lack of independence; long term contracts, additional services offered, payment by the company, close relations between the profession and companies. Views vary on how to address this but it underpins many concerns around the value of, and confidence in, Audit. A tension arises with the acceptance that the large multi-disciplinary firms that dominate are very competent and can offer added value.
- **Overall lack of communication.** There is a theme which is born out through individual comments, and the expectation gap more broadly, that the Audit profession does not communicate with investors and wider stakeholders well. There are calls for more transparency and public understanding of the process and impact of Audit. While this might improve understanding of the value of Audit, alone it is unlikely to change views of its shortfalls.

Appendix A – Full interview details

A full outline of the stakeholders that were interviewed can be found in the table below.

	Interviews Completed – 36 in total
<u>Group 1</u> 15 completed	Regulators, UK x 2 (policy), 2x Basel Committee Investors x 5 (4 x investment funds, trade body) Politicians, 2 x UK MPs, 1 x Chief of Staff to MEP, 2x EU Civil Servants, 1 x UK Civil Servant
<u>Group 2</u> 16 completed	Journalist x 2 Academics x 3 Business x 4 (CFOs) NGO x 2 Business Association x 3 Audit Committee Chairs x 2
<u>Group 3</u> 5 completed	Audit firms x 2 (1 big four, 1 just outside) Accounting bodies x 3 (2 x CEO, 1 x technical director)

Of the stakeholders that were interviewed the following agreed to have their names published as having taken part in interviews as part of the research process.

Name	Organisation
Alun Cairns MP	Member of Parliament
Nigel Mills MP	Member of Parliament
Xavier-Yves Zanota	Basel Committee
Pat Sucher	Basel Committee
Sacha Sedan	Legal and General Investment Management
Dr. Roger Barker	Institute of Directors
Professor Prem Sikka	Essex Business School
Tim Ward	Quoted Companies Alliance
Paul Stephenson	Vodafone Group
Martin Van Roekel	BDO International
Phineas Glover	Association of British Insurers
Kai Peters	Ashridge Business School
Peter Van Veen	
Razvan Hoinaru	