Article:

Murphy, R. orcid.org/0000-0003-4103-9369 (2022) The future of auditing. International Journal of Auditing, 26 (1). pp. 44-47. ISSN 1090-6738

https://doi.org/10.1111/ijau.12266

International Journal of Auditing

The future of auditing

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Background

The Department for Business, Energy and Industrial Strategy (BEIS) issued a consultation document on 'Restoring trust in audit and corporate governance' in March 2021 (BEIS 2021). For a consultation of this type the document was long, at 232 pages. It also asked an exceptional number of questions of those who wished to comment, posing 98 in all[2]. Despite this it has been reported that more than 500 submissions were made. Presuming, however, that those submitting chose to simply answer the questions raised there is a problem with that response rate. What it will do is confirm the bias within the process that is being undertaken.

In his forward to the consultation the Secretary of State for Business, Energy and Industrial Strategy, the Rt, Hon, Kwasi Kwarteng MP said (BEIS 2021, page 5):

> *It is vital that investors, financial markets and all those who depend on the largest companies in the UK can continue to rely on the information they publish. I am determined to reinforce the UK's position in the wake of large corporate failures that have led to job losses and uncertainty among small businesses and local communities. I want to ensure investors can get high- quality, focused and reliable information on UK companies so they can invest here with even greater confidence.*

The comment is fair, and the ambition laudable. What is not apparent is what this has to do with auditing. The noted issues appear to suggest the need for accounting reform. In this essay I evidence my reasons for thinking that before then suggesting what I think the relationship between the accounting standards that we need in the 21st century and auditing might be. The vision is very different from that presented by the Secretary for State for Business, Energy and Industrial Strategy.

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Accounting reform

A persistent theme of the proposals made in this paper and those that preceded it (Brydon 2019, Kingman 2018, Tyrie 2019) is that accounting has failed. As the BEIS consultation notes:

> *Stakeholder and wider public trust in the credibility of directors' reporting and the statutory audit has been shaken by a succession of sudden and major corporate collapses which have caused serious economic and social damage, including the insolvencies of BHS in 2016 and of Carillion in 2018 (BEIS 2021, page 14).*

It, however, then adds:

> *Alongside this, the audit regulator has in recent years found up to a third of audits carried out by the seven largest audit firms to be in need of improvement or significant improvement (ibid).*

This conflation of these issues is mistaken. The apparent assumption is that audit failing is responsible for the risk of previously unheralded corporate failure occurring. What this does is confirm that the audit expectation gap (Quick 2020) is as prevalent in BEIS as it is elsewhere. It may be that audits are of insufficient quality, but as International Auditing Standard 200 notes:

> *The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (FRC 2016, para 3).*

What is apparent is that the auditor does when, necessarily, working within this constraint have no option on the form or content of accounts: they are instead reduced to confirming whether or not the form and content as prescribed are complied with by the reporting entity that has engaged them. In effect, they are reduced by this mandatory auditing standard to undertaking a box ticking exercise that confirms in the case of most UK based public interest entity (PIEs) that the financial statements of the reporting entity comply with International Financial Reporting Standards.

Despite this it is suggested by BEIS (2021, page 16) that because '*the auditor has unique access to a company's information, people and processes*' they can provide an '*ongoing incentive on directors to improve their company's internal processes, including standards of internal assurance, and to describe the state of their business truthfully*'. This is a somewhat surprising claim. It assumes that but for audit the company might not comply with the legal requirement that a company keep proper books and records (Companies Act 2006, section 386, subsections 1 and 2) that are sufficient to enable the directors to prepare accounts showing a true and fair view (ibid, section 393). The claim made also ignores the fact that the duty of the auditor laid down in law is to report whether the accounts give a true and fair view whilst recording which auditing standards have been used when forming that opinion and in accordance with which accounting framework those financial statements were prepared (ibid, section 495, subsections 2 and 3). In the process the auditor is already required to check whether adequate books and records are maintained (ibid, section 498, subsection 1), meaning that nothing proposed by the review advances existing legal requirements in any way whilst reinforcing the constraint that already exists upon the opinion that the auditor can express.

A reasonable conclusion can be drawn from this evidence: it is that if there are unanticipated corporate failures that imply previously published accounts are wrong then despite that fact so long as those accounts have been prepared in accordance with a required accounting framework and the books and records required by law existed then the auditor fulfilled their legal duty even if that results in a failure to give due warning of the impending failure. It cannot, in other words, be assumed, as the BEIS consultation does, that because a company has failed without warning that audit failure need have anything to do with that fact: the audit might have been wholly appropriate given the very narrow obligation laid down in law on the auditor and corporate failure might still follow shortly after.

The chance that this this failure might result from deficiencies in the acceptable accounting framework is exacerbated by the fact that the UK's chosen accounting framework for use by most PIEs is IFRS. The IFRS conceptual framework says:

> *The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity (IFRS 2018, page A17).*

Three logical consequences follow. The first is that the needs of just one stakeholder group in society are met by the existing accounting framework used for PIEs. The remaining stakeholders, including trading partners, employees, regulators, tax authorities and civil society are ignored[3]. It follows that the IFRS framework is not designed to meet a public interest need: it is solely intended to service a private function. It is not in that case suitable for use by public interest entities, but the BEIS consultation does not note this point.

Second, since most of the cost of corporate failure do not fall on shareholders, who are in any case the stakeholder group most easily able to disengage with a reporting entity, the focus in IFRS reporting is inevitably not on the risk that such failure creates.

Third, and this should hardly need stating, this accounting framework is, because of the chosen focus that it has, wholly unsuited for use by public interest entities that are not trading companies. This matters because whilst as BEIS note (BEIS 2021, page 30), to date PIEs have been publicly quoted companies and a limited range of other entities in the financial services sector, the consultation proposes to extend the definition to include all large companies, whether quoted or not, and to what it describes as 'third sector entities' such universities, charities and housing associations given 'the public benefit purpose that is common in such organisations' (BEIS 2021, page 36). This is welcome: a narrow definition of PIEs determined solely by the nature of their ownership is inappropriate when a consistent approach to accounting is required from all entities whose failure

[3] For a discussion of stakeholder related issues see CAN (2021)

might have a macroeconomic consequence, which it is suggested is how a PIE should be defined. That, however, requires that an accounting framework suitable for use by such entities be in place and that is not the case at present.

Combining the noted logic on the duties of auditors, most especially implicit in auditing standards (FRC 2016), and the requirement that they undertake checks to ensure IFRS standards are correctly used, suggests that the reason for unanticipated corporate failures (which are described as audit failures, but appear to be nothing of the sort) appears to suggest three things. The first is that these unanticipated failures arise from failings inside IFRS, and not the audit process. Second, it follows that changing the laws relating to fraud detection and other audit related issues will have little impact on the likelihood of such failures being identified when the law on this issue already appears to be adequate and failings in it appear to have little to do with many of the corporate failures that have arisen of late, Patisserie Valerie apart. Third, extensive reform of the audit profession coupled with changes in audit appointment and supervision processes, which are the focus of the review, without changing what auditors are actually required to do, or what they audit, cannot in that case achieve the objectives set out by BEIS. This is why, as suggested at the outset, it is unlikely that those who have simply answered the questions posed by BEIS in their consultation (BEIS 2021) can do anything more than confirm the bias within the process that is being undertaken.

It is in that case appropriate to ask what reforms should have been offered if the desire really was that the stakeholders of PIEs should be presented with data that meets their needs. In the space available four suggestions are appropriate.

In the first instance it should have been demanded that an accounting framework intended to meet the needs of all stakeholders be created. A suggestion has been included in a submission that I have co-authored to this consultation process (Leaver and Murphy 2021a). Unless financial reporting is reframed in this way, including the obligation to explicitly consider the risk of imminent failure within a framework where prudence is restored to the status that it had in accounting before the inset of IFRS standards then the likelihood that user needs will be met is low.

Second, the specific risk that over-distribution of profits that has been identified as a significant threat to long term corporate stability both within the BEIS consultation (BEIS 2021, 51) and elsewhere (Baker et al 2020, Haslam et al 2021) has to be addressed by basing the definition of distributable profits used for the purpose of determining permissible dividends and share buybacks on group profits and not the reserves of group parent companies, but the consultation has not done that (Leaver and Murphy 2021a, 11). As a consequence one of the biggest risks to corporate solvency has been allowed to persist by the consultation when the opportunity for reform existed.

Third, there is a need to build the impact of climate change reporting into financial reporting or the biggest single threat posed to the ability of PIEs to continue as going concerns will not be reflected in their financial statements (Murphy 2019). There is no proposal within the consultation to achieve this goal.

Fourth, and perhaps most significantly, the role of the auditor must be reconsidered. As a review of audit history reveals (Matthews 2006, Edwards 2019), the idea that the auditor was either independent of the reporting entity on which they reported, or of its actual reporting is recent. The development of financial reporting was dependent upon the desire of the auditor to innovate and evolve that information which their clients offered to their shareholders, and others, to ensure that true and fair reporting was achieved. The assumption that the auditor is constrained by an accounting framework with which they must comply is recent, effectively beginning only with the adoption of international auditing standards as a consequence, in the UK at least, of a European Union directive in 2006 (EU 2006). This constraint on the role of the auditor, especially when combined with the adoption of IFRS as the primary accounting framework for use by PIEs (EU 2002), is central to the actual nature of current audit failure, but there appears to be no intention to address this issue.

Of these four issues the last is the most important. The role of the auditor as an agent with the responsibility to express opinion on the truth and fairness of the accounts of a reporting entity; with the power to determine whether those accounts meet reasonable stakeholder needs; with the responsibility to determine what those reasonable stakeholder needs might be in the context of the reporting entity under consideration and with the power to make good a deficit within its reporting if it thinks it exists, assuming that the reporting entity otherwise declines to do so, is vital. The currently passive observational role of the audit has to come to an end. It should instead be recognised that the auditor has an integral and positive role within the reporting framework.

Adam Leaver and I have suggested (Leaver and Murphy 2021a) that within this dynamic that:

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.*

We suggest that relevance is defined by the stakeholder's need, reliability means free from material misstatement and that sufficiency is determined in relation to purpose. These together represent a new meaning for 'true and fair' fit for the twenty first century.

Extrapolating this idea, and integrating the role of audit within it, we have suggested that:

> *The purpose of the audit of a public interest entity (PIE) is to firstly report on whether the financial statements on which the auditor offers an opinion deliver relevant, reliable and sufficient information to users of those statements and to secondly, where there is a shortcoming, remedy that shortcoming or, if it is not possible to do so, to report why that is and what its consequences are.*

We thus align the purposes of accounting and audit in this statement. We think that essential if there is to be consistency in the approaches used by those engaged in the process of delivering true and fair financial statements.

There could be a vision within audit in the twenty first century, as there could be for financial reporting as a whole. Our suggestions do, we suggest, support such a vision.

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