

Auditing for success: de-risking the auditing process



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The Financial Reporting Council (FRC) has recently renewed its focus on the reform of audit, and in light of this we invited a group of our key clients to join us for a virtual roundtable to discuss their views on a range of related issues, including the proposed revisions to ISA 240. Auditors have always been subject to considerable scrutiny from regulators, the media and the public alike, and discussing the proposed new reforms and how they are likely to impact auditors in practice was insightful and important as it helped to understand their real impact in practice. We were delighted to have a number of senior clients from various accountancy firms to share their thoughts on this and also on the wider, more holistic consultation launched by the Department for Business, Energy and Industrial Strategy (BEIS) on 18 March.

This Reed Smith roundtable event is part of a series we have developed and designed to create a platform for senior business leaders, general counsel, legal and business teams and senior management representatives to share experiences, discuss live issues and explore ideas for the future of legal service delivery.

Our roundtable events, in their virtual and in-person formats, are always held under the Chatham House rule. Therefore, we have not provided specific names or examples and have kept this report confined to themes. This paper outlines the key themes which emerged from our discussion with our clients and the commentary highlights our own observations from a legal analysis perspective.

As ever, we are grateful to our clients for sharing their honest thoughts and feedback on the highly topical area and we would welcome the opportunity to continue the conversation with them on these issues going forward. The current economic climate is uncertain, volatile and unpredictable and the insights shared at our virtual roundtables into current and emerging issues enable us to provide pragmatic and commercial support to our clients.



Jane Howard
Legal consultant
London
+44 (0)20 3116 2895
jhoward@reedsmith.com



Ellie Chapman
Partner
London
+44 (0)20 3116 2864
echapman@reedsmith.com



Charles Hewetson
Partner
London
+44 (0)20 3116 2976
chewetson@reedsmith.com



Mark Pring
Partner
London
+44 (0)20 3116 3858
mpring@reedsmith.com



Louise Aumann
Senior Associate
London
+44 (0)20 3116 2999
laumann@reedsmith.com

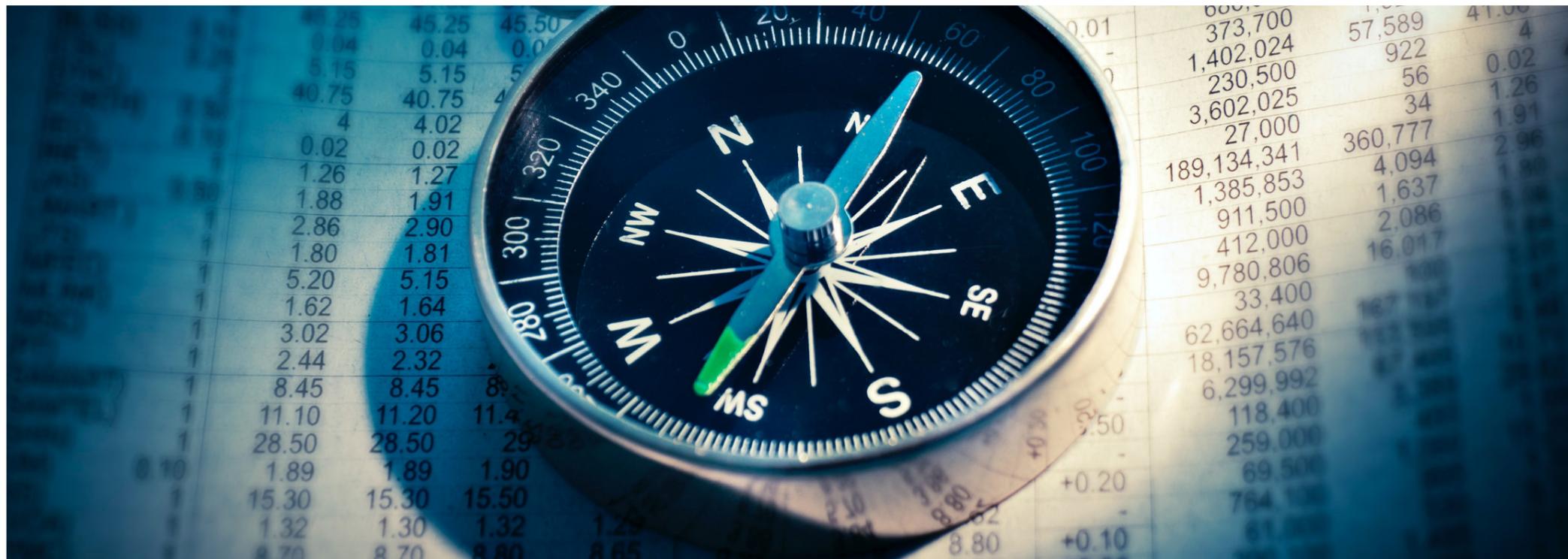
FRC's proposed revision of ISA 240 – is this a long term solution or just a sticking plaster?

Roundtable agenda items

- Do you agree that the FRC's proposed revision of ISA 240 achieves the stated objective of making the auditor's obligations clearer?
- Do you think the revision will bring about significant changes to the way audits are conducted or is it merely a codification of best practice?

Some key observations from our clients included:

The FRC has been seen by some to be operating separately from the Institute of Chartered Accountants in England and Wales (ICAEW) and the relevant government bodies in relation to the UK's auditing practices. The FRC's proposed revision of ISA 240 has been described by some senior practitioners as a 'sticking plaster', focusing on and imposing the sole or a large element of responsibility (and consequently the liability) on the auditor to detect fraud, rather than considering and understanding why and how fraud is perpetuated in corporate organisations in the first place.



- A holistic approach to detecting fraud, looking at the entire ecosystem and working in conjunction with other bodies and the wider audit arena, is likely to be more successful and effective in detecting and preventing fraud. The FRC's proposed revisions have a narrow lens, and, whilst they have helped to generate discussion, are likely – on their own – to have only limited impact in moving the needle forward on fraud detection or prevention.
- There are questions around scope, as the FRC's proposed revisions, whether intentional or otherwise, seem to imply that any fraud involving senior executives or senior management will automatically be material. This has given rise to a widespread discussion on whether audit practices should be restructured to help create a separation in audit practices where senior executives and senior management are concerned, with auditors in effect applying a higher threshold where auditing practices involve senior management and senior executives. For example, as part of this, should auditors adopt a much more detailed and forensic approach when auditing accounts relevant to senior executives and senior management? The ICAEW has criticised the scope of the FRC's revisions and has also questioned whether this focus on senior individuals and the revised approach to audit is actually what the FRC intended to achieve.
- The FRC requested urgent responses from accounting firms in relation to their consultation and received many. However, the FRC does not appear to have shown the same impetus for outlining the next steps and how the practical considerations arising from the consultation will be addressed. Arguably, the way to effect real and meaningful change is to focus on the effective implementation of the reforms rather than merely writing about them. Unfortunately, we are yet to see guidance from the FRC on the actual and practical implementation of its suggested changes.
- Has the FRC failed to focus on the fundamental issue at stake here: why is fraud happening in the first place? Certainly, auditors are alive to the issues relating to detecting and identifying fraud; however, detection and prevention are two separate issues. One falls within the remit of an auditor while the other clearly does not, and the concern is that the FRC's proposed reforms do not clearly distinguish between the two, as far as auditors are concerned. As the ICAEW observed in its feedback, the "proposals raise expectations but do little to raise standards".

- We have not seen the same level of scrutiny or activity from regulators and the government when considering revising or introducing regulatory reforms to help address the perpetration of fraud. The trend is arguably a political one, with the government keen not to be seen as stifling businesses with burdensome regulation, particularly in the current climate. Instead, it is widely perceived that the focus has been to transfer the burden onto auditors and to concentrate the reforms on the conduct of the auditor and ensuring that they are duly sanctioned rather than focussing on the actual commission of the fraud. This stance is clearly a narrow one and arguably lopsided. The FRC seems to have reversed its position, and transferred responsibility and any resulting liability almost entirely onto auditors. The question being asked by an overwhelming majority of practitioners is, what about the perpetrator of the fraud?

- Finally, on the other end of the spectrum, are there similar conversations taking place at the beginning of the fraud chain, i.e., in corporations, about how to address the potential commission of fraud within their organisations? To address these issues at a holistic level, there needs to be a balance in looking at both auditors and corporations, if the issue is to be truly resolved.

Surely, turning to the old maxim, prevention is better than the cure?



Now & Next

In light of the Brydon review, the government wants to drive a new, more holistic approach to all forms of corporate reporting. A key clarification relates to the responsibility of the external auditor. The purpose of ISA 240 is to seek to clarify that responsibility in the context of fraud. The government will deal with a wider set of reforms – the changes to ISA 240 constitute only one aspect of these reforms.

The main proposed changes include the following:

- Strengthening of objectives to emphasise that auditors must aim to “obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud”, and not simply to assess risks and respond to these.
- More emphasis on the need for professional scepticism, including alertness to indications that records or documents may not be authentic. A responsibility on auditors to obtain contradictory evidence.
- A significant increase in the requirements to discuss fraud risk among the audit team at the planning stage.
- Assessment by the auditor as to whether the team needs specialised skills or knowledge (including, possibly, the input of a forensic expert).
- More requirements for response to assessed risks including the ‘stand-back’ requirements recently added to ISA (UK) 540.

There are also new requirements in areas such as communication with those charged with governance, documentation and reporting though these are arguably less significant changes. The changes are scheduled to apply to accounting periods beginning on or after 15 December 2021.

The role of the auditor – is the auditor’s job to be a ‘bloodhound’ or a ‘watchdog’?

Roundtable agenda items

-  The FRC has said that audit teams must have access to the specialists and experts needed to assist in complex areas. How will that be managed if the audit practice is structurally separate from the rest of the firm?

Some key observations from our clients included:

There seems to be an expectation gap between the public, the FRC, the government and auditors on what the role of the auditor is and should be in terms of the responsibility to detect fraud. The ISA 240 revisions seem to have confused the issue further and have potentially widened the expectation gap in terms of what is expected of an auditor. This confusion is endemic and has also been apparent within the judiciary, which is concerning, as it will clearly impact how they could address potential criminal or civil proceedings should any case result in judicial proceedings. This creates inconsistency, and ultimately could result in auditors being unable to perform their role with confidence.

- The FRC has said that audit teams must have access to specialists and experts, if required, to assist them in complex areas. Although auditors will be ring-fenced, the audit teams will still be able to access forensics and other specialist teams if or when they need their support or expertise. The separation between the two functions will have implications around 'buying in' those specialist areas, such as forensics, and may ultimately have an impact on the overall financial viability of some audit practices. There will be an increase in costs resulting from the extra red tape required to make this new model work. However, it is thought this may be less of an issue for larger firms, which should have the infrastructure and resources to implement the required changes. For smaller firms, however, the required structural separation may create significant issues. They will need to consider

some basic issues, such as will they need to hire forensics expertise externally if they do not have the deemed expertise internally? In the same vein, what the FRC means by 'forensic specialist' is unclear at present. Clarity around the level of expertise would be helpful for firms in defining where those experts sit and who they can use.

- In order to advise on a fraud matter, a whole variety of different experts are required, such as tax, audit and forensic specialists, and many of these specialist functions cannot always be ring-fenced. For an audit function to be effective, a global and multi-disciplinary team is often required and perhaps this is a point not recognised or appreciated by the FRC or indeed by the number of challenger firms that are emerging in the market.

- On a more positive note, auditors have always tried to maintain their separation and independence from the rest of their business and therefore the impact that this newly imposed structural separation will have on the way that they are able to undertake their jobs is likely to be minimal in practice. The structural separation could result in an 'upskilling' of auditors, with practitioners spending more time on forensics. However, this brings us back to the recurring question of what is actually expected of an auditor. There is a difference between the purpose and work undertaken by auditors and forensic accountants. Ultimately, is the auditor's role to be a bloodhound or a watchdog?
- A national register of case studies would be a useful resource, as a reference guide and to highlight 'lessons learned'. However, the register is unlikely to advance the current status quo as most accounting firms already reflect on their cases and consider the lessons learned after each matter. Prior to the focus on competition between the Big 4, it was commonplace for their audit teams to discuss best practice and trends openly; this open dialogue is now missing and yet is increasingly required in the current regulatory environment.



Now & Next

- There is currently an expectation gap in relation to the responsibilities of an auditor.
- The FRC states that (as a result of changes to ISA 240) they are not placing responsibility on auditors over and above the responsibility placed on directors. It is the latter that have the primary responsibility for detecting fraud (something that appears to be recognised in the BEIS government white paper, 'Restoring trust in audit and corporate governance').
- The FRC expects clients to receive the same level of professional scepticism from whichever accountancy firm they use.
- Traditionally it is clear that auditors considered themselves as 'watchdogs', but the current changes to ISA 240, and future reforms, suggest that this could change and auditors will be expected to be more akin to 'bloodhounds'.

What next?

Roundtable agenda items

- What do you see as the main enhanced audit risk issues arising from these changes? How can they be addressed?
- Once the government's COVID-19 support is withdrawn, additional corporate insolvencies may follow. This will lead to a further uptick in work for insolvency practitioners. Claims from disgruntled creditors and shareholders may ensue.
- What additional steps might be taken now to help manage such claims or their consequences?

Some key observations from our clients included:

FRC reforms

- The proposed reforms are unlikely to have an impact on audit risk or the behaviour that they are seeking to prevent, due to their narrow focus, as there have not been reforms directed at directors or the liability of senior individuals in corporates. In order to counteract fraud, a cultural shift is required within the wider business sector.
- In tackling similar issues within the financial sector, it was the introduction of the Senior Managers and Certification Regime that helped address the problems senior managers previously had. The focus around the conduct and behaviour of senior managers and the culpability and responsibilities enforced upon each individual really focused minds and resulted in a step change. Without similar regulation for corporates, it is difficult to see how fraudulent behaviour will be properly managed, resolved or indeed prevented. Though the current narrative around fraud focuses on professional services firms, the biggest risk is not zoning in on director liabilities and this is a missed opportunity.
- The FRC has left a number of key concepts undefined and some basic questions unanswered:
 - » What do they see as 'fraud' within this space?
 - » When does aggressive accounting become fraud?
 - » How should auditors define 'fraud' within their work scope?

This is a difficult area and there is no easy solution or easy fix as the FRC (as presently constituted) does not have jurisdiction over directors of corporates. Furthermore, there is still no clarity on what happens once an auditor has identified a fraud or potential fraud during their auditing process. Equally, qualitative standards introduced by the FRC are difficult to define and implement. There is the obvious ambiguity around the language used in the consultation. For example, a fraud committed by a senior manager may fall below the standard deemed to be 'material'; however, notwithstanding this, it is still fraud – what should happen here? What recourse do auditors have in this regard? This is a grey area and will clearly lead to confusion, loopholes and inconsistencies in the way such situations are managed. A general view by audit practitioners is that insufficient consideration has been given to the qualitative and quantitative standards of fraud determined by the FRC.



Preparing for future corporate insolvencies

- In the aftermath of the 2008 financial crisis, accounting firms prepared for an uptick in corporate insolvencies; however, the upsurge of predicted claims did not materialise. In 2021, the general prediction, based on current economic trends, is that there will be an increase in corporate insolvencies, some involving fraud, some resulting from aggressive accounting and others a consequence of simple business mismanagement. Ultimately, there is only so much preparation to help manage such predictions, as each claim will be different and will clearly depend on individual facts and circumstances.
- Not all accounting firms are retaining their insolvency businesses, with Deloitte and KPMG selling off their insolvency practices, so this might not be something that all Big 4 firms have to deal with differently.
- A rise in corporate insolvencies could lead to increased investigations and future regulation, which could also give rise to an increased focus on disclaimers and opinions.

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Now & Next

Insolvency

- Given the impact of COVID-19, once the current government support is withdrawn, many companies will be faced with insolvency, which in turn may result in an increase in regulatory investigations. Many accounting firms have sold or are in the process of selling their insolvency offerings.

Consultations/changes in the pipeline

- Auditors would have a new duty to take a wider range of information into account in reaching their audit judgements, and in giving their opinion as to whether the financial statements give a 'true and fair' view.
- The government proposes a new, stand-alone audit profession supervised by Audit, Reporting and Governance Authority (ARGA), underpinned by a common purpose and principles – including a clear public interest focus – and with a reach across all forms of corporate reporting, not just the financial statements.

Reed Smith Professional Liability team



Jane Howard
Legal consultant
London
+44 (0)20 3116 2895
jhoward@reedsmith.com



Charles Hewetson
Partner
London
+44 (0)20 3116 2976
chewetson@reedsmith.com



Doug Cherry
Partner
London
+44 (0)20 3116 3837
dcherry@reedsmith.com



Elizabeth Mason
Associate
London
+44 (0)20 3116 2856
emason@reedsmith.com



Ali Ishaq
Associate
London
+44 (0)20 3116 3869
aishaq@reedsmith.com



Anna Grieves
Associate
London
+44 (0)20 3116 3834
agrieves@reedsmith.com



Ellie Chapman
Partner
London
+44 (0)20 3116 2864
echapman@reedsmith.com



Mark Pring
Partner
London
+44 (0)20 3116 3858
mpring@reedsmith.com



Louise Aumann
Senior Associate
London
+44 (0)20 3116 2999
laumann@reedsmith.com



Charlotte Stewart-Jones
Associate
London
+44 (0)20 3116 3874
cstewart-jones@reedsmith.com



Dilpreet Hothi
Associate
London
+44 (0)20 3116 3815
dhothi@reedsmith.com



Thomas Firth-Jones
Associate
London
+44 (0)20 3116 3793
tfirth-jones@reedsmith.com

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Phone: +44 (0)20 3116 3000

Fax: +44 (0)20 3116 3999

DX 1066 City/DX18 London

ABU DHABI
ATHENS
AUSTIN
BEIJING
BRUSSELS
CENTURY CITY
CHICAGO
DALLAS
DUBAI
FRANKFURT
HONG KONG
HOUSTON
KAZAKHSTAN
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