

The Challenges Facing Audit: The Need For A Holistic Approach

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Since before the famed fall of The South Sea Company in 1720, issuers of publicly traded securities have faced scrutiny. Laws and regulations have evolved to reflect the nature of markets and the concerns of those who invest in them – an evolution that continues today.

Three hundred years later, following a number of high-profile collapses, we are witnessing another iteration of the needs for disclosure and accountability in the public interest. Despite this long history, many hold a perception that today's issues are unique and unrelated to those that were at play in the Enron Era, the 1929 Stock Market Crash, or even the South Sea Bubble.

In fact, one or more participants of the financial reporting ecosystem played a role in each of these seminal market events – management, corporate governance bodies such as boards and audit committees, investors, regulators, standard-setters, and of course auditors. We are at another turning point, due to recent collapses and the changes that COVID-19 has presented. So what needs to be done to develop a solution fit for the 21st century?

1. Look at all aspects of the financial reporting ecosystem

The financial reporting ecosystem exists to produce accurate, complete, and transparent corporate disclosures that enable markets to function properly. It relies on the constructive and effective functioning of all its participants. Auditors deliver on a public interest mandate by providing independent, objective audit services with quality and integrity. Yet auditors do not function in isolation.

For example, in 2002, the US responded to market shockwaves with Sarbanes-Oxley, focused on corporate and auditing accountability, independent regulation, and a strong focus on effective internal controls. Sarbanes-Oxley has proven to be effective in improving the quality and integrity of financial reporting as demonstrated by the decrease in the number of restatements.

The ability to conduct a quality audit is influenced by the quality of the internal control environment of the audited company. Internal controls that are effectively implemented and maintained with appropriate oversight are fundamental to the delivery of high-quality corporate reporting. These quality control systems form the building blocks of the financial reporting process and, accordingly, require thoughtful design, implementation, and review and testing – particularly in the current environment.

Preparers and auditors alike are affected by restrictions on travel and requirements to stay at home. Companies may obtain information in new or different ways and/or operate controls over the production of financial information differently. There are challenges specifically in audits of multinational entities due to legal restrictions in some countries that limit the transfer of data (including audit working papers) outside the jurisdiction. Regulators can help here.

During COVID-19, the GPPC networks welcomed efforts undertaken by regulators and standard-setters to engage with the profession and investing public. Specifically, financial reporting frameworks require preparers to project future operating results and cash flows as a means of addressing fundamental elements of financial reporting. In light of the unique nature of the pandemic, preparers are faced with significant uncertainties when making these judgments. Instances where regulators have publicly reiterated the responsibilities of companies related to reporting and disclosing the impact of COVID-19 are helpful. Some regulators further stated that

reasonable judgments, made in good faith and guided by the sound application of auditing standards, should be considered in the context in which they are made and on the basis of information available. These are good examples of the ecosystem working together.

Similarly, investors are important actors in the ecosystem. They are empowered to challenge audit committees, boards, and management to ensure they provide the information needed to make informed investment decisions; to become familiar with corporate disclosures and communicate clearly when more information is desired; and to advocate for consistency and coherence between and among standard-setters, companies, auditors, regulators, and others.



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2. Evolve corporate reporting and the audit

Market expectations, evolution of stakeholder needs, and other external developments must sit alongside any changes to corporate reporting and the audit process. Recent regulatory debates and reforms (e.g., the Brydon review in the UK) have highlighted an expectation that corporate reporting should provide a richer, more forward-looking and complete view of company performance. For example, sustainability topics are becoming ever more relevant to the investing community and other stakeholders who are looking for deeper insights from companies on their environmental, social and governance (ESG) performance.

Many investors would like to better understand how a company creates long-term value and maintains its social license to operate. There has been an increased demand to better understand the resilience and long-term sustainability of business and its impacts on people and the planet. This creates a need for a standardised framework, connected to financial information, to drive consistency of measurement and reporting. According to Sir Donald Brydon, ultimately, what stakeholders want to know is, "Is the company being honestly run and is it likely to have a future?"

The recent debates focus on audit relevance, in particular in areas such as sustainability, fraud and viability, adopting a more forward-looking lens, and providing greater transparency around the corporate business model, risks, and its governance and controls. The GPPC networks are keen to support and contribute to this dialogue. Working through this and addressing the questions and challenges being posed will ultimately serve to create a profession, a product, and a system that is more robust, transparent and trusted, and operating in the public interest.

3. Relentless focus on audit quality

It is clear based on the publicly available information that there have been significant improvements in audit quality over the last 10 years, but more remains to be done. Audit firms in aggregate deliver audits for hundreds of thousands of entities annually, but a small handful involve dramatic corporate events. These events are damaging to the employees, pensioners, investors, and other stakeholders as well as the reputation of the audit profession.

The review of these events sometimes raises questions about whether audit

reforms are needed on matters such as competition, concentration, independence, conflicts of interest, and audit quality. The GPPC networks support reforms that incentivise high-quality audits, enable choice, and improve resilience in the market. These should be the overarching objectives of any proposed remedies as well as ensuring that the audit is relevant to changing stakeholder needs and changing business complexity.

Each of the GPPC networks embraces evolution and is committed to continue making improvements and investments in audit quality. The GPPC networks recognise the importance of professional scepticism, culture, tone at the top, ethics and integrity – and invest heavily in technology and talent programs that can provide auditors with new ways to deliver high-quality audits.

The multidisciplinary model, where specialists from other fields are incorporated in the audit process, is an important contributor to high-quality audits. Auditors increasingly use the work of specialists in a number of areas and this is set to increase further in line with the complexity of audited companies and digital advances.

Auditors are focused on serving the public interest and meeting professional obligations – bad audits are bad for auditors, too.

Conclusion

All stakeholders have a role to play in improving the quality and integrity of financial reporting. Auditors are committed to actively evolving to serve the investing public to deliver high-quality audits befitting our changing world. The GPPC networks invite opportunities to engage broadly and constructively for the benefit of society. We're in this together.

