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Dear Steven

Feedback on: Revision to ISA (UK and Ireland) 700

Reform of auditing and audit reports is a worthwhile objective, with issues of audit rigour and value to be addressed. What do users get from auditors? Assurance of course, but how much? How much less likely are materially wrong accounts with a clean audit report?

In this letter I will answer the consultation questions then suggest some simpler alternatives to the disclosures the draft describes that call for a more scientific approach to uncertainties around numbers in financial statements.

Consultation questions

Question 1: *Do you agree that the auditor's report should include a description of the auditor's assessed risks of material misstatement, materiality and the audit scope? If not, why not?*

No. In summary, the information would be too complicated and incomplete to be useful and the requirement for lists of 'risks' is likely to reduce the quality of audits.

The example wording in section 3 is an excellent attempt at what is intended but even this is not really useful. There are more informative, shorter alternatives, as I describe later.

Question 2: *Do you agree that these proposals should be limited to entities that explain how they comply with the Code? If not, why not?*

The proposals should not be applied to any entities.

Question 3:

(a) Do you consider that the provision of such information by the auditor will be of benefit to shareholders and other users of the financial statements and, if so, can you explain what those benefits would be and how they would arise?

(b) Do you believe such information would provide an effective "hook" for investors and other users to start a dialogue with the company about the audit?

The information will not benefit shareholders or other users and it is hard to imagine what useful conversations could flow from it.

Question 4: *Do you believe that directors are likely to disclose information about the audit (of the type that would be required in accordance with these proposals) under the September 2012 changes to the Code? Is it more appropriate for such information to be provided in the auditor's report or by the board in the section of the annual report addressing the work of the audit committee, and why?*

No comment on this.

Question 5: *What do you believe would be, if any, the benefits, costs and other impacts of the proposed requirement to describe in the auditor's report certain risks of material misstatement that were identified by the auditor?*

The list of risks will reduce the quality of audits in two ways.

First, it will encourage use of lists of 'risks' as the basis for audit planning, even at a high level. Auditors should approach their audits rationally, taking into account risk factors in a rigorous and systematic way, using coherent mental models and quantification to guide decisions. Haphazard listing of 'risks' is the opposite of this approach and I have seen it destroy the rigour of internal audits.

Second, where lists of 'risks' are used the requirement to make them public will discourage auditors from listing 'risks' that are insulting to their clients or could damage their reputation, such as those concerning the honesty and competence of senior people in a company. This could then affect audit planning decisions. Isn't it better for auditors to be discreet about their concerns?

This would add to the damage already done by the 'risk' listing language of ISA (UK and Ireland) 315, "Identifying and Assessing the Risks of Material Misstatement".

Question 6: *Do you agree that the basis for determining the risks of material misstatement to be described in the auditor's report (see proposed paragraph 16A(a) of ISA (UK&I) 700) is appropriate?*

No. The basis talks of risks 'identified', which reinforces the encouragement to make lists of 'risks' and will weaken the quality of audit planning.

The difference between systematic assessment and making lists of 'risks' can be illustrated using one of the factors mentioned in the example in section 3: the state of internal controls as previously assessed. The 'risk' is stated as 'Internal control failures in the Far Eastern businesses' but internal control failure is not a risk that needs to be ‘identified’. Internal control failure is always a possibility and will be a standard part of risk assessment for any audit. Assessment of the chance of internal control failures ought to be made across all businesses, not just some. The fact that some businesses have an assessed low risk of internal control failure is just as significant to the allocation of audit resources as the higher risk in others.

Audit risk assessments should be based on a firm foundation of factual evidence, with a layer of subjective impressions added where facts are hard to gather.

Question 7: *The risks disclosed by the auditor in complying with proposed paragraph 16A(a) of ISA (UK&I) 700 may well differ from the principal risks disclosed by the directors in the business review in the annual report. What are your views about this possibility?*

It is obvious that they should. Audit ‘risks’ and business ‘risks’ are completely different things and the auditor’s perspective and knowledge are different from those of the company.

Neither the company nor its auditors should publish lists of ‘risks’. They should manage risk effectively within their core management activities, such as decision-making and planning, rather than launching separate ‘risk’ processes.

Question 8: *Do you believe that the omission from the auditor’s report of a particular risk of material misstatement would pose a threat of significant loss or damage to the auditor if, after the event, it became evident that the risk had given rise to significant damage to the company?*

The list of ‘risks’ has so little meaning that it is hard to see how any argument could be based on it. ‘Risks’ can be written any way you like, so an auditor who is worried about this could write very broad, all-encompassing ‘risks.’ Alternatively, an auditor who is more worried about a problem emerging that *is* on their ‘risk’ list could write a very short list of very narrow ‘risks’.

Question 9: *How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor’s report an explanation of how the auditor applied the concept of materiality in planning and performing the audit, including specifying the threshold used by the auditor as being materiality for the financial statements as a whole, and the balance between them?*

These disclosures leave far too much work for the user to do.

If a user of the accounts cares what the numbers are then that user may also be interested in forming a view as to the true figures the financial statements should have shown. In principle, this amounts to forming a probability distribution over possible values for key figures representing degrees of belief in each value. In practice, it amounts to a worry that perhaps translates itself into an adjustment on a spreadsheet somewhere or a slight reluctance to invest.

If auditors report the risks they see and explain how they have applied the concept of materiality then users will be left with too much work to do to translate this into implications for the reliability of the financial statements. My suggestions below show how much easier it could be.

Question 10: *How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor's report a summary of the audit scope, and the balance between them? Does the illustrative disclosure in Section 3 provide a sufficient explanation of how the audit scope was responsive to the auditor's assessment of risks and materiality?*

Again, too much work is left for the user to do.

Question 11: *Do you believe that the wording of paragraph 16A and paragraphs A9A to A9C is sufficiently principle-based so as to avoid standardised language?*

Yes, they are nicely worded, but the requirements are not ones that should be imposed.

Question 12: *Do you foresee any difficulty if the effective date is periods commencing on or after 1 October 2012?*

No, provided users of the accounts do not try to make use of the text.

Some simple alternatives

In summary, the proposed changes are not likely to help users and are likely to reduce the rigour of audits. What could be done instead? Here are three suggestions.

1) Non-probabilistic insight into measurement uncertainty

Some account balances are inherently harder to determine because they require predictions about the future. For example:

- The cost of tangible fixed assets is easy to determine but their depreciation requires predictions about their useful economic lives and value at the end of those lives.

- Long term contracts require predictions about later profitability.

- Debtors require predictions about the value of debt that will never be recovered.

It should not be too hard to establish a standard classification of account balances into between two and four groups, where each group is typically harder to determine than the next, and so carries a higher level of measurement uncertainty.

Companies, or their auditors, could then report an analysis by value and by percentage of total. Users of accounts would then be able to see how much depends on predictions (and accounting judgements generally). It would be particularly interesting to see big differences in these analyses between companies in the same industry.

Not only would this be interesting information in itself, but this kind of analysis would help to communicate important differences in the inherent auditability of companies, and would highlight where more sophisticated analyses might be worthwhile.

It would be a useful step closer to Confidence Accounting[1].

2) Probabilistic statements about ranges

When an auditor gives a clean audit report this does not mean that each figure has been proven to be perfectly correct. It just means that the figures were acceptable to the auditor. You could imagine a space such that any set of figures falling within that acceptance space would have been given a clean audit report.

Auditors could state their acceptance space, probably in the form of ranges of numbers for a very small number of overall balances, such as the profit figure. For example, a company might report a profit of £2.1bn, and the auditor might accept it because the auditor would have accepted any profit number between £1.7bn and £2.2bn.

A similar alternative would be to ask the auditor to report their p10 and p90 levels for key figures. These are, respectively, the level for that figure such that the auditor sees only a 10% chance that the true figure is less, and the level such that the auditor sees only a 10% chance that the true figure is more.

3) Probabilistic statements about material mis-statements

A slightly different form of statement by the auditor would be to state the probability of material mis-statement, as seen by the auditor, and define quantitatively what material mis-statement means. For example, the auditor might disclose "a 5% chance of material mis-statement, where material mis-statement means the profit is outside the range £1.7bn to £2.1bn, the total balance sheet value is outside £7.8bn to £8.5bn, or the director's remuneration is below £23m."

An embellishment of this would be to require a probability of material mis-statement as seen before the audit work was done and another after the audit work was done. While this might leave auditors at risk of insulting their clients it is also a chance to say how much difference they think their audit makes.

In effect, these two probabilistic suggestions leave the auditor to work out the implications of audit risk analysis, materiality, and work done, rather than leaving the task to the users of the audit report.

Technical basis for probabilistic statements

The techniques needed to support such statements have been known for more than two decades and involve only easy computations[2]. Audit firms employ intelligent people and receive large fees for audits, so the research and retraining should be easy for them – probably easier than they imagine.

[1] See "Confidence accounting: a proposal" by Ian Harris, Michael Mainelli, and Jan-Peter Onstwedder. Published by ACCA, CISI, and Long Finance in 2012.
[2] See "Audit risk and audit evidence: the Bayesian approach to statistical auditing" by Professor Anthony Steele. Published by Academic Press and ACCA in 1992.

Even the crudest model would be more reliable and accurate than unsupported 'professional judgement'.

The probabilistic statements communicate information about the auditor's knowledge. They do not communicate a fact about the financial statements. Clearly, the financial statements published either are true and fair or they are not. There is nothing probabilistic about that.

Probabilities are here being used in the modern sense to represent degrees of belief, not frequencies of outcomes from a repeated experiment, as in early 20th century Frequentism. It would be impossible to measure if the statement is correct from just one audit.

However, if a firm makes many such statements then they can be compared with the extent of any subsequent restatements. We should see that the restatements are usually within the range, or less common than the probability, since some material mis-statements do not result in restatements. If actual restatements were often outside the auditor's acceptance range then it would become increasingly clear which auditors overestimate the power of their audits.

In the UK, auditors receive hundred of millions of pounds in audit fees. Is it unreasonable to expect them to quantify the assurance they provide for this money, and to expect them to master the simple business models needed to support their opinions with more than gut feeling?

Yours sincerely

Matthew Leitch