7 February 2018

By E-mail to: MG2017consultation@iosco.org

Our Ref: NNS/MPC

Dear Sirs

MONITORING GROUP CONSULTATION:
“STRENGTHENING THE GOVERNANCE AND OVERSIGHT OF THE INTERNATIONAL AUDIT-RELATED STANDARD-SETTING BOARDS IN THE PUBLIC INTEREST”

We do not support these proposals.

The consultation document makes frequent references to “the public interest” but appears to see the public interest entirely in terms of the interests of institutional investors in listed companies.

There is a much wider range of stakeholders in the audit process whose interests do not always coincide with those of this group. The effect of these proposals would be to disenfranchise all other stakeholders in favour of this one group. We do not agree with the suggestion that is sometimes made that the interests of investors can stand proxy for those of all other stakeholders, nor the suggestion sometimes made by some investors that they “pay for” audit and therefore that it should be their sole preserve.

Much is made in this consultation document of a supposed conflict of interest between the large auditing firms and (in effect) institutional investors, but there is little analysis of the practical effects of this conflict. The suggestion seems to be that the large audit firms have somehow used their influence in the standard setting process to limit the rigour of auditing. No evidence has been offered to support this view and no examples given of where this might have happened. If there is a drawback to the participation of the larger firms in standard setting, it is more that auditing standards are set primarily with the needs of large listed company audits in mind, the current proposals would add to this problem.

Ideally auditing standards would be more principles based than they currently are, but we would accept that to make the standards more “operational” they need to set out procedures which it would normally be appropriate to apply. Because the procedures set out in the current standards have a listed company audit bias they are difficult to apply more widely. This increases audit costs for all audits, but disproportionately so for SMEs, which in turn is a factor in calls for ever increasing audit exemption. Many companies which are formally exempt from audit see its value and still want to have an audit, but their ability to do so is sometimes hampered by the costs. The long term effect of the proposals in the consultation paper is likely to be that audit will only realistically be available to large listed companies. We do not believe that this is in the public interest.
The outreach event
I attended the outreach event in London because I was concerned about these proposals.

At the beginning of the discussion a number of institutional investors expressed support for the proposals, this is not a surprise as the proposals seem to be entirely for their benefit.

There were some dissenting voices, but their concerns were largely dismissed as details that could be worked out later. The principal point was how the proposals would affect SME audits. If the core requirements for audit are designed only with listed companies in mind, it will then be too late to go back and accommodate SMEs. One possibility would be to have a two tier system of audit, but we would not support that outcome. As suggested above, the long term outcome of these proposals is likely to be a perceived need for further audit exemptions.

I note that reports of the event in the accountancy press suggested that there was “broad support” for these proposals. This was not my impression from talking to other delegates. Some said that they thought that it had already been decided to go ahead with these proposals and that there was no real point in objecting now, or simply that objections would not be listened to. Plainly there were some in the room who supported the proposals, but those who objected were not given a realistic opportunity to make an alternative case.

Oversight
The oversight procedures could no doubt be improved, but the most effective and beneficial form of oversight is through the exposure draft of documents for detailed comment. There are drawbacks to the current system: it is unlikely that stakeholders outside the profession, other than large institutional investors, will comment; and it can sometimes seem that comments made are not fully considered. Nonetheless, in practice, those who do comment can be seen to have weighed up the needs of various stakeholders, and the current approach does seem to work reasonably well.

The proposal that there should be an oversight body with the power to override the results of this due process is alarming. The likely outcome would be the development of standards which are impractical to apply because they have been imposed without due consideration of the practicalities of compliance. A better case needs to be made if the existing arrangements are to be amended.

A better approach
The cost of an audit process that would guarantee that no material errors exist would be prohibitive, therefore auditing can only operate on a balance of probabilities basis. On this basis it would normally be expected that an audit would pick up relevant issues, but failure to do so in a particular case might not always be an indicator of negligence.

Auditing is primarily about gathering information and making judgements.

It is useful to have a set of procedures which, if followed, would normally ensure that an audit has been completed to an adequate standard, but these procedures should be proportionate, and the same procedures may not be appropriate for all audit work.

Although we do not support a two tier audit system, the auditing standards could usefully be recast as a set of principles supplemented with procedures which might be applied in different circumstances. The auditor would need to justify which approach was adopted (or in some cases that no specific investigation into a particular area is required). It would not be necessary for the auditors of SMEs to try to apply procedures which only really make sense in the context of a listed company audit.

This approach would ensure a more appropriate level of audit could be applied to SMEs while retaining those procedures which are more appropriate to listed company audits for their use.
This approach could also cater for new auditing techniques such as data analytics and the use of artificial intelligence. There is now a powerful lobby who are suggesting that such techniques should be used to the exclusion of traditional methods. A better approach would be for these techniques to be encompassed within the standards as alternative ways of applying the core principles identified.

If institutional investors remain unsatisfied with the level of audit on this basis and feel the need for additional work to be done as part of the audit of the companies they invest in, they can arrange through the audit committee for such additional work to be done. There is no need for such work to be seen as an essential part of audit.

Although we have set out our detailed answers to the questions raised in this consultation paper in an Appendix to this letter, our fundamental response is that these proposals need to be reconsidered and a different approach adopted.

Yours faithfully

Michael Comeau
Technical Principal
RESPONSES TO SPECIFIC QUESTIONS RAISED

1 Do you agree with the key areas of concern identified with the current standard-setting model? Are there additional concerns that the Monitoring Group should consider?

No. It is not clear that the IFAC “represents” the accounting profession as suggested, but even given that individual accountants, the firms and the professional bodies do have an influence on standard-setting, the concern that this raises are entirely theoretical. The consultation paper offers no evidence that this influence does in fact have adverse effects. (In the main letter we argue that the dominance of the big four and the mind set of institutional investors does have some undesirable consequences and we spell out what these are.) Auditing standards are primarily used by accountants and the participation of accountants in their development and maintenance is essential if they are to remain practical, and their requirements achievable.

There is already oversight of the standard-setting process but the most important mechanism to ensure that all stakeholders needs are met is the consultation process during the development of each individual standard which is open to all stakeholders. If this process can be seen as adversely affecting the “timeliness” of new standards, it is also the guarantor of their relevance and effectiveness. It can hardly be in the public interest to make rapid and ill thought out changes to the standards.

A simple perception of an adverse effect should not be acted upon unless it can be shown that that perception is justified.

Auditing is primarily about the exercise of judgement, but auditors develop that judgement in the context of professional guidance. New developments will require the guidance to change from time to time, but if the guidance is given in the form of a set of voluminous and frequently changing rules, this will hinder the development of and exercise of judgement. A better approach would be for the requirements of the standards to be expressed as a series of high level principles, which can be supplemented with guidance on how those principles would normally be applied in particular circumstances. Allowing auditors to justify meeting the underlying principles with different procedures in specific cases (which will include the use of data analytics and other automation) will encourage innovation and would better allow audit to keep pace with changes in the business environment. Such alternative procedures could then be incorporated as additional guidance as they become more established.

Compliance with such standards would be more difficult to monitor, but we do not think that the effectiveness of audit is enhanced by reducing the audit process to a series of detailed rules which are in place largely because compliance with them is easy to monitor. In fact these detailed rules inhibit the proper use of judgement. We believe that there is a case to be made that it is the increasingly rules-based nature of auditing which is the true cause of audit failure.

Our more general concerns are set out in the body of our letter.

2 Do you agree with the overarching and supporting principles as articulated? Are there additional principles which the Monitoring Group should consider and why?

We broadly support the principles as articulated, but believe that the broad stakeholder involvement in the consultation process of each document as it is developed is the most effective way of ensuring that the standards are set in the public interest. It is at this level that increased participation from nonprofessional stakeholders could usefully be encouraged. The proposals in the paper seem designed entirely to promote the interests of institutional investors, and the monitoring groups which see themselves as their representatives, at the expense of all other stakeholders.
3 **Do you have other suggestions for inclusion in a framework for assessing whether a standard has been developed to represent the public interest? If so what are they?**

As already suggested, the public interest would best be served by developing more principles-based standards that would:

a) enable economic audits to continue to be available to a wider range of entities; and

b) promote audit judgement over audit process which is likely to be the most effective guard against audit failure.

4 **Do you support establishing a single independent board, to develop and adopt auditing and assurance standards and ethical standards for auditors, or do you support the retention of separate boards for auditing and assurance and ethics? Please explain your reasoning.**

The case for changing the existing structure has not been made. In particular the implied criticism of the existing boards for “reviewing detailed drafting” seems misplaced.

5 **Do you agree that responsibility for the development and adoption of educational standards and the IFAC compliance programme should remain a responsibility of IFAC? If not, why not?**

6 **Should IFAC retain responsibility for the development and adoption of ethical standards for professional accountants in business? Please explain your reasoning.**

We are not aware of any particular reason to change the existing arrangements set out in these two questions.

7 **Do you believe the Monitoring Group should consider any further options for reform in relation to the organization of the standard-setting boards? If so please set these out in your response along with your rationale.**

Although we favour significant changes to the way in which standards are written, we do not see changes in the structure of the standard setting bodies as an essential component of the changes.

8 **Do you agree that the focus of the board should be more strategic in nature? And do you agree that the members of the board should be remunerated?**

No. An essential component in ensuring that the standards are practical and that the requirements are achievable would seem to be to ensure that practising accountants retain a significant say in their drafting. The suggestions that:

a) the board (or boards) be less involved in drafting issues;

b) the board be dominated by non-auditors; and

c) that the board need not seek consensus;

would all seem to point to the development of standards which are increasingly voluminous, frequently change, and impractical to apply.

Although there should be multi-stakeholder representation, in practice these proposals suggest that the board would be dominated by those with an interest only in listed company audits. We would also question whether regulators are properly seen as separate stakeholders with a separate interest in this process, they simply represent the interests of those on whose behalf they are monitoring. We do not see a particular need to amend the existing structure, but if a change is sought it should be that greater emphasis is given to the views of those whose primarily interest is in the audit of SMEs.

The proposals in this section also rest on the suggestion that more extended financing would be available. It is not clear that this will be achieved and without this the suggestions may not be practical. But we would support the wider remuneration of members of the board if this can be achieved.
9 Do you agree that the board should adopt standards on the basis of a majority?
No. It is more important the standards are realistic and widely accepted than that they can be imposed quickly.

10 Do you agree with changing the composition of the board to no fewer than twelve (or a larger number of) members; allowing both full time (one quarter?) and part-time (three quarters?) members? Or do you propose an alternative model? Are there other stakeholder groups that should also be included in the board membership, and are there any other factors that the Monitoring Group should take account of to ensure that the board has appropriate diversity and is representative of stakeholders?

The case made for the proposed changes is not convincing. However the board's decision making would be much enhanced if more of its members had a background in preparing or auditing accounts for SMEs.

11 What skills or attributes should the Monitoring Group require of board members?
A practical understanding of auditing. Non-practitioner stakeholders should have regard to this even if they have not been in practice themselves.

12 Do you agree to retain the concept of a CAG with the current role and focus, or should its remit and membership be changed, and if so, how?
We see no reason to change the existing arrangements.

13 Do you agree that task forces used to undertake detailed development work should adhere to the public interest framework?
The task forces should operate in the public interest, but care must be taken to determine what the public interest really is. This paper appears to identify the narrow interests of institutional investors with the public interest.

14 Do you agree with the changes proposed to the nomination process?
We see no reason to change the existing nomination process.

15 Do you agree with the role and responsibilities of the PIOB as set out in this consultation? Should the PIOB be able to veto the adoption of a standard, or challenge the technical judgements made by the board in developing or revising standards? Are there further responsibilities that should be assigned to the PIOB to ensure that standards are set in the public interest?

We agree that the PIOB should act to protect the public interest, but are concerned with the consultation paper’s perception of what the public interest is. We can see no circumstances in which it would be appropriate for the PIOB to veto the adoption of a standard, other than a circumstance in which the due process of its development was flawed in some way. For example, if criticisms made during the exposure period had not been given sufficient weight. The due process of consultation on draft standards should be the prime method of ensuring that the (sometimes conflicting) needs of different stakeholders are met. The PIOB should not go further than suggest that particular issues of detail that have been raised be looked at again.

16 Do you agree with the option to remove IFAC representation from the PIOB?
No. We see no logic in this proposal.

17 Do you have suggestions regarding the composition of the PIOB to ensure that it is representative of non-practitioner stakeholders, and what skills and attributes should members of the PIOB be required to have?
Members of the PIOB should represent nonpractising stakeholders but should still seek consensus between the practitioners on the board and the interests of all other stakeholders. There should be greater representation of those with an interest in SME audit.

18 Do you believe that PIOB members should continue to be appointed through individual MG members or should PIOB members be identified through an open call for nominations from within MG member organizations, or do you have other suggestions regarding the nomination/appointment process?

It is not clear why the Monitoring Group, who appear to represent a fairly narrow range of interests, should have so much influence over the PIOB.

19 Should PIOB oversight focus only on the independent standard-setting board for auditing and assurance standards and ethical standards for auditors, or should it continue to oversee the work of other standard-setting boards (eg issuing educational standards and ethical standards for professional accountants in business) where they set standards in the public interest?

We see no reason to change the existing arrangements.

20 Do you agree that the Monitoring Group should retain its current oversight role for the whole standard-setting and oversight process including monitoring the implementation and effectiveness of reforms, appointing PIOB members and monitoring its work, promoting high-quality standards and supporting public accountability?

The proposals in this paper suggest that the Monitoring Group represents a fairly narrow group of stakeholders and as such appears to have too much of an influence on standard-setting. Revising the membership of the Monitoring Group to better reflect a wider range of stakeholders is probably not a realistic option, a better solution may be to establish a separate SME group to work alongside the Monitoring Group and to jointly control the PIOB, who should be the primary oversight body.

21 Do you agree with the option to support the work of the standard-setting board with an expanded professional technical staff? Are there specific skills that a new standard-setting board should look to acquire?

We would support an expanded professional staff if financing for this could be made available. However, we do not agree that the existing approach undermines the public interest, whatever the perception in some quarters. The safeguard against any undue influence of seconded staff comes primarily through the due process of exposing potential standards for comment, but also through the existing overview arrangements. The specific skills required for in house staff would largely be recent practical experience of the audit process whether through acting as an auditor or in some cases through acting as a preparer of accounts which have been audited.

22 Do you agree the permanent staff should be directly employed by the board?

Yes, we see no issue with this.

23 Are there other areas in which the board could make process improvements – if so what are they?

As noted above, all the issues raised would be better addressed if the standards were written in a way that more clearly distinguishes:

a) High-level principles which must be adhered to. Additional guidance may be needed to fully explain what these principles mean, but the principles themselves should be stated as simply as possible. (This is not to suggest a return to the pre-clarity standards, the bold type requirement in those standards were not always principles.)

b) Detailed procedures which it would normally be possible to rely on to meet the principles in different circumstances (that is: different procedures may be appropriate in different circumstances such as listed or SME audits).
Auditors would apply judgement to determine which procedures to follow in a particular case, or whether to meet the principles in a different way, which would facilitate the development of data analytics and other computerised techniques within a framework of agreed principles. Such methods could then be included as potential procedures in the standards once they have been better established.

This approach would re-emphasise the need for judgement and the better use of judgement is likely to be the best guard against audit failure. (Albeit that detecting whether a particular audit has been reasonably completed would itself require greater judgement.)

24 Do you agree with the Monitoring Group that appropriate checks and balances can be put in place to mitigate any risk to the independence of the board as a result of it being funded in part by audit firms or the accountancy profession (eg independent approval of the budget by the PIOB, providing the funds to a separate foundation or the PIOB which would distribute the funds)?

No convincing case has been made that, beyond the perception of some, the current arrangements constitute a real threat to the independence of the standard-setting process. The benefits to the larger firms of funding their secondees would include the experience that these individuals obtain from the secondment and ensuring that standards are practical, neither of which are normally against the public interest.

However we have no particular objection to these proposals, if they can be made to work. While audit benefits a number of stakeholders it may not be realistic to obtain funds other than as part of the cost of the audit service itself, reflected in fees which would fund the contributions made by firms (whether or not through the professional bodies).

25 Do you support the application of a "contractual" levy on the profession to fund the board and the PIOB? Over what period should that levy be set? Should the Monitoring Group consider any additional funding mechanisms, beyond those opt for in the paper, and if so what are they?

Although the need for a contractual levy to replace existing arrangements has not really been established, there may be an argument for raising some funds in this way. If such a levy is to be met in part by smaller firms, the standards would need to better meet the requirements of SME audit. While the professional bodies may be able to guarantee funding over a longer period, the circumstances of firms change and the levy period for firms cannot realistically be set as more than a single year.

26 In your view, are there any matters that the Monitoring Group should consider in implementation of the reforms? Please describe.

We do not agree that the reforms proposed in this consultation paper should be implemented. They would amplify existing problems in standard-setting. In particular the impact of the proposals on SME audits must be part of the initial consideration and not tabled for consideration as an afterthought. We believe that our proposals for more principles-based standards should, as well as ensuring that audit remains an affordable option for SMEs, also help to guard against audit failure for listed company audits by placing greater emphasis on audit judgement. We accept that this will be a lengthy project and would propose that the existing standards would remain in place while principles-based standards are developed.

If institutional investors wish to extend the scope of the audit of the companies that they invest in, they can agree to do so through influencing the discussions between the audit committee and the auditor of that entity.

27 Do you have any further comments or suggestions to make that the Monitoring Group should consider?

Only as above.