Audit quality in a multidisciplinary firm

What the evidence shows

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Foreword

The extent to which auditors provide non-audit services is front and centre of the heated international debate on audit. There continues to be concern that independence is compromised in doing so, in spite of strict rules that prohibit or restrict firms from providing such services to audit clients. In fact, some have called for audit-only firms, effectively siloing audit as a stand-alone business.[1] Services that are permitted quite often are complementary to the audit, and threats to independence can be effectively mitigated. However, demonstrating to the public that perceived conflicts of interest are being appropriately managed is challenging.

Users of corporate reports are demanding more information on a broader range of matters, and they want timely access to that information through a variety of platforms. Professional services firms have risen to the challenge and have adapted to various new trends to continue to ensure the integrity of financial reporting. The advent of multidisciplinary firms is the response to meeting current business needs and anticipating emerging demands.

Scrutiny of the multidisciplinary model, and the impacts on audit quality arising from firms offering both financial statement audit and other services, has increased in the international regulatory dialogue that has followed some high-profile corporate collapses. The concept of 'audit-only' firms has been proposed as a solution to the ongoing concerns about audit quality, competition and perceived conflicts of interest in the audit profession.

This report looks at what the evidence says about the multidisciplinary model and its relationship with audit quality, including academic literature, policy and expert views, as well as how the current regulatory frameworks internationally manage the risks. We welcome a robust debate on these issues that no doubt will continue to be important for the profession and policy makers, and encourage a conversation grounded on the facts.

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Introduction

The increasing complexity of business and reliance on technology has strengthened the importance of committed and qualified audit professionals and resulted in a greater demand for specialists. There has been a rapid increase in borderless movement of goods, services and workforce. The growing scale of business today means that entities are now in more markets and countries than ever before. Complex supply chains, ownership structures and transactions have added another layer to the business environment that many entities must operate in. The value created in businesses that financial reports capture has become far more complex, interconnected and intangible.

Considerable changes in the audit landscape have led to a transformation in the way accounting firms (particularly large firms) are organised. They have reinvented themselves as professional services firms to reflect the fact they do far more than just accounting and auditing. The increasing use of technology, with tools such as data analytics, robotic process automation and machine learning, is creating new opportunities for professional services firms. Accounting standards have also become more complex as business transactions are more challenging due to new products, services and financial instruments that are continuously emerging in our global economy.

> ***This report shows, by review of research and other related literature, the multidisciplinary model is one of the best mechanisms to develop the skills, expertise and consistency needed for quality audits.***

Among these changes and new trends, the objective of the audit, to provide financial statement users with comfort that the financial statements prepared by management fairly reflect the business' operations, remains. However, for this goal to be achieved in today's rapidly evolving environment, the audit profession must be agile. This means either employing a range of skilled professionals with diverse backgrounds, or buying-in such skills as and when required where it is uneconomical to retain them in-house, to meet the demands of stakeholders. Superior audit quality can only be delivered if firms have the best people, services and knowledge at hand. This report shows, by review of research and other related literature, the multidisciplinary model is one of the best mechanisms to develop the skills, expertise and consistency needed for quality audits.

Through the publication of this report, we hope to contribute to the debate on multidisciplinary firms and inform public opinion. By detailing the basic elements of an audit and how specialists are incorporated in the audit process, readers will get a better understanding of how the multidisciplinary model is the most effective structure to serve the audit function, and how the rules that have evolved over the past decades serve to mitigate risks associated with audit firms providing non-audit services to some audit clients.

What the evidence shows

The multidisciplinary model

A multidisciplinary firm is one which offers both audit and other services under the same brand name. Other services are often referred to as non-audit services, and include consulting services not related to audits, in addition to services that have a significant relevance to the audit such as focused engagements addressing specific risks identified by audit committees but are outside the scope of the financial statement audit. The growth of multidisciplinary firms is congruent to the fast pace of change and specialised nature of businesses. The objective to provide investors and financial statements users with assurance that financial information is prepared in accordance with the rules often requires the expertise of specialists who span a wide range of industries.

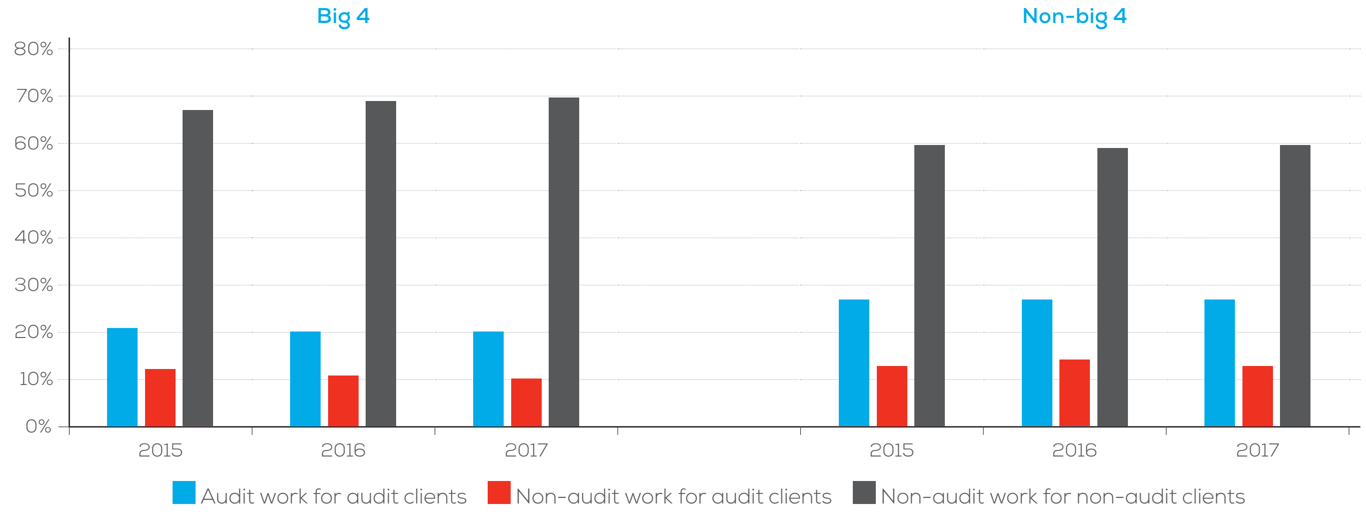
Non-audit services versus audit services

As statutory audit thresholds and audit exemptions have increased, audit work has become a smaller proportion of the total revenue of professional services firms. A UK Financial Reporting Council (FRC) report[2] shows the proportion of accounting firm income that came from audit work (for audit clients) compared to that for non-audit services provided to audit and non-audit clients. The vast majority of non-audit fees actually come from clients for whom firms do not provide audit services (see graph – grey bars). The non-audit services provided to audit clients is relatively small and is not on the rise (see graph – red bars). In part, this is due to the increasing rules in place that limit the non-audit services that can be provided to audit clients.

The debate continues as to whether these levels are acceptable, but it would be difficult to establish a threshold that is not arbitrary, especially in relation to non-audit clients. Also, the distinction between assurance services (such as reviews and compliance engagements) and non-assurance services (such as advisory and consulting work) is not a bright line. There is a natural fit between audit and assurance services. Therefore, it is common for auditors to provide audit clients with related assurance services, such as half-year/interim reviews, or a deeper dive on specific risks for audit committees.

The 2018 IFAC Global SMP Survey[3] found there has been an increase and diversification in the provision of advisory and consulting services. The majority (51%) of firms anticipated a moderate or substantial increase in advisory and consulting services over the next 12 months, compared to 40% for tax services and 36% for both audit and assurance services and accounting, compilation and other non-assurance related services.

In terms of public perception of the role of multidisciplinary firms, findings[4] of a survey into public expectations of audit conducted by CA ANZ and ACCA suggests that the current rules around non-audit services go beyond what the public expect. For example, over one-third of respondents expressed the view that audit firms should be allowed to provide specific advice on accounting treatment of transactions or advise on tax planning for audit clients, despite currently being prohibited or restricted from doing so by existing independence rules.



Source: UK Financial Reporting Council, Developments in Audit 2018 (October 2018)

The results also indicate there is limited support for audit-only firms, or for capping of non-audit services provided to non-audit clients.

Finally, joint research commissioned by the Institute of Chartered Accountants of Scotland (ICAS) and the UK FRC concluded that exposure to non-audit functions affords experts the ability to contribute "broader commercial insight" and a breadth of industry knowledge to the audit which provides benchmarks to the audit team against which to compare the client.

Virtually all participants in the study, which included CFOs and audit committee chairs, attributed the scope of expertise as a significant factor in selecting a firm to conduct their audits. "Without a balanced, cohesive and compatible audit team of the right size and structure, with requisite industry and client business experience and an appropriate mix of capabilities across all the relevant technical areas, a high-quality audit of a complex client is not possible".[5]

Specialists develop and maintain their expertise, at least in part, through work on a wide range of non-audit related engagements. Broad, client-based, commercial experience helps specialists add the type of value the CFOs and audit committee chairs believe is necessary for a high-quality audit.

All this evidence suggests that the presence of multidisciplinary firms in a large and evolving corporate reporting system fills a valuable market need.

How specialists work on today's audits

To understand the complex work that multidisciplinary firms engage in, it is necessary to appreciate what a financial audit is and how it is performed. An audit is an independent, objective evaluation of an organisation's historical financial statements and financial reporting processes. The primary purpose of an audit is to give an opinion to shareholders as to whether the entity's financial report complies with the required standards. However, an audit also provides confidence to wider users such as regulators and the broader public. The basic construct of a financial statement audit can be broken down into three phases as follows.

Phase 1 – Pre-engagement activities, planning and risk assessment

In deciding whether to take on a new audit client or continue with an existing audit client, auditors follow an acceptance/continuance process. This includes gathering information about the nature and complexity of the organisation's business, for example; reviewing the integrity and qualifications of its directors and management. In addition, the auditor evaluates the staffing needed to complete the engagement and determines if each staff member can meet independence and ethical requirements while performing the engagement. Independence is when an auditor can form judgments and draw conclusions free from external influence or bias.

Example

How specialists are involved in pre-engagement activities, planning and risk assessment

- IT specialists may be involved to evaluate internal controls over IT-dependent processes so that system generated information can be relied upon.

If the risks to the firm are significant and cannot be mitigated, it must not accept/continue the engagement. Once the firm decides to accept/continue an audit, an engagement letter is prepared that outlines the respective roles and responsibilities of the auditor and management/those charged with governance of the entity, as well as administrative details such as timing and an indicative fee.

Audit planning involves developing an overall strategy for performing the audit. The amount of planning needed is directly proportionally to the size and complexity of the organisation subject to audit. The auditor develops a deep understanding of the organisation's business and industry and assesses the risks related to the organisation's financial reporting. Documenting internal control processes over key controls and assessing the risk of material misstatement in the entity's financial statements is also essential. All this information is used to design the nature, timing and extent of audit procedures.

Phase 2 – Risk response

In this stage, the execution of the audit is performed. The auditor's objective is to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor's opinion on whether the organisation's financial statements are materially misstated. Broadly speaking, procedures conducted during the audit include:

- Assessing the accounting policies used and significant estimates made by management.
- Testing and concluding on the design and operating effectiveness of the internal controls.
- Examining, on a test basis, evidence supporting the amounts and disclosures in the organisation's financial statements.

Example

How specialists are involved in risk response

- A specialist may be involved to assist with the valuation of complex financial instruments, including expected credit losses.

Overall, the types of procedures applied involve judgement and will vary significantly depending on the risks of material misstatement and the nature of the entity.

Phase 3 – Completion and reporting

Although the audit is planned and performed at the financial statement line item and related disclosures level, auditors express an opinion on the financial statements as a whole. Auditors do not provide opinions on individual transactions, account balances or disclosures. The completion stage would typically include evaluating whether sufficient appropriate audit evidence has been obtained to form an opinion.

Example

How specialists are involved in completion and reporting

- A legal specialist may be involved to provide supporting evidence for the disclosure of a contingent liability for the settlement of a lawsuit.

Where specialists work on the financial statements

Specialists are involved at every stage of an audit where complex or subjective matters are encountered that are potentially material to the financial statements and require specific skills or knowledge to evaluate. Specialists may be needed to assist with obtaining sufficient appropriate audit evidence over certain classes of transactions, account balances and related disclosures, as their tangible skills and specific expertise can be more useful than that of a 'general' audit practitioner. The nature, timing and extent of a specialist's work varies depending on the unique aspects of the audit engagement. The following table outlines some examples of where specialists are likely to be involved in specific areas and line items in the financial statements.

Areas of expertise	Type of specialist	Specialist input related to specific account balances
Information systems	Computer scientist	The extraction and analysis of data populations, and testing of IT-driven controls
Tax	Tax advisor	The analysis of complex or unusual tax compliance issues
Superannuation/ insurance	Actuary	The calculation of liabilities associated with insurance contracts and employee benefit plans
Construction contracts	Engineer	The measurement of work completed for revenue recognition
Regulatory/ legal	Lawyer	The interpretation of contracts, laws and regulations
Environmental	Geologist	The valuation of liabilities, and site clean-up costs
Real estate	Valuer	The valuation of land and buildings

Internal experts versus external experts

"Auditor's expert" is defined[6] as "an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert."

Of a sample of audits conducted by large, global network firms selected for inspection by the US Public Company Accounting Oversight Board (PCAOB), it was found that auditors used the work of at least one specialist in about 90% of those audits. In those, on average five individual specialists performed some work on each audit, and specialists performed work in an average of two fields of expertise on each audit. Substantially all the specialists in the sample were employed by the auditor.[7]

The UK Competition and Markets Authority (CMA)[8] recognises that audit firms rely on expert input of specialists for approximately 10-20% of a FTSE 350 audit, which is a material amount of expertise to outsource or retain within an audit-only firm.

The research commissioned by the ICAS and the FRC, supports the use of in-house experts for "ensuring a consistency of approach and an adherence to confidentiality undertakings." It goes on to say that keeping experts within firms only for the purpose of audit support is "not a viable business model".[9]

The International Forum of Independent Audit Regulators (IFIAR) also supports the use of in-house experts as a measure firms should consider to improve audit quality. The following extract is taken from its 2014 Inspection Findings Survey report[10], and it was repeated in its 2015 report.[11]

"Firms should review their staff structures as to whether changes are needed to ensure the firm has access to resources with appropriate experience and expertise for increasingly complex audits. Increasing complexity in financial reporting requirements, company business models and judgments on accounting estimates mean that audits require audit staff with a range of experiences and expertise. Many audits involve several types of experts, including, for example, valuation specialists, actuaries, geologists, and in the areas of financial instruments and information technology."

Contribution to audit quality

The International Auditing and Assurance Standards Board (IAASB) describes the term 'audit quality' as encompassing the key elements that create an environment which maximises the likelihood that quality audits are performed on a consistent basis.[12] The IAASB's Framework for Audit Quality sets out the input, process, and output factors, as well as key interactions between these elements that are involved in achieving audit quality.

Most existing peer reviewed research[13] points towards an increase in audit quality in cases where a firm offers *both* audit and non-audit services because it allows for the sharing of expertise and systems. Researchers attribute this advantage to a range of factors including knowledge transfer, where auditors benefit from the knowledge of their multidisciplinary colleagues and vice versa. The literature review, which covers the past few decades of research, suggests that the separation of audit and non-audit services creates a barrier for such positive spill-over effects to occur. A limited number of papers indicate that, beyond a certain point, financial dependence may pose a threat to independence. However, there are rules in place to address such risks which are discussed later in this paper.

> ***Most existing peer reviewed research points towards an increase in audit quality in cases where a firm offers both audit and non-audit services because it allows for the sharing of expertise and systems.***

A paper published in the International Review of Law and Economics[14] notes that the provision of non-audit services by auditors to audit clients reduces total costs, increases technical competence and motivates more intense competition. Furthermore, these services do not threaten the quality of the auditor's work nor the auditor's 'independence of mind' (the auditor is actually able to maintain an unbiased attitude throughout the audit). Whereas 'independence in appearance' is dependent on others' perception of this independence.

Work by Lennox (2016)[15] demonstrated that the restrictions imposed by the PCAOB in 2005-06 on tax advice had no effect on audit quality measured in terms of the number of reported errors that gave rise to a financial restatements and shortcomings in filed tax returns. Very recent research from Ciconte et al. (2017)[16] shows that the audited entity also benefits, in terms of increased profitability, when its audit firm also offers non-audit services.

According to a piece in the International Business Research Journal[17], the European Commission's drive to regulate multidisciplinary firms has resulted in an increase in transaction costs rather than an increase in audit quality.

Meanwhile, last year KPMG-UK announced[18] it would stop providing non-audit services to its FTSE 350 audit clients. Since then it has restructured its audit division so that it has a more separate performance management and governance structure.[19] PwC-UK also has plans[20] to split its practice in two – creating a practice with a singular focus on external audit and strengthening its governance with independent non-executives.

However, the evidence cited above suggests that significant uncertainty remains as to whether steps to prevent the provision of any non-audit services to audit clients, in the long run, will benefit high-quality audits, especially those of large, complex public interest entities.

Regulation

In a multidisciplinary firm, the risks of conflict of interest need to be carefully evaluated and mitigated. The response being the development of extensive rules over the past two decades that essentially only allow for non-audit services which do not pose threats to independence. These rules include, but are not limited to, the following.

International

- IESBA's ***International Code of Ethics for Professional Accountants (including International Independence Standards – "the Code")***: contains extensive provisions in relation to auditor independence. Those provisions are a mix of overarching principles (for example Section 120, *The Conceptual Framework*) and specific provisions (for example Section 600, *Provisions of Non-Assurance Services to an Audit Client*). The Code specifies the approach that firms are to apply to identify, evaluate and mitigate/address threats to independence that are created by providing non-audit services to audit clients. A summary of prohibited non-audit services for public interest entities under the current Code is available on the International Ethics Standards Board for Accountants (IESBA) website.[21]
- In September 2018, IESBA approved a project to fully review non-assurance provisions of the Code. Informed by stakeholder concerns, including those of regulators, the project intends to increase confidence in the independence of audit firms. The project will further clarify services that firms can provide to their audit clients. For example, potential revisions (among others recently discussed) to the Code may include:[22]
  - A new requirement prohibiting firms from providing non-assurance services that might create self-review threats to audit clients that are public interest entities;
  - A new requirement for firms to disclose certain matters about the non-audit services that are provided to audit clients, including fees related to such services; and
  - A new requirement for audit clients that are public interest entities to communicate about non-audit service-specific matters, including pre-approval of non-audit services with those charged with governance/ audit committees.
- IAASB ISA 620 ***Using the Work of an Auditor's Expert***: deals with the auditor's responsibilities relating to the work of an individual or organisation in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient, appropriate audit evidence.

Australia

- **APESB APES 110** ***Code of Ethics for Professional Accountants (including independence Standards)***: consistent with the requirements of the international code.
- **AUASB ASA 620** ***Using the Work of an Auditor's Expert***: consistent with the requirements of the international code.
- **Corporations Act 2001**: gives force of law to auditing standards and independence requirements in the ethical standards, and includes stricter auditor rotation requirements, a conflict of interest test, and restrictions on relationships between audited organisations and the audit firm.

New Zealand

- **NZAuASB PES 1** ***International Code of Ethics for Assurance Practitioners (including International Independence Standards) (New Zealand)***: consistent with the requirements of the international code.
- **NZAuASB ISA (NZ) 620** ***Using the Work of an Auditor's Expert***: consistent with the requirements of the international standard.
- **Financial Reporting Act 2013**: gives force of law to auditing standards and professional and ethical standards that apply to assurance practitioners.

USA

- **Sarbanes-Oxley Act of 2002**: restricts the types of non-audit services which professional services firms may provide to their audit clients and imposes audit committee approval requirements and corporate disclosure obligations with respect to audit and non-audit services.
- **PCAOB AS 1210** ***Using the Work of a Specialist***: provides guidance to auditors who use the work of specialists.

UK/Europe

- A 'blacklist' of services, including for example certain tax services, payroll services, and promoting, dealing or underwriting shares in the audited entity, that cannot be provided by the audit firm or its network during the audit or in the financial year preceding the audit.[23]
- A cap on the level of other non-audit services the audit firm may provide to its public interest entity audit clients. This cap limits services to no more than 70% of the average fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity (and certain other related undertakings).[24]
- Ethical standards also ensure that audit partner remuneration cannot consider cross-selling of non-audit services.[25]
- In July 2019 the UK FRC proposed changes[26] to the UK's Ethical and Auditing Standards. The list of prohibited non-audit services that an audit firm may provide to its public interest entity audit clients has been replaced with a much shorter list of permitted services, all of which are 'closely related' to an audit or required by law and/or regulation. No other services can be provided.

Culture and governance

As auditing has become a smaller proportion of the revenues of major firms, one question raised is whether the structure of firms still provides the right incentives to deliver high-quality audits.[27] Firm governance and culture is central to creating the right incentives for audit quality.

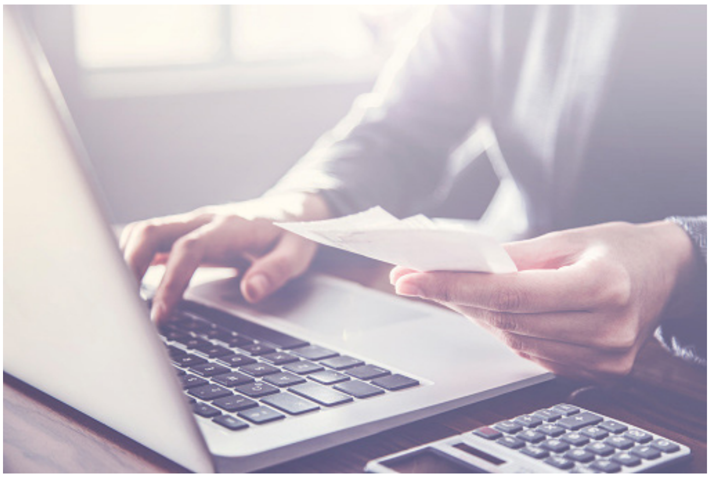
A UK FRC thematic review[28] provides a 'snap shot' of the actions being taken to establish, promote and embed a culture that is committed to delivering consistently high-quality audits among larger audit firms. There is evidence that firms are investing considerable time and effort on their firm-wide culture, such as accountability frameworks and processes to sanction poor quality work or behaviour. Key findings included:

a Culture has been designed (being purpose, values and encouraged behaviours) for the whole multidisciplinary firm.

b Audit remains a core service line for all firms with representation from auditors in senior leadership positions.

> ***Firm governance and culture is central to creating the right incentives for audit quality.***

In determining effective mechanisms to improve audit quality, the Australian Auditing and Accounting Public Policy Committee (APPC) network firms considered what, in their experience, has had the biggest impact on audit quality. They agreed that one of the key drivers of improvement in audit quality was the use of recognition and accountability mechanisms that focus on individuals with audit-related leadership positions.[29]



Attracting and retaining talent

It is important for firms to hire beyond the traditional "accountant" sources as the audit environment grows more complex and expectations of auditors increase. In a report[30] to the US Department of the Treasury, the Advisory Committee on the Auditing Profession wrote; "To ensure its viability and resilience and its ability to meet the needs of investors, the public company auditing profession needs to continue to attract and develop professionals at all levels".

Professional services firms hire a mix of undergraduates, graduates, post-graduates and people without formal qualifications. At the graduate and undergraduate level people are recruited from across all degree disciplines. Rather than focusing on the type of degree or the academic transcript, firms look for those who are curious, adaptable and passionate about collaborating with clients to solve their important problems.[31]

The aspirations and expectations of coming generations are different. IFAC's 2018 survey Make Way for Gen Z[32] indicates one of the top career priorities for the next generation now coming into the workforce was "variety and excitement in my work" with 80% of respondents rating it important or very important. The ability to recruit the best and brightest talent requires that audit firms offer a range of work experience and varied career pathways.[33] On this basis, a multidisciplinary model – providing wider services beyond audit – provides a valuable attraction for specialist talent and enables firms to develop teams with the skills and expertise needed for high-quality audits.

The future of audit

The concept of an expectation gap in audit being 'the difference between what the public expects from the auditing profession and what the profession actually provides' has driven efforts over a number of decades to both educate the beneficiaries of audits, and to reshape the audit itself to better meet expectations.[34] Several recent reviews and inquiries have been conducted in the UK into the regulation, performance of and market for audit services. Over and above those specific matters, this has brought new energy to examining how audits can evolve to address such expectations as the role of auditors in flagging business continuity risks and an expanding range of societal needs for integrity in the economy and capital markets.

The UK Secretary of State for Business, Energy and Industrial Strategy has commissioned Sir Donald Brydon to conduct a review into the quality and effectiveness of audit.[35] The review is intended to take a fresh look at the scope of the audit, how far it can and should evolve to meet the needs of stakeholders, what other forms of assurance might need to be developed, and to define and manage any residual expectation gap. It will test the current audit model and ask whether it can be made more effective. It will consider how the audit product should be developed to serve the public interest in future, taking account of changing business models, new technology and stronger public expectations.

A paper by the UK CMA[36] notes the important balance between getting the audit product right and understanding its inherent limitations. "Expecting auditors to prevent all company failures would be unreasonable, and even among experts there is disagreement on precisely what an audit is supposed to achieve. Clarifying this and considering how audits might best serve shareholders and ultimately the public interest is necessary, which is why we welcome the expected review on the purpose and scope of audit, announced by the government today."

Conclusion

The financial statement audit is fundamental to any market-based economy. This continues to be the case in the information age and into the foreseeable future. However, demand for additional assurance has increased from investors, other stakeholders and wider society over new risks being faced, ranging from business viability to cyber security, climate change and even organisational culture. Meeting these demands – providing the public goods of assurance and integrity – requires a diverse skill base. A multidisciplinary approach, drawing on deep methodology and frameworks for assurance, combined with specialist and subject matter expertise, is well positioned to meet this need and will be increasingly vital as the market continues to evolve towards integrated thinking in the years to come.

The narrower issue of whether audit firms should provide non-audit services to their *existing* audit clients is more nuanced. Standard-setters, audit committees, and regulators are all keenly aware of potential conflicts – real or perceived. Robust rules and policies already exist to mitigate risks to independence and are under review for further enhancement. As this issue continues to be considered, it is important to remember that evidence cited in this paper calls into question the need for sweeping regulatory changes that could have unintended consequences on audit quality.

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