

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

CALL FOR VIEWS

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FOREWORD

It has been argued that “today the standard audit opinion is an outmoded product that nobody values, at a cost that nobody wants to pay. Its requirement by regulators inhibits evolution to assurance of real usefulness and exposes the Big Four to litigation that they cannot afford.”¹

By contrast, others argue that “The independent audit serves a vital role in our capital markets by providing an objective third party opinion on the integrity of financial statements that investors rely upon for investment decisions.”²

These statements seem irreconcilable and when taken together with widespread anxieties about audit as seen in the recent Carillion, Patisserie Valerie and London Capital & Finance cases it is clear that there is considerable confusion. Add in disputes about the interaction between UK company law and International Financial Reporting Standards (IFRS) and it is obvious that there is a need for a reset.

This Review has been established to make recommendations which help to clear this confusion. It requires a back to basics approach combined with an imaginative forward look. The result must be more useful and forward-looking audit. The public interest is clear. As noted recently, “Most people will never read an auditor’s opinion on a company’s accounts. But tens of millions of people depend on robust and high-quality audits.”³

Not everything is broken and many audits are conducted to a very high quality. In many areas the UK has led the world in the development of audit and I am mindful not to discard what is good in the search for what is better.

As a first step this Call for Views is designed to elicit views, facts and opinions to help underpin work in a number of areas. The Review is fully cognisant of

¹ *Countdown*, Jim Peterson (2nd ed 2017)

² Speech to the ICGN Annual Conference 28 June 2016; <https://pcaobus.org/News/Speech/Pages/Harris-speech-ICGN-06-28-2016.aspx>

³ Andrew Tyrie, <https://www.gov.uk/government/news/cma-proposes-reforms-to-improve-competition-in-audit-sector>

the current CMA market study⁴ and Sir John Kingman's Review.⁵ Where these reviews have concentrated on the market delivery mechanism for audit and the regulation of the providers and the ultimate product, this Review will endeavour to determine what product would be of value irrespective of the delivery and regulatory mechanism.

The Review is also mindful of the recent report on 'The Future of Audit'.⁶ The Review will consider the analysis and recommendations in the Committee's report, to the extent that they are relevant to this Review's terms of reference and help to address the questions raised in this Call for Views.

This other valuable work notwithstanding, I am clear that this Review must demonstrate an open-minded approach to questions about the purpose of audit, its social usefulness and the extent to which it fulfils users' legitimate demands. I anticipate that there will be further Calls for Views and the need for deeper research as I develop conclusions. The present Call is neither exclusive nor exhaustive and further topics will be explored in due course. For example, at this stage the Review is not examining in depth the consequences of changing technologies, nor is it attempting to reconcile UK and global practice.

There have been many reviews of audit over recent years. I believe the time is right for conclusions and therefore action.

Sir Donald Brydon

⁴ *Statutory audit services market study*, Competition and Markets Authority December 2018

⁵ *Independent Review of the Financial Reporting Council*, Sir John Kingman, December 2018

⁶ *The Future of Audit*, BEIS Committee Report [HC 1718] April 2019

REVIEW OBJECTIVES

1. The Independent Review will examine the existing purpose, scope and quality of statutory audit in the UK, in order to determine:
 - a) the needs and expectations of users of financial and non-financial corporate reporting;
 - b) how far the audit process and product may need to improve and evolve to meet the needs of users and to serve the wider public interest;
 - c) what specific changes to the statutory audit model and wider regulatory framework for audit may be needed to deliver this, including any changes to company law;
 - d) whether other forms of business assurance should be developed or enhanced to enable shareholders and other stakeholders to assess better the future financial prospects and sustainability of companies.

EXECUTIVE SUMMARY

Introduction

2. The Review is calling for views and information on the quality and effectiveness of statutory audit in the UK. The Review would like your views, supported by evidence wherever possible, on the extent of assurance that audit currently provides to the users of financial statements, and how it might develop to meet better those users' needs and to serve the interests of other stakeholders and the wider public interest.
3. In providing responses, consideration should be given to both the audit *process* and the audit *product*. The Review is mindful that while the two are of course linked, there are distinct issues of quality and effectiveness which attach to each, as explored in the main body of this document.
4. Views are particularly sought on how the statutory audit of Public Interest Entities⁷ could be improved to provide greater assurance to shareholders and other stakeholders, in view of the significant economic and social impact that such organisations have. The Review will at the same time be mindful of the impact of any recommendations on smaller and non-listed entities.

Relevance to other areas of potential audit reform

5. This Review is primarily interested in questions around the purpose, scope and quality of audit, rather than the specific role of the audit regulator or the market through which audit services are provided. These other two areas are being addressed, respectively, in the Government's initial response to Sir John Kingman's Independent Review of the Financial Reporting Council⁸, and in the Competition and Market Authority's on-going market study⁹ into the statutory audit market.
6. Nonetheless, the Review recognises that these separate areas of reform and enquiry have considerable relevance for the quality and delivery of the audit process and product, and the recommendations of the Review will take their

⁷ Currently defined in UK law as companies trading on a regulated market, credit institutions and insurance undertakings.

⁸ <https://www.gov.uk/government/consultations/independent-review-of-the-financial-reporting-council-initial-consultation-on-recommendations>

⁹ <https://www.gov.uk/government/news/cma-proposes-reforms-to-improve-competition-in-audit-sector>

findings into account. This Call for Views also specifically invites input on some of the matters that these separate investigations have highlighted, such as the recommendation in Sir John's report concerning companies' internal control systems.

Scope of this Call for Views

7. Chapter 1 (*Definitions of audit and its users*) provides an overview of statutory audit and what it is supposed to deliver at a minimum. It considers developments over time which have shaped the UK audit process and product.
8. Chapter 2 (*The 'expectation gap'*) compares the requirements of audit in law and in international standards with what is currently expected of audit by shareholders, other stakeholders and wider society. This chapter highlights perceived concerns that audit is not meeting existing requirements.
9. Chapter 3 (*Audit and wider assurance*) looks at the role of audit within the wider context of the assurance that companies are expected to provide to their shareholders regarding management of the business and its key risks. Views are sought on whether external auditors¹⁰ should make greater use of the work of internal auditors, and whether there should be a role for the external audit in assessing directors' disclosures in areas beyond the financial statements. It also highlights how the possible use of experts from other professions or organisations might lead to more effective assurance.
10. Chapter 4 (*The scope and purpose of audit*) Some argue that a significant broadening of the scope and purpose of audit could better serve the public interest as a whole, and views are invited on what this might mean for audit in future. Chapter 4 highlights and seeks views on various changes to the scope and purpose of audit that have been suggested as a means of helping to address the expectation gap. As part of this, the chapter asks whether auditors should have an expanded role in assessing the internal controls of an audited entity.
11. Chapter 5 (*Audit product and quality*) looks at the key enablers of audit quality – distinguishing process from product - and asks whether they are currently working satisfactorily. It questions the binary nature of audit opinions, and

¹⁰ The term 'auditors' is used throughout to mean those providing assessment and/or assurance without reference to their particular qualifications.

also looks at the possibility of graduated findings. The chapter also asks if the current regulatory assessment of quality drives particular and possibly sub-optimal behaviours by auditors.

12. Chapter 6 (*Legal responsibilities*) highlights and seeks views on the interplay between audit and the legal responsibilities of company directors. These include the duty to maintain “adequate accounting records”, and the obligation under UK company law to ensure that dividends are only paid out of “accumulated, realised profits...less accumulated, realised losses”¹¹.
13. Chapter 7 (*The communication of audit findings*) looks at how the auditor’s report is communicated and asks how this might be improved. This chapter also asks whether, and if so how, greater transparency can be provided about the audit process and the auditor’s perspectives.
14. Chapter 8 (*Fraud*) provides an overview of the extent to which auditors may reasonably be expected under the existing regulatory framework to detect fraud in their audit of a company’s financial statements. The chapter asks whether it is reasonable and feasible to expect auditors to play a greater role in detecting material fraud.
15. Chapter 9 (*Auditor liability*) looks at the auditor’s liability for any costs or damages incurred by an audited entity, or by its shareholders or other affected parties, as a result of a negligent audit. A recurring challenge to expanding significantly the purpose and scope of audit, including requiring the provision of a more forward-looking level of assurance, has been the proposition that audit firms¹² liability would need to be limited to make this feasible. The chapter asks whether having differential liability over different aspects of reporting might aid an expansion of assurance.
16. Chapter 10 (*Other issues*) looks briefly at a number of other matters related to the quality and effectiveness of audit. These include the role of technology, proportionality, shareholder engagement with the audit, culture and the cost of the audit.

The appendices include a brief history of audit (appendix 3)

¹¹ s.830(2) Companies Act 2006

¹² ‘Audit firms’ is used throughout to refer to any business which provides audit services, whether as its sole business line or not.

A list of questions is provided at the end of each chapter. It is not necessary for respondents to answer every question, should they wish to focus on a specific area of interest to them. Equally, respondents are free to comment on any other issues arising from the document. Supplementary evidence and information submitted that is not directly related to any of the questions will be considered, provided it is relevant. For example, this Review is not addressing any possible changes to accounting standards, but will consider matters relevant to the audit.

Details of how to respond to this Call for Views are provided at the end of Chapter 10.

CHAPTER 1 – DEFINITIONS OF AUDIT AND ITS USERS

Background

17. The audit of companies' financial statements in the UK has been shaped by developments in company law and in the audit standards set in the UK by the accountancy professional bodies, the Auditing Practices Board established in 1991 and (since 2004) the Financial Reporting Council ("**FRC**"). The UK standards are adapted from those set by the International Auditing and Assurance Standards Board ("**IAASB**"). The interpretation of this statutory and standards-based regime has also been influenced by a number of landmark legal cases over time.
18. Company law does not explicitly define the meaning and purpose of audit, nor for whose benefit it is undertaken. This absence of clear statutory objectives has left scope for the courts to play a significant role in determining auditors' responsibilities, the manner in which they are discharged and to whom they owe a duty of care.
19. The "audit product" has evolved over time in terms of presentation and supporting information. However, its core outputs have remained largely unchanged in the UK since 1947, when the phrase "true and fair" was introduced into auditors' reports and, for the first time, auditors were required to report on the profit and loss account as well as the balance sheet. Some have concluded that the audit has not kept pace with the many other changes affecting the business environment since then.
20. Although the law does not specify for whom an audit is performed, there is a widespread perception that its purpose already extends or should extend to serving a wider public interest, as well as the interests of shareholders. This perception is supported by the requirement for an audit being a matter of law, with the auditor's report having to be made public, and reinforced by international and UK financial reporting standards. The International Financial Reporting Standards ("**IFRS**"), under which all UK-listed entities must report, identify the primary users of financial statements as existing and potential investors, lenders and other creditors.

Definitions

21. ISA (UK) 200 defines the purpose and scope of an audit as follows:

“The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework¹³. An audit conducted in accordance with ISAs (UK) and relevant ethical requirements enables the auditor to form that opinion.

The scope of an audit does not, however, constitute an assurance engagement with respect to the future viability of the audited entity or on the efficiency or effectiveness with which the management or administrative body has conducted or will conduct the affairs of the entity. When conducting an audit, the auditor may identify or be required to consider related matters and, where applicable, may be required to report or to communicate with management or those charged with governance or other parties on such matters in accordance with applicable laws or regulations, the ISAs (UK) or relevant ethical requirements.

As the basis for the auditor’s opinion, ISAs (UK) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive.”

¹³ NB: Under UK company law the “true and fair” requirement takes primacy over adherence to an accounting framework.

Questions

Q1: For whose benefit should audit be conducted? How is it of value to users?

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

Q3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?

CHAPTER 2 – THE ‘EXPECTATION GAP’

22. The term ‘expectation gap’ has generally been used to characterise a perceived difference between what users of financial statements and the public expect from an audit, and what an audit is required to deliver under existing UK law and auditing standards. More recently, in its report on ‘The Future of Audit’, the Business, Energy and Industrial Strategy Committee (“**BEIS Committee**”) referred also to a ‘delivery gap’¹⁴.
23. The key decisions in relation to the future prospects of a business are taken by its directors (rather than the auditors), and it is the directors who establish the company’s system of controls and oversight and approve the audited entity’s financial statements. Thus, in any corporate failure or corporate misreporting the first failure is one by the directors, not the auditors. Some suggest that the expectation gap leads some shareholders and the public to look first to the auditor following such failures, and to overlook the primary responsibility of the directors.
24. Examples of audit expectations which are not matched (or not matched fully) by the corresponding statutory and regulatory framework include:
- (a) an expectation that the audit will provide assurance over the sustainability of an entity or its business model;
 - (b) an expectation that the auditor will have actively sought out any evidence of fraud; and
 - (c) an expectation that the audit will cover all financial and non-financial information published in an entity’s annual report and accounts.

These areas are discussed further later in this Call for Views.

25. A variant on the expectation gap argument is that it is actually an ‘audit quality gap’. This is the suggestion that audit currently fails to do a good enough job in addressing certain key legal requirements, such as those regarding the adequacy of the entity’s accounting records, capital maintenance and the avoidance of inappropriate dividend payments. Should audit better fulfil these requirements, these commentators argue, perceived gaps in expectations may narrow or even disappear.
26. The decisions that lead to corporate failure will be those of the board of directors. An unmodified auditor’s report is not a guarantee that a company will continue in business, even if no ‘material uncertainties’ relating to going concern are disclosed by the directors in the audited financial statements (or

¹⁴ *Future of Audit* [HC1718]

elsewhere in the Annual Report). Nonetheless, an effective audit may help avert a failure through providing insight that enables shareholders to take remedial action at a sufficiently early stage.

27. The valuation of goodwill and other intangible assets is another area where some argue that auditors have failed to challenge management and directors. They point, for example, to cases where such assets were subsequently shown to have little or no value and market valuations at the time of the audit had correctly anticipated this. They suggest that this reflects either a lack of appropriate scepticism by auditors in assessing the valuations or their being willing to back down in the face of pressure from management to do so.
28. Other commentators, however, draw attention to the leeway which accounting requirements give management to make unduly optimistic assumptions in assessing whether goodwill and other intangible assets are impaired. These commentators argue that, as a result, auditors will often need to focus on whether there is sufficient disclosure of the key assumptions used, so that users can make their own judgments on the reliability of the valuations. The fact that investors effectively wrote down such assets in advance of the company indicates, it is argued, that sufficient audited information was available to them.

Questions

Q4: Do respondents consider there is an expectation gap?

Q5: If so, how would respondents characterise that gap?

Q6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

Overview

- 29.** Assurance is commonly defined as “a positive declaration intended to give confidence; a promise”¹⁵. In the business world the definition is often extended to imply the use of a process that justifies such a declaration. The assurance this Review is concerned with is independent assurance, or lack thereof, concerning the statements made by directors of companies. Audit is a sub-set of assurance, relating primarily to the financial statements, but this Review is interested in how assurance around business might be improved generally, whether through enhanced audit or other means.
- 30.** Most owners of companies expect that those they have entrusted with their company’s governance are truthful in all their communications regarding the state of the company and they may require assurance to this effect. It is of course open to the owners to place full trust in those they have entrusted with governance. Yet as the joint stock company model has developed, the principal/agent issue has stimulated an appetite for increased and independent assurance.
- 31.** At the same time the development of the limited liability model has increased the public interest in the behaviour of companies, for example in relation to their liability to taxation. That public interest has extended in recent years to many other behavioural aspects of the companies as their role in society has been subject to increasing scrutiny culminating in the development of Section 172 of the Companies Act 2006¹⁶. As a consequence, the demands for assurance are growing.
- 32.** It is an interesting question whether such assurance should all be delivered through a statutory audit or one commissioned by shareholders, or whether the statutory audit might have two parts, with different liabilities attaching to the providers of the parts and possibly different requirements for independence.

Who provides assurance?

- 33.** It was common practice in the infancy of audit in the 19th century for an auditor to hold at least one share in the entity, with the fact of being a shareholder often viewed as sufficient qualification. A series of corporate failures led, however, to a greater focus by shareholders on auditors’ qualifications. This led to a concentration of auditing provision so that by the late 19th century, just 22 firms of chartered accountants audited around 40%

¹⁵ Oxford English Dictionary

¹⁶ Section 172 of the Act requires a company’s directors to promote the success of the company for the benefit of its shareholders, and in doing so to have regard to a range of other interests, including those of its employees, customers, suppliers, the community and the environment.

of listed companies which had appointed an auditor, with a majority of the others also having appointed professional auditors.

34. The introduction of a statutory audit requirement in the 1900 Companies Act, and a requirement in the 1947 Companies Act for auditors to have an accountancy qualification, or similar experience, further helped drive the 'professionalisation' of auditing.
35. The advent of audit regulation in the UK in 1991 led to further tightening of the eligibility criteria for both firms and individual auditors. Firms are now required to be registered as auditors and comply with rules relating to their ownership and management. Individuals taking overall responsibility for an audit are required both to have a recognised audit qualification and to have obtained regulatory approval to sign auditor's reports on behalf of their firm.
36. Auditors of larger and more complex entities need to have access to a range of specialist skills and experience beyond audit and accounting (for example, IT, valuations, tax, actuarial and legal). The impact of technological change suggests that specialist IT skills are likely to become progressively more important to the conduct of audits.
37. ISA (UK) 620 on "Using the Work of an Auditor's Expert" covers what the auditor is expected to do as a basis for relying on the work of experts (in fields other than accounting or auditing). The large firms' multi-disciplinary models mean that the required skill sets may often be available in-house. In some areas, however, such as the estimation of oil and gas reserves, this may not be the case.
38. Alternative models for the conduct of large audits in the future could, perhaps, be envisaged. For example, a major consultancy or technology business might take the lead role while contracting-in specialist expertise that it does not have in-house. This would require existing restrictions on the ownership and management of firms eligible to act as auditors to be changed.
39. The provision of assurance on emerging forms of reporting, such as integrated reporting, sustainability reporting and non-financial reporting on environmental, social and governance matters, is a developing area on which the IAASB is currently consulting¹⁷.

Internal Audit

40. Many large businesses, particularly those in the financial services sector, have a well-developed internal audit function. In such businesses, internal audit plays a key role in providing assurance regarding the design and

¹⁷ <http://www.ifac.org/publications-resources/consultation-paper-extended-external-reporting-assurance>

operation of the organisation's internal controls over financial reporting (and other matters) to boards, audit committees and management.

41. ISA (UK) 610 sets out the basis on which work performed by an internal audit function may be used by an external auditor. While the international standard also allows internal audit to provide direct assistance to the external auditor, the UK standard specifically prohibits this. The Review is interested in exploring the interaction between internal and external audit.

Questions

Q7: What should be the role of audit within wider assurance?

Q8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?

Q9. Are the existing boundaries between internal and external audit clear?

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

Q11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

CHAPTER 4 – THE SCOPE AND PURPOSE OF AUDIT

Overview

42. The scope and purpose of audit is determined by law and by the auditing standards set by the FRC as the designated Competent Authority for audit in the UK¹⁸. The FRC's policy is to base its standards (ISAs (UK)) on the international standards set by the IAASB:

“Where necessary, the international standards have been augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context”¹⁹

43. Case law has interpreted the purpose of an audit and the parties to whom the auditor owes a duty of care. The leading case of *Caparo Industries plc v Dickman* [1990] suggests that the ultimate purpose relates to stewardship and governance:

“It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.”

44. ISA (UK) 700 requires a specified description of the scope of the auditor's responsibilities to be included in the auditor's report, either by way of cross-reference or directly within the report itself. It is standard practice for auditors to cross-refer to the applicable statement on the FRC's website (the “**FRC Statement**”) which is reproduced for information at appendix 2.
45. The rest of this chapter considers certain areas where it has been suggested that the scope and purpose of an audit could be widened.

Risk and internal controls

46. The FRC Statement makes it clear that the auditor's responsibilities in relation to the entity's internal control systems are generally limited. It states that the auditor “*obtains an understanding of internal control relevant to the audit in*

¹⁸ The Statutory Auditors and Third Country Auditors Regulations 2016 (SI 2016/649)

¹⁹ The Financial Reporting Council – *Scope and Authority of Audit and Assurance Pronouncements* (June 2016)

order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the entity's internal control".

47. ISA (UK) 330 requires the auditor to test the operating effectiveness of relevant controls if either "*substantive procedures alone cannot provide sufficient appropriate audit evidence*" or "*the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures*".
48. In practice, the auditor of a major entity with large volumes of transactions will normally need to rely on, and therefore test, the operating effectiveness of certain internal controls. The auditor is required to summarise in the audit report how the most significant assessed risks of material misstatement ("key audit matters") have been addressed and will often refer to having tested specific internal controls. While ISA (UK) 701 also requires "*where relevant, key observations arising with respect to those risks*" to be provided, the auditor's report does not usually include substantive commentary on the effectiveness or otherwise of relevant controls.
49. ISA (UK) 260 specifies certain additional matters which auditors are required to report to the audit committee of a premium listed company or other entity which reports on its application of the UK Corporate Governance Code. These include, based on the audit procedures performed, the auditor's views about:

"The effectiveness of the entity's system of internal control relevant to risks that may affect financial reporting."

and

"Other risks arising from the entity's business model and the effectiveness of related internal controls to the extent, if any, the auditor has obtained an understanding of these matters."

50. In planning their work, auditors are obliged to consider the principal risks in the business relevant to the audit and develop an appropriate audit response. There is no formal obligation on directors to provide the auditor with a risk map to assist this work.

Questions

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

Q14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

Going concern

- 51.** The Auditing Standard on Going Concern, ISA (UK) 570, requires the auditor to conclude on the following:
- (a) the appropriateness of the directors' use of the going concern basis of accounting; and
 - (b) based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- 52.** The financial reporting frameworks applicable in the UK (IFRS and UK GAAP) generally require the use of the going concern basis of accounting unless management intends to liquidate the entity or to cease trading or has no realistic alternative to doing so. Since such circumstances are very rare, the use of the going concern basis of accounting will nearly always be appropriate in practice. Use of the going concern basis of accounting does not imply a certainty of continued operation.
- 53.** IFRS and UK GAAP require any identified material uncertainties about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern to be disclosed in the financial statements. The auditor's focus is therefore on assessing whether any such uncertainties exist and, if so, whether they are disclosed appropriately in the financial statements.
- 54.** The auditor is required under ISA (UK) 570 to evaluate the directors' going concern assessment over the same time period used by them, and to disclose if that period is less than 12 months from the date of approval of the financial statements (if the directors have not already done so). The auditor is also expected to "remain alert" throughout the audit for evidence of events or conditions that may call the entity's going concern status into question.

55. If the auditor concludes that a material uncertainty with regard to going concern exists, the auditor must draw attention in the auditor's report to the relevant disclosures in the financial statements. If such disclosures are inadequate, the auditor must issue a modified opinion. Application guidance to ISA (UK) 570 indicates that, in the absence of any specific disclosure requirement, the auditor should assess whether disclosure of identified events or conditions is necessary for the financial statements to give a true and fair view.
56. The FRC issued a consultation²⁰ on 4 March 2019 proposing changes to ISA (UK) 570 to increase the work which auditors are required to perform in relation to going concern. It proposes:

“auditors make greater effort to more robustly challenge management’s assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement;

“improved transparency with a new reporting requirement for the auditor to provide a conclusion on whether management’s assessment is appropriate, and to set out the work they have done in this respect; and

“a stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when the auditor draws their conclusions on going concern.”

57. The FRC states that the proposed changes to its Auditing Standard are consistent with existing requirements under law and Accounting Standards; and that the need for any changes to the legal and reporting framework is a matter for this Review.
58. The FRC has agreed to share responses to its consultation with the Review. The Review will consider this area in more detail after the FRC’s consultation has concluded.

²⁰ <https://www.frc.org.uk/news/march-2019/frc-consults-on-stronger-going-concern-standard-fo>

Questions

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

Q16: Should there be greater transparency regarding identified “events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern”?

Viability

59. The UK Corporate Governance Code includes the following provision relating to the directors providing a “viability statement”:

“Taking account of the company’s current position and principal risks, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.”

- 60.** Auditors are required (under ISA (UK) 570) to “read and consider” the directors’ explanation, in the light of the knowledge they obtained in their audit of the financial statements, and determine whether they have anything material to add or draw attention to.
- 61.** The FRC’s consultation on changes to its Going Concern standard proposes requiring the auditor to “perform such procedures as are necessary in the auditor’s professional judgment” in order to identify material inconsistencies between the viability statement and the knowledge obtained from their audit.
- 62.** Sir John Kingman recommended the introduction of a duty of alert for auditors to report viability or other serious concerns, suggesting that the system applied in France might provide a model for this. The French system requires auditors to report viability concerns to the board initially, and to escalate them to the shareholders and ultimately to a regulatory body if their concerns are not addressed.
- 63.** Sir John also reported that viability statements are not performing an effective role as they generally consist of boilerplate statements that provide little meaningful insight for investors and other users of financial statements. He therefore recommended that they either be reviewed and reformed, with a view to making them substantially more effective, or abolished. The FRC is currently considering how the Code provision might be revised to better achieve its underlying objectives.

64. If reformed viability statements were to provide more useful information to users in future, this might well give rise to a demand for a greater level of independent assurance regarding these statements. One possible direction of travel might, for example, be commenting on the sustainability of the entity's business model.

Questions

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

Q18: Should such a statement be subject to assurance?

Q19: Who might be capable of giving such assurance?

Unaudited information

65. There may be confusion over which information disclosed by companies has been subject to audit. Often, information influential to analysis and understanding is not subject to audit, nor even to a lower level of assurance. For example, preliminary results are generally not fully audited. Additionally, a range of potentially important forward-looking information published by companies is not subject to audit.
66. Material published alongside the audited financial statements in annual reports is also not generally subject to audit. Rather, the auditor is required to read this and identify whether the other information is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated. If the auditor identifies such material inconsistencies or material misstatements, it must disclose this in its report, if the matter is not rectified by the company before publication.
67. This 'read requirement' applies to many numbers which frame investors' understanding of the performance of companies. Certain metrics that are central to the assessment of some industries, such as oil reserves for energy companies, or risk weighted assets for banks, are not subject to audit. Nor are the key performance indicators that all companies are required to disclose as part of their strategic reports. No assurance is provided that these are indeed the key performance indicators that are used within the boardroom to oversee the operational delivery of the business. Companies increasingly disclose alternative performance metrics that adjust the GAAP financial results for various factors; again, auditor oversight of such metrics can be limited.
68. In addition, increasing weight is being placed by investors on qualitative information and on indicators of the long-term health of a business,

encompassing issues such as culture, environmental, social and governance (“**ESG**”) metrics, gender pay gap and payment practices. These indicators are also of central importance for a number of the key stakeholders of a business.

69. The FRC undertook a thematic review of auditors’ work relating to other information in the Annual Report in 2018²¹. It reported that the nature, extent and quality of the work performed varied considerably, both between and within audit firms, and linked this to a lack of prescriptive requirements for auditors. It suggested that an expectation gap existed in this area which could increase further if the unaudited material continues to expand.

Questions

Q20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Q22. If so, what information might usefully be subject to audit or another form of assurance and why?

²¹ www.frc.org.uk/auditors/audit-quality-review/thematic-inspections

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

Overview

- 70.** For this Review it will be important to establish clarity around concepts of audit quality. There are two distinct aspects: the quality of the auditor's performance against whichever standards or principles have been agreed and the quality of the audit output in meeting the legitimate demands of those for whom the auditor's report is intended. This review is mainly focused on the second of these, but recognises that where judgment is so intimately bound up with the output there is an inevitable interaction between the two interpretations of quality.
- 71.** Current work by audit regulators and inspectors around the world is thought to focus on the first issue, of how well audits deliver on the standards (while recognising that compliance, on its own, may not always deliver a high-quality audit). The CMA concluded that the concerns raised in a high proportion of the FRC's (confidential) reports on individual audits which it reviewed related to a lack of professional scepticism and challenge rather than simply failures of process. Nevertheless, some suggest that the behaviours spurred by the inspection regime may lead to an excessive focus by audit teams on "completing the audit file".
- 72.** The quality of output by reference to users' needs or desired outcomes is sometimes mentioned but does not hold precedence.

Questions

Q23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

Q24. Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgment?

Binary nature of audit

- 73.** Audit is at present largely a pass or fail test. The auditor usually concludes at the end of the audit process that the company's financial statements provide a true and fair view of the company's position and performance over the period, and that the financial statements are prepared in accordance with the relevant accounting framework. At this point the auditor provides a clean, that is 'unmodified', opinion. There are three types of modified opinion:

(a) a qualified ('except for') opinion;

- (b) an adverse opinion indicating that the financial statements do not give a true and fair view; or
- (c) a disclaimer of opinion (i.e. unable to form an opinion).

74. In practice, while there may occasionally be emphases of matter, a modified opinion is extremely rare. The profession indicates that this is because the threat of any concerns being made public is usually sufficient to secure the necessary changes to the financial statements. In contrast, critics worry that this is evidence of a lack of robustness and challenge, as well as a lack of transparency. There are several recent examples of companies that have failed soon after receiving clean audit opinions.
75. Perhaps, some argue, the binary nature of the audit opinion is part of the problem, making a modified opinion seem like a nuclear option. A modified opinion is now so rare that it may precipitate crisis at a company that receives one.
76. This issue helped drive the introduction of the pioneering extended auditor reports in the UK (a model which has now been followed globally). A key aim was to require the auditors to provide greater insights into issues relating to the audit of the financial statements. Even so, these additional disclosures do not essentially alter the binary nature of the audit opinion; they simply provide additional colour and context about relevant issues. Some extended auditor reports have therefore taken it a step further by providing graduated findings (that is, a sense of how cautious or optimistic accounting judgments are) on individual areas of the financial statements.
77. Audit committees currently receive a rich range of insights from the auditors, but shareholders and broader stakeholders generally do not. The Review is interested in views on possible models for published auditor reporting that may provide more meaningful insight and narrative, across the whole of the audit or perhaps on particular elements. This may provide greater insight for users, more scope to influence the company, and triggers for shareholder intervention without adverse consequences. By contrast, the binary opinion has the advantage of simple clarity.

Producer-led audit

78. The world of audit remains a producer-led industry, with largely producer-defined technical and ethical standards, and a producer profession mandated to deliver the product.
79. More recently, senior members of the profession (including the chief executives of the ICAEW and ICAS) have been publicly supportive of the need for a fundamental review of the purpose and scope of audit. The significant questions raised about the value of audit in the wake of the financial crisis, and subsequent major corporate collapses, are likely to have been underlying causes of this.

Questions

Q25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

Q26. Could further narrative be disclosed alongside the opinion to provide more informative insights?

Q27. What would prevent such disclosures becoming boiler plated?

Q28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

CHAPTER 6 – LEGAL RESPONSIBILITIES

Overview

80. Parts 15 and 16 of the Companies Act 2006 set out requirements:

- (a) for all companies to produce and publish a set of financial statements;
- (b) for large and medium-sized companies to have those financial statements audited; and
- (c) the associated duties of auditors.

81. There are no fewer than 1,064 uses of the word audit or auditor in the legislation as originally enacted. It might therefore be assumed that a clear and precise view of the law as it pertains to audit could be formed. Nonetheless, there is currently wide debate as to whether the law functions effectively in this area. It is one of the aims of this Review to understand:

- (a) where there are elements of ambiguity between company law and international accounting standards insofar as they may impact on audit; and
- (b) whether there are any practical actions that could remedy such ambiguity for the benefit of the users of financial statements.

82. During the course of its inquiry into the Future of Audit, the BEIS Committee heard evidence during a number of public sessions²² in which witnesses were asked for their views on the subject of the UK’s capital maintenance regime. The principle of capital maintenance stipulates that directors may not pay dividends other than out of a company’s accumulated realised profits.

83. Members of the BEIS Committee and some witnesses challenged whether the current approach meant that directors are able to pay what are termed by some “illegal” dividends. The basis for this point of view has been extensively publicised over the years, with conflicting legal opinions commissioned from leading QCs, by investors and the FRC.

84. On publishing its report, the BEIS Committee made several recommendations urging Government and the FRC to work together urgently to address issues relating to capital maintenance and the definition of ‘realised profits’. It went on to reject any legislative changes “the aim of which is to adapt the law to the accounting standards.”²³ This Review does not expect that the BEIS Committee recommendations need restrict it from seeking views on the topic insofar as it is relevant to the value of the audit product.

²² <https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/inquiries/parliament-2017/future-of-audit-17-19/>

²³ *The Future of Audit*, BEIS Committee Report [HC 1718] April 2019

85. There is insufficient space in this document to dissect the respective arguments comprehensively, but the Review understands the essence of them to be:

- (a) a view put forward by the ICAEW in 2005²⁴ and subsequently supported by the FRC. Firstly, that the capital maintenance regime is too rigid in its linking of accounting profits to distributable reserves and, secondly, that the application of International Accounting Standards in determining what constitutes realised profits does not conflict with company law; and
- (b) a contrary view, put forward by a group of investors in response to the ICAEW and FRC positions²⁵, that the primacy of company law is undermined by the application of International Accounting Standards and leads to sub-optimal outcomes for investors, whereby directors are able to apply an unacceptable degree of judgment and can pay dividends out of amounts that should not be treated as realised profits, thus degrading the shareholders' capital.

86. It is telling that the ICAEW's most recent technical guidance on this topic runs to 170 pages.²⁶ The Review is keen to hear the views of respondents as to whether they support the argument for the primacy of the law in this area, and how the conflicting views may be resolved.

Director obligations vs. auditor obligations

87. The recent judgment on the case of *Assetco Plc v. Grant Thornton UK LLP*, provides a short and helpful summary of the core legal duties required of directors and auditors in relation to the preparation and audit of financial statements, reproduced below:

“As regards the directors, the provisions of part 15 require:

- (1) Every company to keep adequate accounting records (s.386);
- (2) The directors not to approve accounts “unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss” (s.393(1));

²⁴ *Implications of IFRS for distributable profits*, ICAEW briefing paper

²⁵ <https://www.sarasinandpartners.com/docs/default-source/esg/position-paper---investors-must-know-what-is-real-11-may-2017.pdf?sfvrsn=2>

²⁶ TECH 02/17 BL Guidance on realised and distributable profits under the Companies Act 2006

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- (1) Every company to keep adequate accounting records (s.386);
- (2) The directors not to approve accounts “unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss” (s.393(1));
- (3) The company accounts to be approved by the board of directors, and to be signed on behalf of the board by a director (s.414); and
- (4) The directors to prepare a report for each financial year, containing a statement that so far as each director is aware there is no relevant audit information of which the company’s auditor is unaware, and that each director has taken all that steps which he ought to have taken as a director in order to make himself aware of any relevant audit information (s.418(2)).

“As regards the auditor, parts 15 and 16 requires the auditor:

- (1) To have regard to the directors’ duty only to approve accounts giving a true and fair view, when carrying out their functions (s.393(2));
- (2) To state whether, in the auditor’s opinion, the annual accounts give a true and fair view, have been properly prepared in accordance with the relevant financial reporting framework, and have been prepared in accordance with the requirements of the Act (s.495); and
- (3) To carry out such investigations as will enable the auditor to form an opinion as to whether adequate accounting records have been kept by the company, and whether the accounts agree with the accounting records (s.498(1)).”

88. ISA (UK) 250 requires auditors to “obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements”.

89. Application guidance in ISA (UK) 250 states that, in the UK, the relevant laws and regulations include “those which determine the circumstances under which a company is prohibited from making a distribution except out of profits available for the purpose”. Under section 830 of the Companies Act 2006, profits which are available for distribution are “accumulated realised profits... less accumulated realised losses.”

90. The FRC reviewed auditors' consideration of laws and regulations in a 2013 thematic review²⁷. It reported that auditors tended not to view this as an important and integral part of their work and to presume that issues were unlikely to arise in this area. It made recommendations for improvements to both auditors and audit committees, including that audit committees should seek to understand how compliance with relevant laws and regulations has been addressed by their external auditors.
91. The Companies Act requirement that the auditor carry out investigations necessary to form an opinion that the audited entity's accounting records are adequate is reinforced by a requirement that the auditor disclose in its extended auditor report if such records have not been kept. Notwithstanding this, it may be that the requirement is understood differently by different auditors, and applied with varying degrees of rigour.
92. Sir John Kingman recommended that "the Government, working with the new regulator, should task the regulator to develop detailed proposals for an effective enforcement regime in relation to Public Interest Entities that holds relevant directors to account for their duties to prepare and approve true and fair accounts and compliant corporate reports, and to deal openly and honestly with auditors." He further recommended that this should apply to a company's CEO, CFO, chair, and audit committee chair.
93. In its response, the Government noted that primary legislation would be required to implement this recommendation. It is not the role of this Review to comment on the implementation of prior recommendations. However, it is of interest to this Review in considering whether the audit product may be improved (including to serve better the principles of the UK's capital maintenance regime) and responses which take into consideration the wider context are welcomed.

²⁷ www.frc.org.uk/auditors/audit-quality-review/thematic-inspections

Questions

Q29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

Q30. Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

Q31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

Q32. How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records? Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?

CHAPTER 7 – THE COMMUNICATION OF AUDIT FINDINGS

94. The Review is keen to understand how audit, in terms of audit process, outcomes and quality, can be made more visible. This greater visibility might in itself drive higher audit quality. Increased transparency might involve further enhancements to the requirements for auditor reports. It could also entail better and more direct forms of dialogue and communication between the auditor and users of financial statements that could build trust and bolster quality. The Review would welcome comments on whether this is practical and would be seen as useful, including comments about how the current auditor reporting requirements might helpfully be extended.
95. There is already some scope for formal interaction between shareholders and the auditor at the AGM, but this rarely occurs in practice. Certain shareholder powers under the Companies Act 2006 to influence the audit are also not to our knowledge generally used. If there are ways to make these existing powers more effective and relevant, the Review would welcome suggestions. Beyond this, there may be ways to make other use of the AGM such that the auditor's accountability to shareholders is more effective.
96. In addition to accountability through the AGM, the Review is keen to understand if there would be interest in an annual assurance meeting which opened accountability not simply to shareholders but to the broad range of stakeholders to which directors are accountable. If there is potential value in such a meeting, it would be necessary to agree who would be permitted to attend and who would be held accountable through the meeting.
97. The audit committee holds the direct relationship with the auditor and navigates any differences of view between management and the auditor. This means that there is a significant dependency on the quality of the audit committee, and particularly of the audit committee chair. In consequence investors may want to seek closer and more regular dialogue with audit committee chairs and members to have confidence in the quality and thoughtfulness of audit committees' approach.
98. There may also be ways in which the effectiveness of the audit committee's work can be made more apparent, potentially including: transparency of the committee's mediations between the differing views of auditor and management; more visibility of the debate and discussion about key audit and accounting judgments by the committee itself; and the scope of its own challenge to management and reporting.
99. Regarding the audit report itself, there may be merit in considering how it can better demonstrate consistency and continuity in the auditor's approach from year-to-year. For example, the extended auditor reports introduced in 2012 include a 'key audit matters' section, which highlights the major issues (including business risks) that were of most significance to the audit of the

financial statements. While a helpful innovation, it is not always clear why some such 'audit matters' feature in one year's audit report, but not the next. Some continuity and extended commentary on such matters from year to year in the auditor report may be useful, to tell a better 'audit story' over time.

Questions

Q33. Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

Q34. Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?

Q35. Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?

CHAPTER 8 – FRAUD

- 100.** Since the inception of company auditing in the mid-19th century, the role of the company auditor with respect to fraud has never been entirely clear. Accounting literature in the late 19th century emphasised fraud detection. The leading textbook of the time²⁸ believed that auditors could better promote their services if they emphasised their fraud detection capabilities. However, by 1936 the well-known Spicer and Pegler's *Practical Auditing* stated "...the main object of an audit is the verification of accounts and statements prepared by a client... Although of great importance the detection of fraud and error must be regarded as incidental"²⁹
- 101.** Fraud is a broad legal concept and the auditor does not make legal determinations as to whether or not fraud has occurred. The Companies Act 2006 makes no explicit reference to any responsibility of the auditor with respect to fraud.
- 102.** The auditing standard dealing with fraud (ISA (UK) 240) directs auditors to focus on intentional misstatement of the financial statements, arising from either fraudulent financial reporting or misappropriation of assets. It requires auditors to make a rebuttable presumption that revenue may be materially misstated due to fraud and to design and perform appropriate audit procedures in response to this and other identified fraud risks.
- 103.** The auditor's responsibilities relating to fraud have been the subject of considerable debate over the years, both in the UK and internationally. Over recent years potentially fraudulent financial reporting practices have again attracted considerable attention. This has given rise to renewed debate regarding the nature of auditors' responsibilities for detecting fraud and whether auditors are fulfilling these responsibilities in practice.
- 104.** The FRC Statement of the auditor's responsibilities (appendix 2) states:

"The auditor's objectives are to obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error... The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control."

²⁸ Dicksee, LR (1892) *Auditing: A Practical Manual for Auditors*, Gee, London

²⁹ For further detailed discussion see "Changing Perceptions of the Role of the Company Auditor the role of the Company Auditor, 1840-1940" Chandler, Edwards and Anderson, *Accounting and Business Research* Vol 23 No 92.

- 105.** The FRC reviewed auditors' consideration of fraud risks in a 2013 thematic review. It reported that fraud audit procedures tended to be viewed as a compliance exercise rather than as an important and integral part of the audit, with evidence of a presumption by audit teams that issues relating to fraudulent reporting were unlikely to arise in the entity they were auditing.
- 106.** The FRC's report on its thematic review findings³⁰, issued in January 2014, stated that there needed to be a better focus on how fraud risks may affect the financial statements and that auditors should improve the quality and effectiveness of the audit procedures performed. It also recommended that audit committees discuss fraud risks, and the audit procedures performed to conclude on them, with their auditor.

Questions

Q36. Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?

Q37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

Q38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

³⁰ www.frc.org.uk/auditors/audit-quality-review/thematic-inspections

CHAPTER 9 – AUDITOR LIABILITY

- 107.** Auditors' exposure to liability exists in relation to both failure to discover issues with the reliability of the financial statements, and/or drawing conclusions for which there is no reasonable basis.
- 108.** The issue of auditors' exposure to litigation is often raised by the profession whenever the case for substantive changes to auditors' responsibilities is being considered. For example, the 1992 McFarlane Report stated:

“Auditors are constrained by the prospect and scale of potential litigation. This is a barrier to proactivity and change ...and the development of a more responsive profession.”

- 109.** It went on to suggest that a solution would need to be found to this issue if auditors were to have responsibilities to a wider group than just shareholders and the audited entity itself. Jim Peterson views limitation of auditor liability as an “unachievable ‘magic bullet’”.³¹
- 110.** For some time, the ICAEW has advised firms to include a so-called ‘Bannerman paragraph’ in their auditor’s reports to help limit their potential liability, thus reports may include a statement such as:

“This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.”

- 111.** This is intended to be a factual statement of the current legal position. Some believe, however, that there is a need to move on from this boilerplate, to promote public confidence in the value and continued relevance of audit.
- 112.** Limiting auditors' liability used to be prohibited by company law, with unlimited liability sometimes described as a “driver” of audit quality (the implication being that limiting auditors' liability could reduce their incentives to perform a quality audit). The Companies Act 2006, however, introduced provisions permitting contractual limitation of liability (through a Limited Liability Agreement, or LLA, between the auditor and the company). Any such

³¹ *Countdown* (2nd ed) – Jim Peterson

LLAs require annual shareholder approval and are also subject to an overarching “fair and reasonable” test to be applied by the courts.

- 113.** In the absence of any agreed contractual limitation in accordance with the Companies Act 2006, audit firms in the UK have unlimited joint and several liability to the audited entity and its shareholders. Where a claim is brought by the audited entity, however, for losses suffered due to a negligent audit, case law³² indicates that the courts will take contributory negligence by its directors and/or senior management into account in deciding the quantum of any award.
- 114.** While LLAs have been permitted since 2008, they have not been used in practice to any significant extent, if at all. A key reason cited for this is that a company’s directors would need to be satisfied that recommending an LLA to shareholders is consistent with their fiduciary duties. A further reason given is that, for companies which are also listed in the US (where limiting auditors’ liability is not permitted), such an agreement may not be acceptable to the US securities regulator.
- 115.** Significant claims against auditors are thought to be generally settled out-of-court, thus avoiding the potential reputational damage involved in a court case. The recent award in the AssetCo case of £21 million in damages, which related to a firm outside the Big 4, was reportedly the second largest court-ordered award against a UK auditor.
- 116.** When the provisions permitting LLAs took effect in 2008, representatives of institutional investors³³ stated that proportional liability (auditors only being liable for their own share of the fault, as opposed to that of others) was their preferred form of limitation; and that they did not consider an LLA including any fixed cap element (for example, a fixed monetary cap or one based on a multiple of audit fees) to be appropriate.
- 117.** The institutional shareholders, operating through the Institutional Shareholders Committee (the “ISC”), also referred to a need for companies to get “something in return” for agreeing to limit the auditor’s liability, with a particular focus on audit quality:

“In agreeing to limit liability, companies are reducing their opportunity to recover losses from their auditors. They will need to reassure their shareholders that they have obtained something in return for this. Investors will welcome disclosure from audit committees as to the ways in which they have used their discussions with auditors on liability limitation to assure

³² See, for example, *Assetco Plc v Grant Thornton UK LLP* [2019] EWHC 150 (Comm).

³³ <https://www.theaic.co.uk/sites/default/files/uploads/files/ISCAuditorLiabilityLimitationJun08.pdf>

themselves that audit quality will be preserved and enhanced, and to secure other benefits for the company. In this regard, shareholders attach great importance to 'true and fair'. The ISC is keen that this is reinforced by audit committees with auditors when entering into liability limitation agreements in order to, inter alia, mitigate any tendency to unduly defensive auditing."

- 118.** All audit firms are required to have professional indemnity insurance or other appropriate arrangements in place to meet claims arising against them. The largest firms' arrangements for meeting claims are believed to be complex in nature and, although reviewed periodically by the FRC, are opaque to users of audit.
- 119.** Reputational damage arising from an "audit failure" is seen by some as being a much more significant threat to the continued viability of the largest UK audit firms than potential inability to meet a successful claim.
- 120.** It has been suggested, by members of the profession and others, that the statutory provisions relating to auditors' liability continue to represent a barrier to making significant changes to auditors' responsibilities which may be in the public interest. It may be important to distinguish between parties to whom auditors might be responsible and those to whom they may be liable for any failure; these need not be the same groups. Auditors' liability is also relevant in the context of the CMA's work relating to competition in the market for audits of large listed companies.
- 121.** One possible approach to improve the usefulness of the audit would be to maintain the current liability regime for the statutory audit against defined standards and apply a different approach to liability in respect of wider assurance services within the context of a redefined statutory audit.

Questions

Q40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

Q41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

Q42. Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?

Q43. How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

Q44. To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?

CHAPTER 10 - OTHER ISSUES

Technology

- 122.** New technology offers the promise that audit could move away from the sampling of transactions and instead look at most or all of them. Data analytics could be more widely applied to identify trends or anomalies and flag up areas for further investigation and study. The Review is keen to understand how far there is actual delivery on this promise across audits currently, and whether this varies according to the audit firm or the scale or geographic spread of the audit.
- 123.** As well as a greater breadth of coverage, the underlying opportunity of this application of technology is that it should enable greater intelligence to be applied within the audit. Auditors would be freed from the more mechanical aspects of audit and enabled to focus on the anomalies and issues, applying due scepticism and judgment to unearth any matters of concern.
- 124.** The Review is also seeking input as to whether technology can be used to provide insights or assurance that go beyond the traditional core audit. To highlight possible examples, technology might assist in:
- a) supporting controls testing or segregation of duties testing;
 - b) using insights from social media and other external data to provide further testing of the entity's financial statements and reporting;
 - c) making it easier to detect fraud; or
 - d) assurance on algorithms, cyber-security or other technology.
- 125.** The implications of technology will form a sub-strand of the Review and a further Call for Views will form part of this work. The Review also intends to establish a small Technology Advisory Group to assist with this work.
- 126.** Nonetheless, at this stage, it would be useful to receive high-level responses to two questions. The Review is willing to facilitate appropriate commercial confidentiality in these responses which should be clearly marked as 'confidential'.

Questions

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

Proportionality

- 127.** This Review has been stimulated in part by dissatisfaction with audit following a number of high-profile corporate failures. As the Review progresses, a series of possible changes to statutory audit will emerge for consideration. Any extension of statutory audit, whether in terms of variables assessed or opinions offered, will come at a cost.
- 128.** It may be that respondents consider at the same time that some current activities are viewed as no longer necessary or desirable, particularly in the context of any extension of audit activity. For example, some have questioned whether all notes to the financial statements need to be audited.
- 129.** The Review is aware of the large number of consultations affecting boards, governance, stewardship, audit and controls in recent years. In considering responses the Review will be mindful of the proportionality of any recommendations in terms of its costs to business, UK competitiveness and any anticipated benefits.

Questions

Q47. Are there aspects of current audit procedures or output that are no longer necessary or desirable?

Q48. Given that a zero failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

Q49. Does today's audit provide value for money?

Q50. How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?

Shareholders

- 130.** Currently there is work underway looking at issues around stewardship.³⁴ This Review is interested to learn in depth how shareholders use audit reports and does not intend to examine issues that have no direct relevance to audit.
- 131.** It has been suggested that the pass/fail nature of the audit opinion means that it receives only a cursory examination from shareholders and potential

³⁴ <https://www.frc.org.uk/consultation-list/2019/consulting-on-a-revised-uk-stewardship-code>

shareholders. For such investors it is alleged that it is sufficient to check if there is a qualification in the report. Some have indicated that the boilerplate nature of most audit opinions means that investors rank the information in the audit report more lowly than other external analysis of an entity.

- 132.** The Review has at this stage found little evidence suggesting there is any significant interaction with auditors outside the AGM, where again, interaction is very cursory. The processes for a shareholder to commission particular work from an auditor are complex but it is argued that there should be specific scope to do this to gain extra assurance. As the auditor is in a privileged position in relation to all shareholders such activity would need to be very carefully defined and rights and obligations clearly understood.
- 133.** Elsewhere in this Call for Views there is a suggestion of a facility to hold an annual assurance meeting with auditors. It is however questioned whether shareholders (for whom asset managers stand in lieu) have the resources to devote to such activity.
- 134.** Finally, there is no clear analysis of the wishes of shareholders in relation to audit scope, even though currently the law makes clear the audit is carried out for their benefit. By definition, the wishes of others are not taken into account either, other than as expressed in law.
- 135.** The Review intends to conduct a study around these issues. In the meantime, it would be helpful to receive views regarding the following questions:

Questions

Q51. What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

Q53. How could shareholders express to auditors their *ex ante* anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

Q54. What assurance do shareholders currently obtain other than from audit reports?

Culture

- 136.** There is enhanced interest in culture in the corporate world.³⁵ The culture of the audit firm is also considered by many to be relevant.
- 137.** With boards being required to report on culture some argue that there should be some form of assurance associated with these reports. Indeed, understanding the management culture is generally viewed as important by auditors before either accepting an engagement or planning an audit. Anxieties about culture nonetheless find no outlet in the audit report.
- 138.** Simultaneously, the FRC emphasises the need for a sceptical culture amongst auditors and some have questioned whether it is possible for junior auditors to know enough to have informed scepticism. As behaviour so often follows reward it is interesting to consider in what way desired behaviour in individual auditors is encouraged by remuneration structures.

Questions

Q55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

Q56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

Q57. Should the basis of individual auditors' remuneration be made available to shareholders?

Cost

- 139.** There appear to be a wide range of views about the current cost of audit. Taken together with other governance costs some argue that the overall cost of governance is one of the factors causing companies to delist from public markets.
- 140.** The cost of audit is generally reflected only in one number approved by shareholders. There appears to be no mechanism for understanding the constituent parts of this cost other than use of the AGM.
- 141.** By contrast there appear to be anxieties about the profitability of audit particularly in the context of what are said to be higher margin non-audit

³⁵ <https://www.frc.org.uk/directors/the-culture-project>

business lines in the major accountancy firms. This has even caused some to question the long-term viability of the audit function and its ability to recruit the brightest and the best.

Questions

Q58. Do respondents view audit costs as generally too high, about right or insufficient?

Q59. Would users of financial statements wish more detail on the make-up of audit fees?

Q60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

ABOUT THIS CALL FOR VIEWS

Who is this for?

1. The Review would welcome views from any respondents with an interest (direct or indirect) in the audit product

How to respond

2. This call for views closes on Friday 7 June, 2019 at 5.00p.m.
3. Please send any response to brydonreview@beis.gov.uk
4. If you do not have access to email, you can write to Brydon Review Secretariat, Orchard 1, 1st Floor, 1 Victoria St, London, SW1H 0ET.

Disclosure of the information you provide

5. Because information provided in response to this call for views will be received by the Review Secretariat which is hosted by the Department for Business, Energy, and Industrial Strategy, that information may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA) and the Environmental Information Regulations 2004).
6. If you want information you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.
7. In view of this it would be helpful if you could explain to us why you may regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.
8. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding.
9. **It is the intention of the Review to publish all submissions it receives (subject to the above) at the time of the publication of the final report.**

Personal data

10. The following is to explain your rights and give you the information you are entitled to under the Data Protection Act 2018.

11. Please note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

The identity of the data controller and contact details of our Data Protection Officer

12. The Department for Business, Energy and Industrial Strategy is the data controller. The Data Protection Officer can be contacted at dataprotection@beis.gov.uk

Why we are collecting your personal data

13. Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

Our legal basis for processing your personal data

14. The Data Protection Act 2018 states that, as a government department, BEIS may process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

With whom we will be sharing your personal data

15. Your data will be shared with the Independent Reviewer.

Your rights, e.g. access, rectification, erasure

16. The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right:
 - a. to see what data we have about you
 - b. to ask us to stop using your data, but keep it on record
 - c. to have all or some of your data deleted or corrected
 - d. to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law.
17. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.
18. Your personal data will not be sent overseas.
19. Your personal data will not be used for any automated decision making.
20. Your personal data will be stored in a secure government IT system.

APPENDIX 1 – REVIEW TERMS OF REFERENCE INCLUDING DETAILS OF ADVISORY BOARD AND AUDITORS ADVISORY GROUP

A. Purpose

The Secretary of State for Business, Energy and Industrial Strategy (BEIS) invites Sir Donald Brydon to conduct a review into the quality and effectiveness of audit.

The review process needs to be a thorough examination of the issues and allow for gathering evidence and consulting with stakeholders and experts. Sir Donald is expected to submit a report to the Secretary of State for Business, Energy and Industrial Strategy by the end of 2019. The final report will be published, and the Government will consult on its response to the review's recommendations.

B. Review Objectives

The review is commissioned in response to the perceived widening of the “audit expectations gap” - the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail. Recent company failures have brought this gap into greater focus. There may be an additional gap between the information users of audited accounts believe is needed and what is available to them through audited financial statements or other publicly available information.

In general, the audit opinion relates to past performance and the position of an entity at its balance sheet date. Expectations of audit and, more widely, assurance are growing and it is important that the audit responds effectively to those expectations.

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 users of accounts, what other forms of assurance might need to be developed, and to define and manage any residual expectations gap. It will test the current statutory audit model and ask whether it can be made more effective as currently established or whether it requires amendment. 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.

It is intended that as a result of the review's recommendations any expectations gap will be better understood, and users of accounts will have greater assurance about the future of the entity concerned.

C. Scope

The review's scope is taken to include the objectives and context included in these terms of reference.

The objectives of the review are ambitious and will result in the need to consider, amongst other things, the following:

1. Understanding the needs and expectations of stakeholders who make use of company audits:
 - a. The origins and perceptions of the expectations gap;
 - b. What can be done to ensure that investors and other stakeholders fully engage with audit and understand its scope and limitations.
2. The scope of audit:
 - a. What information future investors and the users of corporate information are likely to require a company to produce (drawing on the work of the FRC in this regard) and, in that context;
 - b. what assurance investors and other users of corporate information will need; and
 - c. how any extension of that assurance can be achieved at a proportionate cost to corporates.
3. How assurance is provided and how that assurance can be made more effective for investors:
 - a. From whom and how the assurance should be provided;
 - b. The extent to which auditors can and should assess whether underlying information is reliable;
 - c. The extent to which auditors can and should assess the impact of uncertain future events; and
 - d. How audit can respond to the opportunities and challenges of new technology and other forms of innovation to increase the assurance and effectiveness of audit.
4. How any change to the current statutory audit model will impact on potential liability of auditors.
5. How communication of audit finding to users can be improved to enable that information to be of more use.
6. The potential benefits and opportunities for international engagement and cohesion across the world on auditing standards.

The review will coordinate its work with the ongoing work of the FRC and will focus initially on the audit of Public Interest Entity companies whilst taking into consideration the effects on other relevant entities. It will also consider the proportionality of the balance in terms of cost to produce against benefits to the users in making recommendations.

D. Context

The present review is launched in the context of the Independent Review of the Financial Reporting Council which commented on the need for this review to be “driven by the interests of consumers and users of audited figures, not producers or the audit profession.” It is also launched in the context of the Update Paper, “Statutory audit services market study” published by the Competition and Markets Authority which commented on the need to clarify “what an audit is supposed to achieve on a conceptual

level and ... how audits might best serve shareholders (and ultimately the public interest).”

The government’s expectation is to see the UK at the forefront of corporate governance internationally. This includes maintaining a leadership position internationally in terms of the evolution of the audit.

E: Governance

The review will be led by Sir Donald Brydon.

The Independent Reviewer will be supported by Advisory Groups that will advise on the direction of the review and sources of evidence and will help to scrutinise and challenge emerging findings and recommendations. It is anticipated that in addition to a user dominated group, there will be an audit profession group and a technology group, the precise structure of which remain to be determined.

F. The Review Secretariat

The review will be supported by a small dedicated Secretariat acting in support of the Independent Reviewer.

The review is endorsed by BEIS, the Financial Reporting Council (FRC), the Institute of Chartered Accountants in England and Wales (ICAEW) and the Investment Association. The secretariat may therefore include secondees from the Financial Reporting Council, BEIS and members of the Investment Association, to ensure that the review has access to knowledge and expertise from the audit, accounting and investment professions.

The Institute of Chartered Accountants of England & Wales has also agreed to provide £500,000 of funding for use on the review.

All supporting organisations recognise and accept that their contribution to the review is unconditional. The review will be conducted on an independent basis.

G: Stakeholder Engagement

The review will undertake engagement with a wide range of stakeholder groups in order to fully understand the range of issues and ensure constructive challenge.

Details of the Advisory Board and Auditors Advisory Group

The meetings of both these groups will be confidential during the Review. Minutes of each meeting will be published on Gov.UK at the conclusion of the Review.

Each individual named below has been invited to contribute to the Review in a personal capacity and on the basis of their skills and experience. They will not represent their organisations at the meetings, and the views they offer are their own.

Advisory Board

- Luke Chappell
- Carole Cran
- Margaret Ewing
- Simon Fraser
- Mark Freedman
- Alison Hopkinson
- Professor Chris Humphrey
- Emme Kozloff
- Natasha Landell-Mills,
- Michael McLintock
- Sarah Parkes
- Julia Wilson

Auditors' Advisory Group

- Hywel Ball
- Gilly Lord
- Mark Rhys
- Phil Smart
- Scott Knight
- Steve Gale
- Michael Izza
- Maggie McGhee
- Annie Graham

APPENDIX 2 – FRC STATEMENT OF THE AUDITOR’S RESPONSIBILITIES

Applicable for audits of financial statements for periods commencing on or after 17 June 2016

The auditor’s objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes the auditor’s opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (UK) (ISAs (UK)) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs (UK), the auditor exercises professional judgment and maintains professional scepticism throughout the audit. The auditor also:

- Identifies and assesses the risks of material misstatement of the entity’s (or where relevant, the consolidated) financial statements, whether due to fraud or error, designs and performs audit procedures responsive to those risks, and obtains audit evidence that is sufficient and appropriate to provide a basis for the auditor’s opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtains an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s (or where relevant, the group’s) internal control.
- Evaluates the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Concludes on the appropriateness of the directors’ use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s (or where relevant, the group’s) ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor’s report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the auditor’s opinion. The auditor’s conclusions are based on the audit evidence obtained up to the date of the auditor’s report. However, future events or conditions may cause the entity (or where relevant, the group) to cease to continue as a going concern.

- Evaluates the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation (or gives a true and fair view).
- Where the auditor is required to report on consolidated financial statements, obtains sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the consolidated financial statements. The group auditor is responsible for the direction, supervision and performance of the group audit. The group auditor remains solely responsible for the audit opinion.

The auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit.

For listed entities and public interest entities, the auditor also provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence, including the FRC's Ethical Standard, and communicates with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards.

Where the auditor is required to report on key audit matters, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Reporting on the financial statements

The auditor's report is required to contain a clear expression of opinion on the financial statements taken as a whole.

To form an opinion on the financial statements the auditor concludes as to whether:

- sufficient appropriate audit evidence has been obtained;
- uncorrected misstatements are material, individually or in aggregate;
- the financial statements, including the disclosures, give a true and fair view;³⁶ and

³⁶ This conclusion is required only with respect to financial statements which have been prepared in accordance with a fair presentation (or true and fair) framework (examples are International Financial Reporting Standards as adopted by the European Union and United Kingdom Generally Accepted Accounting Practice).

- the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework, including the requirements of applicable law.

In particular, forming an opinion on and reporting on the financial statements involves evaluating whether:

- the financial statements adequately refer to or describe the applicable financial reporting framework;
- the financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor considers the relevance of the accounting policies to the entity (or where relevant, the group) and whether they have been presented in an understandable manner;
- the accounting policies selected and applied are consistent with the applicable financial reporting framework, and are appropriate;
- the accounting estimates made by the directors are reasonable;
- the information presented in the financial statements is relevant, reliable, comparable and understandable. In making this evaluation, the auditor considers whether:
 - the information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterised; and
 - the overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matter disclosed;
- the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements;
- the terminology used in the financial statements, including the title of each financial statement is appropriate.

When the financial statements are prepared in accordance with a fair presentation framework, the auditor also evaluates whether the financial statements achieve fair presentation including consideration of:

- the overall presentation, structure and content of the financial statements; and
- whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation (or gives a true and fair view).

Unmodified opinions

An unmodified opinion is expressed when the auditor is able to conclude that the financial statements give a true and fair view³⁷ and comply in all material respects with the applicable financial reporting framework.

Modified opinions

The auditor modifies the opinion when either:

- the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The auditor expresses a qualified opinion when either:

- misstatements, individually or in the aggregate, are material but not pervasive to the financial statements; or
- the possible effects on the financial statements of undetected misstatements, arising from an inability to obtain sufficient appropriate audit evidence, could be material but not pervasive.

The auditor expresses an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

The auditor disclaims an opinion when either:

- the possible effects of undetected misstatements, arising from an inability to obtain sufficient appropriate audit evidence, could be both material and pervasive to the financial statements; or
- in extremely rare circumstances involving multiple uncertainties, the auditor concludes that notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Emphasising certain matters without modifying the opinion

In certain circumstances an auditor's report includes an emphasis of matter paragraph to draw attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. An emphasis of matter paragraph does not modify the auditor's opinion.

Communicating "other matters"

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is

³⁷ Only applicable with respect to fair presentation (or true and fair) frameworks.

relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor does so in a separate section in the auditor's report with the heading "Other Matter" or other appropriate heading.

Other information included in the annual report

The auditor is required to read all financial and non-financial information (other information) included in the annual report and to identify whether the other information is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit or otherwise appears to be materially misstated.

If the auditor identifies material inconsistencies or apparent material misstatements, the auditor determines whether there is a material misstatement in the financial statements or a material misstatement of the other information. Where the auditor concludes that there is an uncorrected material misstatement of the other information, the auditor is required to report this in the auditor's report.

Other legal and regulatory requirements

The auditor may be required to address other legal and regulatory requirements relating to other auditor's responsibilities in the auditor's report.

APPENDIX 3 – A BRIEF HISTORY OF AUDIT

Company Law

Modern auditing emerged in the 19th Century following the removal of legal obstacles to the formation of joint stock companies and a series of corporate failures. Certain statements from that time regarding the perceived limits of audit continue to have some resonance today. For example, it was stated in the 1896 Kingston Cotton Mills Co. case that:

“An auditor is not bound to be a detective, or to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog not a bloodhound.”

In the early 20th century, audit became more formalised in nature, through a shift in thinking towards the importance of “statement verification”.

The 1928 and 1929 Companies Acts provided for the first time that a profit and loss account, as well as a balance sheet, must be submitted to the shareholders but did not require it to be audited.

The public evidence sessions that led to the 1928 Act highlighted the tension between the auditor being engaged by management but performing a duty to shareholders. For example, one prominent member of the accounting profession stated that:

“To my mind the peculiarity of the legal position of the auditor of a company is that the value of the auditor’s advice and opinions is available to the management, whom he does not represent, but is not available to the shareholders, whose agent he is”.

The perceived importance of audit continued to grow in the inter-war years in response to accounting scandals such as the Royal Mail case of 1931. This case essentially involved the misrepresentation of the profit and loss account through the use of “old” reserves in order to give a false impression of the current health of the company’s business.

The Royal Mail case and others led eventually to a strengthening of the UK’s company law legislation, in particular through the Companies Acts of 1947 and 1948. The principal changes to audit and accounting introduced by this legislation were:

- (a) a requirement for auditors to provide a wider “true and fair view” opinion, covering the profit and loss account as well as the balance sheet; and
- (b) a requirement for consolidated accounts to be prepared and for auditors to report on them.

These developments explain the origin of many aspects of the Companies Act 2006 as it applies to auditors today.

Auditing standards

In comparison to company law, auditing standards are a relatively recent development in the UK. The first (rather brief) UK auditing standards were issued by the profession in 1980. There was, however, a significant body of non-mandatory guidance for auditors.

High-profile corporate failures in the late 1980s and early 1990s, involving BCCI, Polly Peck and Mirror Group Newspapers (among others), gave rise to significant pressure to enhance both the quality and relevance of audit in the public interest. This led to a separate Auditing Practices Board (APB) being established by the profession in 1991.

The APB subsequently established a comprehensive body of auditing standards (broadly in line with those established by the profession internationally). The standards were “principles-based” in nature and afforded firms flexibility to develop their own distinct audit methodology.

The APB’s standards recognised that it was not cost effective for auditors to examine all transactions. They were based on an “audit risk model” approach to determining the nature and extent of audit work. This approach focuses on reducing to an acceptable level the risk of the financial statements being materially misstated.

A number of the major audit firms subsequently sought to develop a “business risk” audit model instead. A study by Lemon, Tatum and Turley published in 2000 comments “While the audit risk model defines risk entirely with reference to financial statement misstatement, the new methodologies offer a much broader view of the range of risks of the business that are relevant for consideration by the auditor”.

The same study explained the broader justification for business risk auditing as follows: “the failure to detect processing errors is rarely the cause of audit problems. Rather the major issues that have an impact on audit effectiveness are more likely to be associated with the manner in which the business entity is managed to achieve its objectives. Factors such as the business environment, governance issues and the nature of managerial control will ultimately have significance for the financial statements – their accuracy, issues of fraud and going concern”.

The Business Risk approach did not, however, gain as much traction as its advocates had hoped. It was not widely supported within the profession and some regulators were also sceptical. A previous Chief Accountant of the US SEC commented as follows to the US Panel on Audit Effectiveness in 1999: “...over 80% of the fraud cases involved the highest levels of management ...the very group responsible for ensuring the adequacy of the control environment. The irony of today’s audit processes is that significant audit assurance is derived from internal controls; however, the very group ... charged with ensuring the effectiveness of internal controls is responsible for committing fraud”.

He advocated that auditors should be required to perform additional forensic type procedures during their audits, specifically designed to detect fraudulent activities by management.

UK Auditing Standards have become more detailed and prescriptive in nature over time. The FRC adopted International Standards on Auditing in 2005 with some

limited UK add-ons (ISAs UK), soon after assuming responsibility for UK Standards. The ISAs (UK) mandate an audit risk model approach and appear to have led to greater standardisation of audit methodologies across the major firms.

The FRC, and other audit regulators internationally, have consistently highlighted the exercise of professional scepticism, and appropriate challenge of management, as key elements of a high quality audit and called for this to be better reflected in the ISAs.

Reviews of audit

Despite the shift of thinking which occurred in the earlier part of the 20th century, and the many published documents on the subject, the “audit product” and the manner in which it is produced have remained largely static.

An APB paper on “The Future Development of Auditing” (also known as “the McFarlane Report”), issued in November 1992, addressed many fundamental issues which are being discussed again today. It identified “major concerns about the current state of auditing” and concluded that “the auditing profession needs to accept change”. Despite this, major changes of the type discussed were not taken forward.

This has led to a perception that the audit profession has been resistant to major change. The McFarlane Report identified concerns about the potential impact on the financial liability of auditors as a significant factor in calibrating the profession's response to proposals for change.

A later (post-financial crisis) review of “*The Future of Assurance*” by a Group convened by the Institute of Chartered Accountants of Scotland (ICAS) reported in 2010. More recently, senior members of the profession (including the ICAEW and ICAS chief executives) have been publicly supportive of the need for a fundamental review of the purpose and scope of audit.

The significant questions raised about the value of audit in the wake of the financial crisis, and subsequent major corporate collapses, appear to have led to a growing consensus within the UK of the need to consider significant changes if the audit product is to regain public trust and remain of value in the future.