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Dear Sirs

### **ICSA response to the independent review into the quality and effectiveness of audit**

We welcome the opportunity to comment on the independent review into the quality and effectiveness of audit.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the audit function. Our members are therefore well placed to understand the issues raised by the independent review into the quality and effectiveness of audit.

In preparing our response we have consulted, amongst others, with members of the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of this group, nor of the companies they represent.

We offer below some general comments and then some specific answers to the questions raised in the call for views, although we have focussed the latter on those areas in which our members have particular knowledge and experience.



## General comments

The independent review into the quality and effectiveness of audit is a very welcome development. The quality and effectiveness of audit are critically important issues and improvement is essential. In recent months we have seen, and responded to, Sir John Kingman's review of the Financial Reporting Council, the Competition and Markets Authority review of competition in the audit market and the BEIS committee report. In our view each of these look at important issues but would have benefitted from following a proper independent review of the fundamental purpose of audit, rather than preceding it and it is hard not to draw the conclusion that, to some extent at least, these earlier reports have been intended to influence this wider review. All make some good points, but they do not reflect the overarching view that this review has the opportunity to take.

For example, our members have been consistent in telling us that the audit committees with which they are familiar take their work, especially insofar as it relates to challenging management and ensuring the independence of the external auditor, exceptionally seriously and profoundly disagree with those who assert otherwise. Similarly, the CMA review falls into the trap of assuming that companies select and pay their own auditors, thereby overlooking the independent role of the audit committee. Their suggestion of independent appointment of auditors usurps the rights of shareholders to appoint their own professional advisers and serious consideration needs to be given to whether or not this is desirable. Other recommendations, such as the full, legal separation of audit and non-audit work and mandatory joint audits have some superficial attractions, but risk allowing legitimate concerns about the concentration of the audit market to become conflated with the central issue of audit quality. These proposals do not address this fundamental problem and we are sceptical as to how much they will be able to achieve unless three central issues are first addressed in order to improve the audit market: education; training; and trust.

Firstly, there must be clarification of the role of audit in order to reduce the huge perception gap that exists. The political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be. The average man in the street might believe that the purpose of audit is to stop companies from going bust whereas auditors themselves might believe that their role is simply to check the accuracy of the historical information provided to them.

Accounting and auditing legislation, regulation and standards are very important here. The invitation to comment for the Competition and Markets Authority review of the statutory audit market noted (paragraph 2.25) that International Financial Reporting Standards have developed "over time from an approach based on historic cost accounting to that based on fair value accounting. The key principle is that assets and liabilities should be valued on market prices, based on the idea this would make the financial statement more 'useful to users'. Some commentators have argued that fair value accounting

has led to greater risk because of the difficulty, and subjective nature, of valuing and auditing certain assets and liabilities.”

As we said in our response to that invitation to comment, “We leave the debate over which approach to accounting standards is correct to those better qualified, but we do offer the observation that a number of the ‘accounting scandals’ that we have seen in recent years have at their heart questions of judgement. Whether particular value could, or should, be regarded as crystallised in the accounts should, in our view, be a question of fact rather than of opinion – either it is yours or it isn’t. It should not be possible for one accountant to draw up the books for a period and have them audited against current accounting standards and for another to perform the same exercise, for the same period, have it audited by a different auditor and find many millions of pounds difference. We cannot recall a single occasion when such a restatement has ensued to the benefit of shareholders. In our view, a detailed examination of the appropriateness of the use of fair value accounting would be an extremely useful first step in improving the quality of audit and accounting standards revised as necessary to give greater clarity on where judgement has been applied by either the preparer or auditor.

Secondly, much more training is required to foster a greater spirit of professional scepticism among auditors. Not only does the audit process not do what many in our society believe it should, it fails to do properly the bare minimum of what it is actually supposed to do. Politicians and other stakeholders question why the quality of accounting and auditing is not of the standard they expect. This is the delivery gap, rightly identified by the BEIS Committee, who argued that “the expectation gap must not be allowed to mask the serious failure of audit to deliver on its own current terms”. We do not agree, however, that the Committee is right to add that “the delivery gap is far wider than the expectation gap”. Both are significant and equally important issues and neither should be overlooked. To what extent do audit standards, regulation and legislation meet legitimate societal expectations and to what extent does auditor performance deliver high quality audits against existing requirements?

Thirdly, there is the issue of a lack trust in the ability of auditors outside the Big Four. The lack of confidence on the part of companies, investors and some regulators in the ability of smaller auditors to perform to the same standard is an issue of trust and without the accuracy or inaccuracy of this perception being tested by an independent body, any potential misconceptions will continue to abound. It is essential that the validity of any gaps in auditing ability is investigated as the inclusion of challenger firms in the audit market will not serve to improve that market if those firms genuinely are performing at a lower standard.

Your review directly addresses the first two of these issues and we would commend to your attention the third.

## **Responses to specific questions**

### **Chapter 1: Definitions of audit and its users**

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

We support the IFRS position that the financial statements are for existing and potential investors, lenders and other creditors. We believe audit should be conducted primarily for the benefit of the company, shareholders and creditors. It provides assurance to the board and is one of the safeguards needed by shareholders to ensure a company is being run properly by management for the benefit of shareholders as a whole as the owners of the company. The audited accounts of a company are public documents, available for inspection by all those who have, or intend to have, dealings with the company as part of their due diligence. As such it should be possible for reliance to be placed upon them.

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

The audit should be designed primarily to enhance the degree of confidence in the company's financial statements. As a corollary this will add a degree of confidence in the entity as a whole in terms of its financial stability, but should not be interpreted as providing assurance over future financial stability or over other, or all, aspects of the company by anyone who may use a company's accounts. A wide range of people read companies' annual reports, for a variety of reasons, and the directors are responsible for ensuring the accuracy of all the information provided. The audit should be designed to provide increased confidence for shareholders and creditors in the accuracy of the company's financial position as stated in the company's accounts, but responsibility for their accuracy rests with the company's directors.

#### **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?**

No. We believe it is unnecessary to provide greater legal clarity regarding the purpose of audit and for whom it is conducted. We believe a better approach is to have clear audit standards setting out the purpose of audit, overseen by the audit regulator, whose authority is underpinned by statute. Standards can be easily updated if a change to audit is needed to respond to changing circumstances, whereas amending law is a far more difficult and lengthy process.

All those for whose benefit the audit is conducted will have a legal relationship with the company, whether they are shareholders, lenders or other creditors. We therefore believe it is unnecessary, and would be unhelpful, to set out a definitive list in law of all those for whom audit is conducted. This list should be defined by nature of their legal relationship with the company.

## Chapter 2: The 'expectation gap'

### Q4. Do respondents consider there is an expectation gap?

Yes.

### Q5. If so, how would respondents characterise that gap?

We believe the political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be, and we believe there is an important education issue here. Sir John Kingman's review identified the need for a piece of independent work to be carried out to explore the issues arising from the audit expectation gap, and we welcome this recommendation. It is probably an oversimplification to say that the average man in the street might believe that the purpose of audit is to stop companies from going bust whereas auditors themselves might believe that their role is simply to check the accuracy of the historical information provided to them.

With regard to the three areas set out in the consultation under 24 a - c as examples of audit expectations which are not matched by the corresponding statutory and regulatory framework, we believe it would be a mistake to try to address public expectations of audit by amending the statutory and regulatory framework, as public expectation varies widely. We believe it would be better for the existing scope of audit coverage to be made clear and any necessary changes made to auditing standards.

We would like to make an additional comment on paragraph 26 which states that "an effective audit may help avert a failure through providing insight that enables shareholders to take remedial action at a sufficiently early stage". We would argue that an effective audit may help avert a failure through providing insight that enables **directors** to take remedial action at a sufficiently early stage. We agree that the decisions that lead to corporate failure will be those of the board of directors, but directors do not deliberately make poor decisions. Decisions are taken in what the board believes is the best interests of the company at the time the decision is taken. But circumstances can change and sometimes new information comes to light. Sometimes decisions can simply be wrong but misjudgement is not a crime. The **directors** need to be alerted to any audit insights immediately, so they can take swift action to remedy the situation. Should the directors fail to address the issues identified by the auditor then, of course, the auditor should alert shareholders. A mechanism for this already exists by way of a qualified audit report, if appropriate, but we see no reason why there should not also be an alert to shareholders and the regulator if the board has failed to address the auditor's concerns.

We would highlight that paragraph 62 discusses Sir John Kingman's recommendation that there be a duty of alert for auditors to report on viability or other serious concerns, and suggests the system in

France might provide a model. The French system requires auditors to report concerns to the **board** initially, and to escalate them to the shareholders and ultimately to a regulatory body if their concerns are not addressed. We believe this is the appropriate response.

**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?**

Yes, to some extent. We believe there are a number of factors that lead to the perception of a ‘delivery’ or ‘quality’ gap, not all of which are valid. In some cases, this is due to the ‘expectation gap’, whereby the political, press and public expectation of the role of audit is very different from what it is actually required to be.

However, there are also problems around a lack of clarity over accounting rules and standards and the exercise of judgment, which contribute to a ‘delivery’ or ‘quality’ gap. For example, the difference in interpretations of judgement noted in our general comments above are difficult for a non-accountant to understand and creates an impression of ‘smoke and mirrors’. One interesting piece of feedback from our members when considering the impact of audit rotation was that it is not uncommon, when a new auditor asks why something is recorded in a particular way, for the finance team to respond that this is how the previous auditor said it should be done.

We also believe the standard of audit and the professional skills of the individuals carrying out audits has reduced in recent years and, in many cases, lacks the professional scepticism needed to identify the first signs of a potential problem. This is possibly a consequence of the downward pressure on audit fees, combined with the quality of auditor training and an over-reliance on junior staff.

We believe that the regulator should be empowered to take firm action in all cases where there is evidence of a delivery gap.

### **Chapter 3: Audit and wider assurance**

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

We do not believe it would be helpful for an audit to provide wider assurance over areas such as sustainability and ESG not currently covered by the audit. These areas do not lend themselves to being objectively checked by an external person qualified to carry out audit. These matters frequently require in-depth knowledge of business operations and the exercise of business judgment by directors. Whilst these are attractive opportunities for the consulting arms of audit businesses, in our view the focus should be on reducing the opportunities for audit firms to become involved in non-audit work.

**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?**

Yes. Certain businesses and sectors are inherently more complex and risky and it is appropriate that the level of assurance should reflect the individual business. Large, complex, global businesses need input from many additional disciplines and will be subject to the legal requirements in all the jurisdictions in which the company operates.

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

Yes. We believe the UK standard that prohibits internal audit providing direct assistance to the external auditor makes these boundaries clear.

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

The UK standard goes beyond the international standard and prohibits internal audit providing direct assistance to the external auditor. The consultation acknowledges that many large businesses, particularly in financial services, have a well-developed internal audit function. It is important to remember that both the external auditor and the internal auditor meet confidentially with the audit committee, and in a business with a well-developed internal audit function, the audit committee will meet regularly with the internal auditor throughout the year. Clearly, internal audit practice varies amongst companies and so one UK standard would seem inappropriate. We therefore believe it better for the auditor to decide whether and, if so, how far to use evidence obtained from work by internal auditors, with two provisos: firstly that the external auditor should be able to seek guidance from the audit committee, which is best placed to understand the strengths and weaknesses of the company's internal audit function; and, secondly, that the external auditor remains solely responsible for its conclusions and so must feel able to place absolute confidence in the work of internal audit on which it relies.

**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?**

No. We believe auditor independence is important and that the quality of the audit product is enhanced by auditor independence. That said, a balance needs to be struck. We do not advocate changing auditor and/or audit partner too frequently as it can take some time for a new auditor/audit partner to fully understand the company such that the quality of audit is increased.

## Chapter 4: The scope and purpose of audit

### *Risk and internal controls*

**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?**

No. We believe the current requirements for a directors' statement on risk management and internal controls under the Companies Act, the UK Corporate Governance Code and the FCA's Disclosure and Transparency Rules, together with the FRC's related Guidance, are sufficient. These requirements are already quite extensive and it is difficult to see what further detail could be provided that would be useful.

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

No. The auditor reviews the effectiveness of the company's systems for risk management and internal controls that affect financial reporting, but the directors are, and should be, responsible for ensuring the accuracy of their statement on company's systems for risk management and internal controls – which can cover a wide range of topics.

**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?**

No. It is important that auditors are able to report all their findings and any concerns to audit committees in confidence. The audit committee comprises non-executive directors whose role includes to represent the interests of shareholders. Auditors need to be able to speak freely about any concerns they may have, whether or not there is any evidence of specific findings, so the audit committee can investigate such matters with management to either satisfy themselves concerns are unfounded or require action be taken. Requiring auditors to report publicly on any concerns over the effectiveness of internal controls expressed to the audit committee would result in unproven concerns not be expressed, with the potential for internal control failures not being identified and rectified by the company. If the audit committee fails to engage with concerns raised by the auditor, then the auditor should mention the matter in its report to shareholders.

## ***Going concern***

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

Yes. We believe the current regulatory framework relating to going concern fit for purpose. However, we would support the suggestions in the FRC March 2019 consultation on strengthening the going concern standard that “auditors more robustly challenge management’s assessment of going concern and thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement.” We would also support “a stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when the auditor draws their conclusions on going concern.” These would all appear to be examples of good practice, which probably already happen during the majority of audits.

### **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”?**

No, not if this means reporting publicly, but all identified “events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern” should be reported to the board immediately. If such events are not, or cannot be, addressed the existing requirement for this to be highlighted in the auditor’s report would apply. With regard to the FRC March 2019 consultation on strengthening the going concern standard, we see no reason why the audit report should not provide a conclusion on whether management’s assessment of going concern is appropriate, including setting out the work that the auditor has done in this respect.

## ***Viability***

### **Q17. Should directors make a statement about the sustainability of the entity’s business model beyond that already provided in the viability statement?**

No. The viability statement is the board’s assessment of the future prospects of the company, at the time the statement is made. This assessment is made on the basis of the company’s current business model which would be changed, if the board did not believe it was sustainable. We therefore do not believe any further statement on the sustainability of the business model is needed. Many unforeseeable events will occur after the viability statement has been published and, if an event impacted the company’s business model to the extent it was no longer sustainable, the board would need to respond quickly and revise its business model in response to these new events.

**Q18. Should such a statement be subject to assurance?**

No. We believe the current requirement for the auditor to read and consider the directors' explanation of the viability statement, in the light of the knowledge obtained during their audit, and determine whether they have anything material to add or draw attention to is sufficient.

**Q19. Who might be capable of giving such assurance?**

We believe the current viability statement is all that is required and the current requirements for the auditor to 'read and consider' are sufficient.

***Unaudited information***

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

No. It is for the board to report on the future prospects for the company, based on information available at the time the statement is made and this suggestion would simply substitute the auditor's business judgement for that of the board. All forward-looking information is to some extent unreliable because it cannot factor in unforeseeable future events that could impact the company. Forward-looking information can only be provided on the basis of what can be foreseen at the time the statement is made. It would be possible for an auditor to review the information on which the directors have based their judgment and confirm the information is correct, but the directors' business judgment on what this information indicates to them about the future prospects for the company is where differences of opinion may occur. This is not something that could be audited.

**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?**

No. Other areas of financial and non-financial information in the annual report frequently involve business judgments by the board. It is difficult to see how a reliable audit of these other areas could be carried out and we believe the cost would outweigh any benefit to users.

We believe it is important that auditing focuses on the benefit to shareholders. We would highlight a concern about the suggestion in paragraph 68 that reports on issues such as culture, ESG metrics, gender pay gap and payment practices could be audited as they are also important for key *stakeholders* of a business. We do not believe it is helpful to encourage stakeholders to believe that audit is carried

out in their interests as this contributes to the misunderstanding that has resulted in the 'expectation gap'.

It is also important to note a company's *stakeholders* include everyone the company has to consider when making decisions. Stakeholders vary considerably, and not all will have an interest in the continued success of a business. Many companies in sectors such as defence, the extractive industries or tobacco/alcohol will have pressure groups as stakeholders, who have no legal relationship with the company and whose aims will be to change the company's business operations for political reasons, or see the company fail. These objectives are at odds with those of shareholders for whose benefit the directors have to act and for whom the audit is being carried out.

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

As set out in our response to Q21, other information in the annual report frequently involves business judgments by the board, so we do not believe audit or other assurance would be useful and the cost would outweigh any benefit to users. We also do not believe it is helpful to suggest that information in the annual report should be provided for key *stakeholders* and it should not be audited for them.

**Chapter 5: Audit product and quality**

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

Yes. The value and quality of the audit product is of primary importance to companies and shareholders, who appoint the auditor, set the audit plan and pay the audit fee. A quality audit requires the skills of a competent auditor with the professional scepticism needed to identify potential issues and the audit committee needs to be comfortable that the audit partner and audit team have the necessary skills and expertise. The effectiveness of the audit process is a separate issue on which government and regulators need to agree. This review is a key input to that debate.

**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?**

We have no experience of this issue.

## ***Binary nature of audit and producer-led audit***

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

We can see the advantages and disadvantages of the binary audit opinion vs more graduated disclosure. On balance we think the clarity provided by the current 'pass or fail' test with the three types of modified opinion available if needed, to be preferable to graduated disclosure, particularly in the light of the more detailed extended auditor reports that are becoming increasingly common.

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

We believe that extended auditor reports already provide such insights. Additional information disclosed alongside the audit opinion should be received by the audit committee/board only. It is the board's role to oversee the management of the company and any action that needs to be taken as a result of receiving this additional information should be taken within the company. Disclosing this detail publicly would risk involving shareholders in management of the company. However, should the auditor identify a serious issue that is not being addressed by the company, the auditor can and should raise the issue with the regulator and, if necessary, publicly.

### **Q27. What would prevent such disclosures becoming boiler plated?**

We do not support routine public disclosure. The likelihood of boiler-plate reports is one reason for this.

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

We have not attempted to answer this question as we believe the audit profession is best placed to understand the issues, although we believe that a fundamental review of the purpose of audit and any associated changes to standards is overdue.

## Chapter 6: Legal responsibilities

### *Director obligations vs auditor obligations*

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

We believe that elements of ambiguity between company law and international accounting standards should be addressed and clarified (as suggested in paragraphs 83 to 86) so that legal and regulatory requirements are clear to both those preparing the financial statements and those auditing them. Clarity will benefit all parties. The role of the auditor should be confined to auditing material produced by the company and confirming that the company has complied with relevant law and regulations.

**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?**

With regard to addressing inconsistencies between company law and accounting standards, we would reiterate our comments in Q29 above. We believe clarity should be provided for those preparing the financial statements and those auditing them, and believe this should be sufficient to meet public expectations.

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

Yes. Once clarity over the legal and IAS positions has been resolved, there is no reason why figures for distributable and non-distributable reserves should not be disclosed.

**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?**

We have not attempted to answer this question as we believe the accounting bodies are best placed to explain auditing practice in this area. Feedback from companies is that auditors make considerable efforts to do so.

## **Chapter 7: The communication of audit findings**

**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?**

No. Shareholders approve the appointment of the auditor by resolution at general meeting and have the power not to approve the appointment for the coming year if they are in any way unhappy with the auditor. The auditor is also available to shareholders at general meeting if there is anything shareholders wish to discuss.

Opening this dialogue to anyone who reads annual reports and/or considers themselves to be stakeholders will cause a number of problems. It will lead to confusion over the reason for the audit, who it is for and what aspects of the annual report are the subject of the audit. It will exacerbate the existing problems with the audit 'expectation gap', with the public believing the audited company accounts are intended to provide assurance on all aspects of reporting for any member of the public who chooses to read the report and/or considers themselves a stakeholder. In this regard, please also see our comments about the differing nature of stakeholders in our response to Q21.

**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?**

No. We believe it is important that the auditor and the audit committee are able to have free and frank discussions in confidence, so that differences of opinion can be aired and judgments challenged. Once discussions have taken place, should the auditor remain concerned about judgments or any other element of the accounts, these should be made public as part of the audit findings. In many cases, the audit committee section of the annual report already discloses those areas where there has been discussion between the auditor and the committee, but such disclosure, which is to be encouraged, should be left to the discretion of the committee.

**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?**

Yes. It would seem appropriate that progress with any key audit matters featured in a previous audit report should continue to be reported until after the report confirms the matter has been concluded.

## Chapter 8: Fraud

**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?**

No. Users' expectations of an auditors' role in fraud detection will vary according to their differing levels of understanding of UK law and audit standards and in many cases the assumption will be that fraud will always be detected.

We do not believe that auditors should be given greater responsibility to detect material fraud. It is not possible to manage users' expectations if their expectations are out of line with law and standards, and all responsibility for fraud must remain with those committing an offence. This proposal would create an unreasonable responsibility on the auditor. However, we believe more could be done during an audit to identify potential fraud and we support existing proposals such as the suggestions that the auditor and audit committee discuss fraud risks and to increase awareness of potential indicators of fraud that may be identified during the audit.

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

We do not believe the problem lies with existing auditing standards. We believe an appropriate fraud detection mindset requires that the individuals carrying out the audit are sufficiently skilled and experienced, with the necessary level of professional scepticism.

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

Yes, possibly, but it should be called something different. This would seem an appropriate test in relation to the auditor's professional standards, based on level of qualification and experience but the test should be at a level reflecting the auditors higher level of expertise than the 'reasonable person' test common in law, hence the suggestion of a different name.

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

Yes, possibly. It would seem appropriate for this to be included as part on the auditor's review of a company's system of internal controls.

## **Chapter 9: Auditor liability**

**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?**

We have not attempted to answer questions 40 to 44 covering questions of auditor liability as we believe the accounting bodies are best placed to explain the impact of auditor liability on auditing practice. As a matter of general principle, however, we do not support the idea of limiting auditor liability.

## **Chapter 10: Other issues**

### ***Technology***

**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?**

We have no comments on Questions 45 and 46 as we have no experience of how new technology is being used within the audit profession. However, given that audit is often reliant on sampling, technology should enable the use of much larger samples, which in turn may enhance the quality of audit.

### ***Proportionality***

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

We have no examples to offer.

**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?**

We believe it is for companies to assess the value of the audit. Boards and, in particular, the audit committee understand the need to have an effective audit, limiting the potential of future corporate failure. Boards have an interest in obtaining reliable assurance that companies' financial statements are correct and in investigating any issues identified by the auditor.

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

Yes and no. We believe that the downward pressure on audit fees in recent years has compromised quality in an attempt to remain competitive. In our view the fees paid represent value for money but would suggest that, possibly, fees are too low. The focus should be on increasing audit quality whilst accepting fees may need to be higher.

**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?**

We believe it is important to focus on the benefits to the company and shareholders as users, rather than other stakeholders who could be a wide range of people with varying interests. Any extension of audit must demonstrate a need for the information to be audited for the benefit of shareholders, not just other stakeholders' wish to receive additional audited information that would add to costs without any benefit to shareholders. We would counsel caution over adopting some of the more radical options that will be put before you. Proportionality is key.

### ***Shareholders***

**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?**

We believe audit reports are read to some extent by shareholders generally, however we have no experience of automated processes used by major investors or any use of AI.

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

No. We do not believe there would be any demand for additional opportunities for interaction between shareholders and auditors, nor would it be practical or desirable. Indeed, some of our members have reported that few shareholders take advantage of opportunities to meet the audit committee or its chair. There is currently ample opportunity for shareholders to engage with auditors at the AGM and we have no evidence of shareholders experiencing difficulties in doing so if they wish.

**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?**

We do not believe it would be helpful or practical to involve shareholders in the planning or approval of the audit plan. Shareholders cannot have sufficient detailed knowledge of the internal management of the company to be able to make the necessary judgments. This would involve shareholders in management activities in an unacceptable way.

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

In addition to receiving audit reports, shareholders have the opportunity to speak to the auditor at the AGM. Shareholders are also responsible for approving the appointment of the auditor so can exercise their right not to approve the appointment if they are unhappy.

***Culture***

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

We do not believe it would be possible or desirable for auditors to report publicly on a company's culture. Assessment of a company's culture by an external party whose expertise is in auditing, not organisational culture, will be limited and somewhat subjective. We believe it is appropriate for discussions on the auditor's experience of culture to take place between the auditor and the audit committee. An organisation's culture is the responsibility of the board and, as such, auditor comment on culture will be welcomed by the audit committee and the board, to be taken into account along with all other information the board has on the company's culture.

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

We believe appropriate scepticism by the auditor can, and should, be demonstrated in the auditor's discussions with the audit committee and evidenced, along with the audit committee's work to satisfy itself of appropriate auditor independence and scepticism, in the audit committee report. It is key to the audit committee's confidence in the findings of the audit that the auditor can demonstrate that additional enquiries have been made in areas where the auditor has suspicions or concerns.

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

Currently, shareholders authorise the directors to set the fee for the audit by resolution at the AGM and that fee is reported in the annual accounts. We have no evidence that shareholders wish to have more involvement in audit fees or require additional information such as on the basis of individual auditors' remuneration. As with the scope of the audit and audit plan, we believe the directors are best placed to set the audit fee and understand the basis of individual auditors' remuneration.

**Cost**

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

Probably insufficient. We believe the downward pressure on audit fees has lowered quality. It has increased the time spent on audits by junior members of staff and reduced the level of involvement by an experienced auditor and the audit partner. We believe the overemphasis on the percentage of fees paid for non-audit services compared with the fee paid for the audit has resulted in insufficient attention being paid to the audit fee itself.

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

No. There is already sufficient disclosure to assess auditor independence, such as disclosure on the level of non-audit fees, and the make-up of audit fees is an internal matter for the company, with the necessary knowledge to judge whether it is appropriate.

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

Probably not. As discussed above, we believe the quality of audit has suffered due to the downward pressure on audit fees. We believe a realistic reassessment of the cost of audit would be welcome, together with an acceptance that fees may need to increase.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

**Peter Swabey**

Policy & Research Director