



Reputability LLP  
Adam House  
7-10 Adam Street  
London,  
WC2N 6AA

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## SUBMISSIONS TO THE BRYDON REVIEW INTO THE FUTURE OF AUDIT

### EXECUTIVE SUMMARY

We recommend the following.

1. Auditors' brief should extend to the truth and adequacy, including completeness, of the whole annual report, taking account of the latest governance standards and expectations, such as those set by the FRC.
2. Auditors and all of their related entities should be forbidden from providing non-audit advice to an audited firm or any related company.
3. Legislation should provide for Shareholders' Audit Committees. These should be composed of a wide cross-section of shareholders, including large and small shareholders, who have held their holdings for a minimum number of years.
4. Should they so decide any time, shareholders should have the right to institute a Shareholders' Audit Committee with the power to:
  - a. Select and dismiss auditors
  - b. Negotiate the terms of the audit contract
  - c. Direct the audit, including directing focus to any area of the Annual Report and Accounts thought to require particular attention.
  - d. Receive audit reports on behalf of all shareholders
5. Companies should have the power to bar from the Shareholders' Audit Committee any person who is reasonably believed to present a risk that confidential information acquired during the process might be shared or used for purposes that are against the long term interests of the company. This would include competitors and potential predators and their potential advisers.
6. Companies should continue to bear the cost of the audits.

## BACKGROUND

Reputability LLP is a consultancy and think tank specialised in governance, particularly from the perspective of reputational, behavioural, organisational and leadership risk. You can read more at [www.reputability.co.uk](http://www.reputability.co.uk). We have written extensively on subjects in this field, as you can see at [www.reputabilityblog.com](http://www.reputabilityblog.com) and <https://www.reputability.co.uk/#publications>

The author of this note, Anthony Fitzsimmons, is Chairman of Reputability and lead author of *“Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You”*.

We have taken as our starting point that your 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.”*

## INTRODUCTION AND DISCUSSION

In the first edition of his seminal book ‘The Intelligent Investor’ Benjamin Graham devoted 30 pages to *“The Investor as Business Owner”*. Two linked insights remain relevant today and are relevant to the future scope of audit.

Graham first insight contrasted the theory of shareholder rights with reality. He saw shareholders as notionally “king” with the power to “hire and fire managements and bend them completely to their will”. In practice he saw them as “a complete washout”. *“As a class they show neither intelligence nor alertness. They vote in sheep-like fashion for whatever management recommends and no matter how poor the management’s record of accomplishment may be.”*

The ability of ultimate shareholders to influence management has diminished. Most individually owned shares are held through nominee accounts that, in practice, disenfranchise shareholders. Managers of collective investments provide patchy stewardship.

Private shareholders could easily be re-enfranchised by legislation and technology. A resurgence of individual shareholders at AGMs would help boards to focus on public perceptions and the penetrating questions that astute shareholders ask. Savvy shareholders can force focus on shortcomings sitting in boards’ blind spots.

Turning to fund managers, the UK Stewardship Code is inadequate because it is voluntary and has limited scope. The Financial Conduct Authority should develop robust rules that force institutional investors’ incentives and behaviour into alignment with the interests of their ultimate clients, such as retail investors and future pensioners most of whom seek steady long-term growth. To support this, legislation,

not just the UK Corporate Governance Code, should make it the unambiguous primary duty of directors to promote long term sustainable success. Striving for the long term easily makes the company prey for corporate raiders seeking short-term profits. It is therefore logical for voting power to be aligned with duration of shareholding, giving full voting power only to long term investors.

That leaves a fundamental question: how can good stewards get the information they need to do their job properly?

The answer ought to be through informative company reports. The FRC has made good progress on company reporting requirements but the scope and quality of information provided in Annual Reports depends on management openness. This sometimes seems to be in proportion to management competence.

Extending the scope of audit to the whole annual report will help ensure the accuracy of information provided. But it will not solve the problem of inadequate or absent information.

For those who can see through corporate spin and market groupthink, it is not difficult to identify companies from which more information is needed. Graham suggested investigating those whose return or profit margin has persistently lagged their peers and those who have lost market share. He also highlighted the importance of management competence. This is a crucial tell-tale of future failure, along with leadership characteristics such as CEO arrogance, hubris and dominance and boards that lack the skills needed to appoint and manage a CEO and to oversee the business.

Graham's second insight is relevant here. He proposed that shareholders of *"underperforming"* companies should be able to *"call in outside business engineers to pass upon the policies and competence of the management"*. These outside experts would be *"selected by an independent committee of stockholders"* with the report *"submitted directly to stockholders"* and the cost borne by the company.

Auditors could fill much of this role. The Big Four's move away from calling the firms they audit 'clients' is a start but insufficient because their appointment and tenure depend on the auditee's board. They have powerful incentives not to rock the board's boat. The parallel trend, away from providing other services to audit clients, is helpful but too modest.

The solution we recommend is for this Review to follow the direction recommended by Graham.

Legislation should give shareholders the right to create an independent Shareholders' Committee of shareholders large and small. Such a committee should have powers, should they decide to use them, to appoint the auditor, to direct the audit and the investigation of any murky corners (including leadership competence), and to receive reports on behalf of shareholders. When this right has been exercised Boards will still prepare the accounts and annual report, but they will be audited by an entity that owes allegiance only to shareholders.

This should also help to remove the perverse incentives under which the audit profession has laboured for too long, allowing auditors to use their professional skills and judgement to the full. It should also help stem the steady stream of predictable, avoidable corporate failures.

## RECOMMENDATIONS

We therefore recommend the following.

1. Auditors' brief should extend to the truth and adequacy, including completeness, of the whole annual report, taking account of the latest governance standards and expectations, such as those set by the FRC.
2. Auditors and all of their related entities should be forbidden from providing non-audit advice to an audited firm or any related company.
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6. The companies should continue to bear the cost of the audits.

We will be happy to elaborate on this note should the need arise.

*Anthony Fitzsimmons*

Anthony Fitzsimmons  
Chairman  
For and on behalf of  
Reputability LLP  
[www.reputability.co.uk](http://www.reputability.co.uk)  
[www.reputabilityblog.com](http://www.reputabilityblog.com)

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<sup>i</sup> The Intelligent Investor, First Edition (1949) page 217