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Dear Sir or Madam

### Independent Review into the Quality and Effectiveness of Audit: Call for views

Thank you for the opportunity to comment on the Independent Review into the Quality and Effectiveness of Audit.

We have three essential points to make:

- we are generally supportive of the points raised by Sir Donald Brydon;
- the background against which he has been tasked with making recommendations has been covered before<sup>1</sup> and conclusions reached then are still in point; and
- failure to effect change now will only perpetuate the same public disquiet in the near future,

and have responded only to those Questions which we felt were either the most important or in relation to which our experience lent an answer.

Yours faithfully



Jonathan Ericson  
Head of Audit

## RESPONSE TO DETAILED QUESTIONS

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

#### Question 1 - For whose benefit should audit be conducted?

Auditors are appointed by the shareholders usually following the recommendation of the directors, and the independent audit is performed for the benefit of the shareholders. but "[b]oth auditors and directors of companies have focused on a relatively narrow interpretation of the statutory duties of auditors as laid down in company law"... and the consequence has been that "the present scope of the audit and the legal framework in

<sup>1</sup> See, in particular, *The Future Development of Auditing – a Paper to Promote Public Debate*, the Auditing Practices Board, November 1992.

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contd.

which it is conducted militate against auditors successfully meeting the needs of shareholders and others with an interest in the audit process"<sup>2</sup>

The issue to be resolved is (i) which interests the audit should serve and (ii) how serving them can be done proportionately – the emphasis should be on effecting change in relation to the systemically important and other, large-scale, companies (the Public Interest Entities) and having regard to the fact that "a great deal of auditing today is performed effectively and to a high standard"<sup>3</sup>.

#### ***How is it of value to users?***

The value that users derive from an audit is a function of the auditor's technical competence and independence from management.

#### ***Question 3 - 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?***

Consistent with the points we made at the start of our response, change in the legislative framework within which audit works is likely inevitable but should be calibrated in a proportionate way and focused on the largest entities where the range of shareholders and associated interest groups is more disparate than smaller entities, which are often owner-managed and/or individually insignificant to the sustainability of the capital markets.

#### **Chapter 2: The 'expectation gap'**

##### ***Question 4 - Do respondents consider there is an expectation gap?***

YES

##### ***Question 5 - If so, how would respondents characterise that gap?***

Users of financial statements, however they are defined, are demanding far more assurance over a wider number of areas than the current ISA audit is designed to provide. Often users have unrealistic expectations and want more assurance than auditors are both able to and are prepared to provide.

In our view, it is more purposeful to focus on the ends that audit might usefully meet than how the gap can be articulated: the audit should provide an independent opinion to those with an interest in the company that the auditor has received from management an "adequate account of the proper conduct of the company's affairs, the company's financial performance and position at a certain date, and future risks attaching to the company"<sup>4</sup>

##### ***Question 6 - 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

Our response to Question 5 refers.

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

##### ***Question 7 - What should be the role of audit within wider assurance?***

This is not a question the answer to which can be determined solely by reference to *auditors'* duties: a statutory means should be created of identifying those users whose interests should be recognised in financial information issued by *management*; and how the audit report might be reconciled with those interests.

We are supportive of a model whereby the mandatory true and fair audit requirement for shareholders is supplemented by other assurance engagements that provide levels of assurance and assessment of future risks that are more suitable to the demands of other users.

<sup>2</sup> Ibid, page 1.

<sup>3</sup> Ibid, page 4.

<sup>4</sup> Ibid, page 5.

**Question 8 - 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?**

The Review should keep in mind the need for its recommendations to be proportionate in themselves and to bring about only proportionate change to the legislation and regulation affecting audit.

**Question 11 - 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

Independence is a key requirement for external auditors and in our view it is not something that should be compromised.

#### **Chapter 4: The scope and purpose of audit**

**Question 12 - Should directors make a more explicit statement in respect of risk management and internal controls?**

YES

We are supportive of directors making a more explicit statement in respect of risk management and internal controls. The Sarbanes-Oxley regime in the USA increased directors' responsibilities relating to the maintenance of internal controls and the preparation of company accounts and has led to stronger internal controls in those companies where the Sarbanes-Oxley requirements apply. Directors in the USA are now much more accountable for the internal controls in their organisations and this has helped to improve confidence in these companies.

We understand that the Department for Business, Energy and Industrial Strategy intends to consult on the potential for introduction in the UK an equivalent of the US SARBOX regime and we would support such an extension.

**If so, should such a statement be subject to audit?**

YES.

**Question 13 - Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?**

YES

**Question 17 - Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?**

YES

Although the usefulness of current viability statements has been questioned, in our view it would be helpful for directors to make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement. It is unclear whether the review is suggesting that the viability statement should be expanded to include sustainability or whether there two separate statements would be required. Whatever approach is adopted it would need to be explained otherwise users will not understand the distinction between viability and sustainability.

**Question 20 - Is there a case for a more forward-looking audit?**

YES

Although auditors cannot predict the future in the abstract and auditors have no access to special or additional information that management does not already have, we believe that there is a strong case for a more forward-looking audit. As the 1992 paper put it, "[I]t is reasonable to expect directors to respond to expectations that an



unbiased commentary on future prospects is given, and auditors to take on some role in warning shareholders or other stakeholders of substantial future risks"<sup>5</sup> in a statement separate from the audit report.

***What would be the main benefits and risks?***

Society's expectations of directors' conduct and their accountability have changed and the role of audit would be seen to have developed to reflect that change but the main risk is that change is not proportional to cost and benefit.

**Chapter 5: Audit product and quality**

***Question 28 - To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?***

The development of professional standards of all kinds is almost inevitably producer-led. The difficulty with it is a top-down and incremental approach to it when more collaborative are more likely to be fruitful.

**Chapter 6: Legal responsibilities**

***Question 29 - 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?***

Issues around capital maintenance should become matters for the auditor to examine only in relation to heavily risk-weighted ventures (infrastructure and other capital intensive businesses, for example), and then only in relation to the accuracy of the financial statements, not the annual report.

Prudence is not as current a concept in auditing as it should be: it should be brought to bear purposefully in relation to company expenditure and distributions related to capital maintenance (and net investment and work-in-progress), and linked to judgements about risk and net cash flow.

***Question 32 - How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records?***

Auditors are currently required by the companies act to report by exception when adequate accounting records have not been kept by the entity.

***Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?***

NO

In our experience, unless the auditor is faced with a limitation of scope that is material enough to require a qualification, it is rare for auditors to report by exception that adequate accounting records have not been kept by the entity. The existing requirements set a fairly low bar for adequate accounting records and it is an area where a change in company law would be required to improve reporting.

**Chapter 8: Fraud**

***Question 36 - Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards?***

NO

ISA 240 acknowledges that, "owing to the inherent limitations of an audit undertaken in accordance with current practice, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed..." but this 'reasonable expectation' provision is uncertain in application to different circumstances, and the term 'fraud' too generic to be able to be applied to all kinds of misrepresentation or illegal acts by management.

<sup>5</sup> Ibid, page 7.

contd.

***If not, should auditors be given greater responsibility to detect material fraud?***

The greater the degree of accountability expected by the public of the management of Public Interest Entities, correspondingly the expectation on auditors will increase but we believe that in that event there should be an explicit emphasis on the expectation on the *internal* audit function, not the external one.

***Question 37 - Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?***

YES

We consider existing auditing standards do help to engender an appropriate fraud detection mindset on the part of auditors. However, professional scepticism is key to fraud detection and improvements can be made to ISA 240 to better incorporate professional scepticism and improve the fraud detection mindset this engenders.

**Chapter 9: Auditor liability**

***Question 41- If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?***

Additional statements by the auditors such as future risks should be covered by a limitation of auditor liability in respect of those statements.

***Question 42 - 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?***

We support this question being remitted to the Law Commission. Associated questions – the operation of the joint and several liability principle, and proportional liability – could usefully be remitted to the Law Commission as well.

**Chapter 10: Other issues**

**Questions 49, 50 and 54**

- ***Question 49 - Does today's audit provide value for money?***
- ***Question 50 - 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?***
- ***Question 54 - What assurance do shareholders currently obtain other than from audit reports?***

No response is offered as these questions should be answered by shareholders and users of financial statements.

***Question 56 - How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?***

We recognise that professional scepticism is an essential part of any audit but demonstrating that appropriate scepticism has been exercised in reaching the judgments underlying the audit report is not very easy or practicable to do. As stated in our response to question xx above we are in favour of the graduated audit report model and believe that the greater freedom this offers auditors to report on key audit matters and areas that they consider to be important would allow auditors more scope to communicate where they have been sceptical and challenged their clients.

**Questions 57 to 59**

- ***Question 57 - Should the basis of individual auditors' remuneration be made available to shareholders?***
- ***Question 58 - Do respondents view audit costs as generally too high, about right or insufficient?***

contd.

- **Question 59 - Would users of financial statements wish more detail on the make-up of audit fees?**

No response is offered as these questions should be answered by shareholders and users of financial statements.

**Question 60 - Is the profitability of the audit function sufficient to sustain a high-quality audit industry?**

YES

In our view the profitability of the audit function currently sustains high-quality audits.