

# Sarasin & Partners submission to Brydon Review into the Quality & Effectiveness of Audit

14<sup>th</sup> June 2019

## Introduction<sup>1</sup>

Audit is, above all, vital to the public interest. Andrew Tyrie, Chair of the Competition and Markets Authority, captured the audit's critical but largely invisible role with this comment:

*"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".*

Precisely so. The auditor is equivalent to a structural engineer checking there are no leaks that might destroy a dam or impinge on the integrity of a bridge. It is only when audit fails that we notice. And the consequences of failure can be devastating for staff, suppliers, customers and millions of people that have placed their savings in the audited companies' shares or debt.

Recently, we have been noticing more failures. And too often they appear to have been failures that might have been avoided or ameliorated by earlier intervention by the auditor and those they could have alerted to problems.

The Government's decision to launch an Independent Review into the quality and effectiveness of audit is thus both timely and urgent, and Sir Donald Brydon's commitment to propose action – rather than further reviews – is likewise welcome. There have already been numerous reviews of audit and many have highlighted potentially systemic and serious failures, harmful to the public interest<sup>2</sup>. It is time to make audit work for shareholders and the public.

It is also right that this Review starts from the beginning. The Government needs to decide on behalf of the public what exactly the audit is there to do. Only then can we ask whether this purpose is being achieved.

## Who is audit for?

First, it is important to be clear who the audit is for. Ultimately audits must support the public interest. To do this, they should be directed towards providers of capital – shareholders and creditors – in a way that supports long-term stewardship. Auditors write their opinions today for "the members" of a company (i.e. the shareholders), but most observers would accept their broader responsibility. Indeed, all the large audit firms have their own "Public Interest Committees / Boards" to help keep them live to their public interest roles.

## Going "back to basics" must start with protecting capital

If it is accepted that the auditors owe a duty of care to the public, and that this is delivered through the provision of assurance to shareholders and creditors, the Review needs to look back to look

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<sup>1</sup> We attach a more detailed investor position paper, signed by 14 investors and pension trustees, "Investors and the public need to know whether profits and capital are real" (June 2019), which forms part of this submission. This submission also builds on other recent submissions to which we refer, notably our submission to the BEIS Select Committee inquiry into "The Future of Audit" (January 2019); submission to the Kingman Review (2018); submission to the CMA investigation into Audit (2018).

<sup>2</sup> Since the Financial Crisis, examples in just the UK include the House of Lords Economic Affairs Committee inquiry into audit in 2012; the Parliamentary Commission on Banking Standards in 2013; the UK Competition Commission's inquiry into the audit market in 2013/4; Parliamentary BEIS Select Committee inquiry into the Future of Audit 2018-19; and the Competition and Markets Authority review of the audit market 2018-19.

forward. The importance of the market-wide function of audit was well understood by the architects of our system of company law. This has been built on over the years but has never fundamentally changed. Nor should it.

Our Companies Act remains a strong document, setting out in clear terms what the duties of auditors are and, in particular, their responsibility to not just follow a set of accounting standards, but to form a view as to whether the accounts that directors produce are “true and fair”, and also whether the dividends companies propose to pay are legal. The latter sits at the heart of the UK’s capital maintenance regime. Where a proposed distribution is to be paid out of a company’s paid-in capital, this is illegal as it could threaten the solvency of the entity, and it is the auditor’s responsibility to sound the alarm.

These should not be process-based judgements that ignore outcomes, but hard calls on capital strength. Audit should not just be about ticking boxes; its core purpose is to protect capital. This is where, in our view, auditors are falling short today. Auditors have effectively lost sight of this core purpose as prescribed in the Companies Act.

Auditors like to highlight an “expectations gap”, which refers to the fact that the public misunderstands the auditor’s role, and worse still overestimates what auditors can do. In our view, this characterisation is not just self-serving, but flawed. The problem is not one of expectations; rather we have a grave “delivery gap” when it comes to audit.

### **Individual auditors may be diligent, but they are following the wrong rules**

This is, of course, not to say all is rotten with audit. Most auditors are professional, hard-working and diligent. The central problem is that they are following the wrong rules<sup>3</sup>.

Rather than ensuring strict adherence to restrictions on distributions out of capital, and thus a prudent approach to accounting for both realised revenue as well as foreseeable losses/liabilities (whether or not they can be easily measures or timed), auditors’ focus appears to have been almost entirely on whether international accounting standards (IFRS) are being properly applied. The problem is that following IFRS cannot be relied upon to deliver adherence to the law<sup>4</sup>.

Moreover, there is little evidence that the capital maintenance regime is being enforced: there are no explicit assurances provided to shareholders on this, and there have been company failures like Carillion that have happened soon after dividends have been paid. Also, where companies have found they have paid illegal dividends, it has (as far as we know) never been discovered by the auditor<sup>5</sup>.

### **Why might auditors have forgotten about capital protection?**

How this might have happened requires a detailed analysis of how auditors have interacted with regulators and policy-makers over the years. There are plenty of academic and investigative papers that delve into the political economy of audit – and this submission does not review these<sup>6</sup> – but we would make three salient points:

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<sup>3</sup> There are other problems, of course, notably linked to pervasive conflicts of interest and threats to independence. The point here is that even if those structural problems are addressed, we won’t improve audit quality until the question of purpose is addressed. Please see other concerns outlined in our submissions to the CMA, The BEIS Select Committee’s inquiry into “The Future of Audit”, as well as our submission to the Kingman Review.

<sup>4</sup> Our attached Position Paper “Investors and the public need to know whether profits and capital are real” (June 2019) elaborates this point, as do two legal opinions produced in 2013 and 2015 by George Bompas QC.

<sup>5</sup> See investor position paper “Investors need to know whether profits and capital are real”, June 2019 for examples.

<sup>6</sup> A recent example that documents in detail instances of apparent regulatory capture is provided by Richard Brooks, “Ben counters”, 2018.

- Auditors appear to have been extremely influential in shaping international accounting standards (IFRS) – as well as the endorsement process employed in the European Union – which are applied in the UK today<sup>7&8</sup>.
- The audit industry has long lobbied in favour of re-writing UK company law to align with these accounting standards, over which they had considerable influence. Indeed, they still do today<sup>9</sup>. They argue for the UK to abandon “complex” and “outdated” capital protection rules that place excessively “rigid” limits on dividends.
- In the meantime, representatives of the audit industry have sought to conflate the Opinion required on whether accounts provide a “true and fair” view according to the Companies Act, with the separate Opinion they must provide on adherence to accounting standards<sup>10</sup>. These are in fact distinct, and two legal opinions provided by George Bompas QC in 2013 and 2015 set out why they must remain distinct, since the true and fair opinion is tied to adherence to the capital maintenance regime, not IFRS.

A deeper reason as to why auditors would wish the UK to abandon the capital maintenance regime could be because these rules demand an absolute judgement around accounts being true and fair and dividends being legal, rather than a view on whether the process (adherence to standards) has been followed. This requirement to form a view on the accounts might be viewed as increasing legal risks for auditors, and thus something they would naturally like curtailed.

Whatever the reason, it appears today that the audit industry is not implementing the capital maintenance regime with sufficient rigour, if at all. This needs to be addressed urgently, as was clearly highlighted by the BEIS Select Committee’s final report on “The Future of Audit” in April.

## **To conclude**

We believe that it is auditors’ failure to check directors’ adherence to the capital maintenance regime that explains more than anything else what is going wrong with audit today. Auditors have, put simply, lost sight of their core purpose to protect capital.

There are, of course, other failures also, many of which we have made submissions or public statements on, and which are being considered by this Review or related reviews (e.g. CMA’s review of market structure and Sir John Kingman’s review of the FRC). However, until we address the question of what the audit is for, and – in our view – reaffirm the centrality of capital maintenance, we will not set the UK on a path towards a more resilient and sustainable business sector. Given the significant geopolitical, economic and environmental uncertainties facing the UK today, this is more urgent than ever.

In what follows we provide more detailed answers to specific questions set out in the Call for Views. The core of our submission, as noted, is found in the attached investor position paper “*Investors and the public need to know whether profits and capital are real*” (June 2019).

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<sup>7</sup> See the European Parliament’s Own Initiative Report on governance weaknesses at the International Accounting Standards Board and specifically concerns over the excessive influence of the Big Four audit firms as well as flaws with the disconnect between IFRS and capital maintenance rules in the EU: [http://www.europarl.europa.eu/doceo/document/A-8-2016-0172\\_EN.html?redirect](http://www.europarl.europa.eu/doceo/document/A-8-2016-0172_EN.html?redirect)

<sup>8</sup> Sir John Kingman’s 2018 review highlights related problems with the regulator, the Financial Reporting Council (FRC), being too close to the industry and the urgent need for reform.

<sup>9</sup> See the ICAEW Chief Executive’s recent evidence to the BEIS Select Committee in Jan / Feb 2019

<sup>10</sup> The conflation of the legal true and fair standard with adherence to accounting standards is evident, for instance, in ISA 200, which links the two by referring to “...give a true and fair view in accordance with the framework.” But, as noted in the Call for Views, the UK’s true and fair requirement takes primacy over the accounting framework.

## 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?**

As noted in the introductory statement, we believe the audit should be first and foremost for the public benefit, and therefore designed to promote responsible long-term business conduct and investment by ensuring directors produce accounts that comply with the UK Company Law, including the capital maintenance regime.

The immediate audience for the audited accounts are shareholders and creditors, whose capital is tied up in a business and who are tasked with holding directors to account. Audit should not seek to facilitate trading by providing a “market value”, but should underpin long-term stewardship by providing a prudent (not overstated) view of capital and performance. In this sense, we do not believe auditors should concern themselves with the requirements of short-term traders in the market, but focus – as described – on their core purpose in capital protection as this fulfils a public interest goal.

This means auditors should ensure foreseeable losses/liabilities are properly accounted for (e.g. pension liabilities; legal liabilities; climate-related losses/liabilities), so the company does not knowingly under-provide and thus put itself, and its shareholders, in a situation where it cannot meet foreseeable cash demands.

We believe this is already the legal standard as set out in CA06 Part 23 s839, 840 and reinforced elsewhere.

#### **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?**

As already highlighted, we believe the UK’s Companies Act 2006 remains a strong document in relation to accounts and audit. Several sections of the Companies Act explicitly set out responsibilities for auditors as well as directors as they pertain to accounts. For instance, Part 23 of the Companies Act 2006 deals with rules linked to distributions. This is a core purpose.

The problem, in our view, is not the law, but the lack of enforcement and the need for clear Government-approved guidance for implementation.

Most importantly, requirements relating to director and auditor duties under the capital protection regime appear not to have been upheld. This may be partly due to pervasive weaknesses at the regulator, the FRC, as documented in our and others’ position paper “Investors require a robustly independent audit regulator” (October 2017) and subsequently detailed in Sir John Kingman’s report into the failures at the FRC (Dec 2018).

The failures help explain why the regulator seems to have failed to properly and independently check industry Guidance (TECH02/17) for implementing the key capital maintenance provisions under Company Law. As detailed in our attached paper “Investors and the public need to know whether profits and capital are real” (June 2019), this Guidance appears to be misaligned with the intent of Company Law, and yet is widely followed by directors and auditors as if it were government guidance.

So, in summary, we believe it is most urgent that the government:

- Take ownership of the Guidance for how directors and auditors should be implementing the capital maintenance regime. The existing industry guidance should be replaced, and independently verified.
- Ensure this guidance is properly enforced by an independent regulator, ARGA.

The first step can be initiated immediately. We do not believe either step requires changes to existing statute, and would be cautious about such a move given the risk that the audit industry would be in a position to apply disproportionate pressure for changes that benefit auditors, but not the public. The ICAEW's stated goal, for instance, has long been to align the rules around dividend restrictions with accounting standards to reduce "complexity" and excessively "rigid" rules on dividends<sup>11</sup>.

Please also refer to Sarasin & Partners submission to the BEIS Select Committee review of the "Future of Audit" (Jan 2019).

## Chapter 2: The 'expectations gap'

**Q4. Do respondents consider there is an expectations gap?**

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

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

We take these three questions together. Please also refer to the introduction.

We have long considered the characterisation of problems with audit as arising due to an "expectations gap" as wrong-headed. The audit industry has tended to frame the problem in this way, thereby steering any investigation towards how to 'fix' people's expectations, rather than fixing audit quality. Put simply, the subtext of the "expectations gap" is that expectations are wrong, not the audit.

We reject this proposition, and believe it has for too long diverted attention away from the failures with audit. There is an 'audit quality gap', or as the BEIS Select Committee described, a 'delivery gap'.

The starkest evidence for this delivery failure is the damaging company failures in recent years, several of which were arguably permitted by lax accounting, and thus weak audits.

It is widely accepted, for instance, that more prudent accounts focused on protecting capital at banks would have revealed weaker capital positions and thereby prevented (or at the very least brought out more clearly and earlier) the level of risk-taking that occurred in the years leading up to the financial crisis. This is a key reason the G20 tasked the accounting standard setters IASB and FASB with revising loan loss provisioning rules that were perceived to leave out foreseeable losses embedded in the loan books.

Whatever the accounting standards, however, our view is that audited accounts should never have left out foreseeable losses due to the legal requirements linked to capital protection. The fact that standards permit such omissions does not recuse directors and auditors from following the capital maintenance rules.

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<sup>11</sup> Please see ICAEW, Briefing Paper "Implications of IFRS for Distributable Profits", 2005 and the more recent oral hearing with the head of the ICAEW, Mr. Izza, on 5 February 2019: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/oral/96157.pdf>

The same is true of how companies approach asset impairments, e.g. goodwill, legal liabilities, etc. Likewise, on the income side, whatever the revenue recognition standard is under IFRS does not remove the requirement for directors and their auditors to track what has been realised in cash or near cash versus what is anticipated.

Our submission to the BEIS Select Committee (Jan 2019) and attached Position Paper provide more detail on why we believe audit is failing to live up to requirements to protect capital.

Essentially, we believe that auditors are central to ensuring directors fulfil their legal duties not to distribute out of capital, and auditors have explicit duties in this regard (Part 23, CA06). This is implemented through the auditing of published company accounts that deliver a “true and fair” view of the underlying capital strength and performance of the business.

Auditors must produce a written Opinion on whether the accounts meet this test. This Opinion is separate to their Opinion on compliance with accounting standards. They are not the same thing. The true and fair test is linked to adherence to capital maintenance regime requirements that prohibit overstatement by: 1) requiring that only realised profits are included in the published accounts; and 2) all unrealised and foreseeable losses/liabilities are treated as realised and included. In other words, the published and audited accounts must be prudent to then provide a basis for legal dividends to be determined.

We see little evidence that auditors are implementing these requirements. For instance:

- The published accounts for both parent and group rarely (if ever) split out realised from unrealised profits;
- It is uncommon to have much detail in the accounts on non-distributable capital;
- There is no disclosure of what additional work has been undertaken to justify the second Opinion on meeting the true and fair requirement;
- Auditors appear to presume the true and fair standard is met as long as IFRS are adhered to (made worse by the FRC’s faulty guidance on the meaning of “true and fair”);
- Auditors at times point to “optimistic” assumptions in the accounts which they permit because they argue that as long as they are “reasonable” they have no grounds to force management to take a more prudent view (e.g. Deloitte comments on the optimistic discount rate assumption used in calculating Tesco’s pension liability in their 2017 Annual Report, which led to a substantial reduction in the reported pension liability); and
- In companies that have notified shareholders that an illegal dividend was paid, this was never uncovered by the auditor.

### Chapter 3: Audit and wider assurance

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

We are open to the auditor providing broader assurance, especially around the statements in the ‘front-end’ of the Annual Report and Accounts, which includes non-financial disclosures. We do not see a conflict where the auditor’s responsibility remains clearly to protect the public and shareholders, and as such committed to applying professional scepticism to ensure these disclosures are prudent and true.

Indeed, often the so-called non-financial disclosures have a material bearing on the reported accounts, which it will be important for the auditor to consider. We have specifically been calling for auditors to ensure they consider companies’ exposure to climate risks, such as those that come with

decarbonisation, as part of the audit<sup>12</sup>. Currently, most companies are looking at these disclosures as part of their non-financial reporting, but they have the potential to be financial, and materially so.

Turning to forward-looking statements, there could be a role for the auditor to ensure the statements are rooted in a true and fair view of the company's current position, taking into account foreseeable losses/liabilities. It is not clear to us that the current "consistency" requirements makes this sufficiently clear, or how the auditor would flag to shareholders any inconsistency that they identify.

This links to the need for more detailed and graduated auditor reports to shareholders dealt with later.

**Q.10 To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?**

We would expect the auditor to consider evidence from internal audit as part of their review of the company's financial controls. We would have concerns, however, if the auditor presumed this data was correct and relied upon it without proper checks.

**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?**

Independence in audit is essential. If anything, according to evidence gathered by the CMA, we continue to see insufficient emphasis on independence, with Audit Committees favouring 'chemistry' and auditors' ability to get along with key executives over their willingness to challenge those executives. We need more emphasis on independence, not less.

Greater independence from the audited entity is important to audit quality. As already noted, auditors appear to be failing to follow rules on capital protection and this has harmed audit quality. With the right rules reinstated, ensuring demonstrably independent auditors will be vital. For this reason we have supported the creation of pure audit firms, as detailed in our latest submission to the CMA.

In terms of innovation, the problem is arguably too much innovation, or at least the wrong sort of innovation. Audit firms have massively expanded the depth of their relationships with auditee companies. Even with new rules governing limits on non-audit work, audit firms are continuing to foster these relationships but often phasing the audit and non-audit work so they do not overlap.

What is needed is for innovation to be tailored towards the needs of the public and shareholders. New ways to proactively spot aggressive accounting or fraud, or to ensure accounts are reflecting upcoming economic headwinds would likely improve audit quality. One example could be for the audit firms to institute regular and public meetings with shareholders to ask them to outline key problems they see with the accounts, so they can build these factors into future audits. Where a company is being shorted, auditors could research whether weak accounting is part of the identified problems. Likewise, better and clearer reporting by auditors to shareholders would be a further welcome innovation.

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<sup>12</sup> Please see our report N. Landell-Mills, "Are oil and gas companies overstating their position?", August 2018, which outlines potential deficiencies in oil and gas companies accounting assumptions linked to a failure to reflect material downside risks to oil and gas process from the energy transition. A group of investors have written to the large audit firms in the UK to set out expectations that auditors consider climate-related risks in their audit process as they would any other factors that could materially impact the true and fair view opinion.

## Chapter 4: The scope and purpose of audit

### **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?**

We are not experts on internal control rules, but there appears to be a major problem of enforcement when it comes to internal controls linked to tracking distributable reserves and profits, and preventing illegal dividends.

Directors have legal duties to affirm that the financial statements presented to shareholders are “true and fair” and also to ensure dividends are not paid out of capital. Both statements require strong internal controls. Auditors likewise have a duty to form an independent opinion as to whether these statements are reliable and illegal dividends are not paid. *Caparo Industries plc v Dickman* [1990] sets this out clearly. Auditing standards (ISA (UK) 250A) also make clear auditors’ responsibility to check whether laws and regulations have been followed as far as they would have a material bearing on the accounts<sup>13</sup>.

There are clearly requirements already for directors and auditors to make sure companies’ internal controls are robust. It would seem, though, that implementation may not be sufficient. We are aware that some academic work suggests that requiring an explicit statement on risk management and internal controls has focused minds in the US, and mandating an audit of this statement would arguably do the same for the auditor. We would therefore be supportive of such a requirement as a tool to ensure effective enforcement of existing laws and regulations linked to our accounting and capital maintenance regime.

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

As per the response above, as long as this requirement is consistent with and reinforces existing laws and regulations related to internal controls and capital protection, this could be helpful.

### **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?**

The auditor works, ultimately, for shareholders, who have a direct vote on their appointment. Consequently, we would support more detailed disclosure in several areas, including on internal controls. As we pointed out in our introductory comments, the current silence from auditors on whether or not dividends are legal, and how they came to form a view that the accounts meet the true and fair standard as distinct from complying with accounting rules reduces the value of the audit.

Not only would better disclosure reassure investors that the necessary systems are robust, but it would provide more information for shareholders to both judge the quality of the audit, but also directors. This is essential if our system of accountability through shareholder voting for directors and auditors at AGM’s is to be effective.

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<sup>13</sup> ISA(UK) 250A (Revised June 2016) “Considerations of laws and regulations in an audit of financial statements” sets out in general terms the auditor’s responsibilities in respect of laws and regulations. Para 13: “*The auditor shall 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.*” The standard refers explicitly to dividend rules in paragraph A8: the auditor must “determine the circumstances under which a company is prohibited from making a distribution except out of profits available for the purpose”.



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

Again, we believe that the law is appropriate, but not being properly enforced due to misaligned accounting standards and faulty regulation.

To form a Going Concern judgement it is essential that directors and auditors have clarity on true capital strength, and this means being able to differentiate between distributable and non-distributable capital. Non-distributable capital is lower quality because it has an element of uncertainty attached to it, e.g. due to it having not been realised or due to foreseeable loss/liabilities that would impinge on its ability to absorb losses.

As noted in the introductory remarks and the attached investor paper (“Investors and the public need to know whether capital and profits are real”, June 2019), Part 23 of the Companies Act 2006 requires the calculation and disclosure of non-distributable reserves. This is necessary to track the legality of dividends (which cannot be paid out of capital), but also to provide reassurance over capital strength – and thus the going concern basis for accounting.

The problem is that this does not appear to be being implemented. This is at least what recent corporate failures, from BHS to Carillion, to Interserve and London Capital & Finance, suggest. It may well have also played a role in the failure to see impending solvency problems at the banks in the Financial Crisis. It is also a reasonable explanation for recent self-declared illegal dividends from, for instance, Dominos Pizza and Keyword Studios. In neither case did the auditor identify the problem, which suggests they were not tracking the level of distributable reserves.

Three reasons these critical capital protection rules may not be being implemented are:

- 1) IFRS do not require the calculation or disclosure of realised and unrealised income, or distributable/non-distributable reserves, and directors are unaware they have additional duties under the law beyond compliance with accounting standards. In February 2019, the IASB published an article explicitly stating that IFRS should not be presumed to meet legal capital protection requirements<sup>14</sup>.
- 2) The guidance on calculating distributable reserves produced by the audit industry is, in our view, flawed – we detail the reasons why we believe this to be true in the attached position paper (Jun 2019).
- 3) The FRC has failed to provide its own guidance on capital protection but has repeated the Institute for Chartered Accountants for England and Wales’ (ICAEW’s) assertion that there is no requirement to disclose what company’s distributable/non-distributable reserves are.

We set out specific recommended actions to address these weaknesses in the attached investor paper (June 2019), including calling on the Government to:

- Produce its own independently verified guidance for adjusting IFRS accounts to calculate realised profits and distributable reserves.
- Ensure that directors are keeping records of their realised and unrealised profits and distributable and undistributable capital.

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<sup>14</sup> <https://www.ifrs.org/news-and-events/2019/02/returns-reinvestment-opportunities-and-dividend-distribution/>

- Require companies to publish their realised and unrealised profits and capital in their annual audited accounts to shareholders, and how these have been calculated<sup>15</sup>.
- Ensure auditors are checking that these numbers are reliable, and require that they provide an explicit opinion on their findings, with any relevant commentary, e.g. on key judgements made, in the published annual financial statements.
- Ensure that these disclosures are made for the parent, subsidiary and group accounts, to give shareholders sufficient comfort around the entity's dividend paying capacity and capital strength.

The proper enforcement of these rules would, in turn, underpin a more reliable Going Concern statement.

**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”?**

Yes. As outlined in the attached position paper, we believe there is already a requirement for companies to be accounting for and disclosing foreseeable losses/liabilities even where these are hard to measure or uncertain in timing. We would also be in favour of greater disclosure around potential events/conditions that may not be considered probable, but could threaten a company's future solvency.

We are not persuaded by concerns that this will generate extreme market reactions. Generally speaking, if the market suspects problems but they are hidden you are more likely to see panic. Better for a company to objectively and calmly set out possible threats for investors to consider.

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

We concur with Sir John Kingman's assessment that viability statements are generally boiler-plate and offer limited insight into real threats to an entity's solvency. We do not think we need a new statement. Rather the regulator should ensure the existing viability statements are implemented as originally intended.

A key concern has been the short-time frames over which the directors look out. This is often far shorter than the company's real planning horizons. Mining and oil and gas companies for instance often use between 3 and 5 years (standard across most companies), and yet their capital expenditure programmes will often span decades.

In our submission to the FRC leading up to the introduction of the viability statement we were clear that it is important for directors to reassure investors that they are managing the business to ensure sustainability taking account of foreseeable headwinds. This is not a promise of solvency, which would be unreasonable to expect, but a commitment to responsible and prudent management. This could be achieved under the existing framework, but it needs to be enforced by the new independent regulator, ARGAs.

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<sup>15</sup> An argument against requiring companies to provide a breakdown between realised and unrealised profit is that it will incentivise management manipulation: executives will be encouraged to engage in end of reporting period sales to boost the reported realised profit number. Once booked, the management then repurchases the same assets, leaving shareholders worse off (post transaction costs etc) versus the situation where such sales did not take place. However, this behaviour is a good example of “window dressing”, which would be prohibited under rules that require accounts to reflect the underlying and ongoing health of the business. Such accounting misconduct should be dealt with through a robust and independent audit, not by reducing transparency to shareholders.

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

We are of the view that viability statements are closely tied to the going concern assessment, which should be subject to audit. The key difference is the time frame over which the viability statement looks. We would support the auditor offering an opinion as to the consistency of this statement with their understanding of the entity's capital strength and known risks. This cannot be a guarantee, just as the statement is not a guarantee of solvency by the directors, but the auditors should alert investors and the public if they believe that it is misleading.

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

The company's independent auditor can provide an opinion on whether it is consistent with what they know about the company's capital strength at the time of the audit, which incorporates a number of forward looking assessments (see Q18).

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

We believe that the priority should be getting the basics right. Auditors need to ensure they are fulfilling current duties under the Companies Act to protect capital and provide a basis for shareholders to hold directors to account. This does have a forward-looking element already, as auditors need to be ensuring that foreseeable losses and liabilities are properly reported.

We are not convinced auditors are well-positioned to provide assurance on forward-looking statements in companies' Strategic Reports or elsewhere, beyond the current responsibility to flag where these statements are inconsistent with the audited accounts. The Government should focus first and foremost on getting this judgement working properly.

**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?**

There is a case for third party assurance for a broader set of data provided by companies, especially where this is relied upon by investors.

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

We believe that numbers linked to remuneration payments; adjusted IFRS metrics; other quantitative disclosures linked to key performance indicators that investors track as part of assessing business prospects, like carbon emissions, workforce data (pay gaps), etc. deserve third-party assurance. The key will be ensuring that the auditor is fully independent of management and any consultant who is used to help produce these numbers.

**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?**

We strongly agree that the quality of audit needs to be considered separately to whether or not a particular audit process was followed properly. While the two ought to be complementary, they are not the same thing.

There is always a danger that auditors fall into the trap of 'ticking every box, but missing the point'. In particular, it is quite possible that auditors will come up with the wrong final Opinion that accounts meet the true and fair standard, even if they checked compliance with the accounting

standards. This was arguable the case in several recent corporate failures, not least the banks like HBOS and RBS. Questions may also be raised over how challenger banks accounts have been signed off by the auditor, while the Bank of England reportedly found concerning weaknesses in internal controls, and excessively aggressive assumptions linked to loan book losses<sup>16</sup>.

We describe why audit processes today may fail to ensure the law is followed in the attached position paper (June 2019).

**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?**

To the extent that auditors are currently placing emphasis on completing the audit file, and yet we continue to see company failures – and arguably therefore weak audits, this would suggest it is at the very least not helping. This is not to say proper records should not be kept, but in the end a good audit depends above all on sound judgement and a willingness to challenge management.

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

We are in favour of greater disclosure by the auditor to shareholders and would support graduated audits. Shareholders are largely in the dark over the key judgements being made and how the auditor has gained sufficient comfort to sign off management’s assumptions.

Recently introduced Auditor and Audit Committee Reports to shareholders have improved matters, but we still face often boilerplate language about the fact that assumptions are “in the reasonable range”, without much substantive insight as to how that judgement was reached, or whether the reasonable range is related to IFRS requirements for neutrality, or whether the range is prudent.

Occasionally, the auditor indicates that the assumptions are at the upper end of the range, e.g. Deloitte highlighted the relatively high discount rate used to calculate the pension liability in Tesco’s 2018 Audited Accounts, but this remains rare. We would like to see more information on the substance of the judgements made. We would also welcome more disclosure around the scenarios used to test sensitivity of published results to different (generally more prudent) assumptions. This is particularly important where sensitivity is high.

To take an example, we understand for auditors that oil and gas companies’ balance sheets are sensitive to future long-term oil price assumptions that go into, for instance, impairment tests. However, there is hardly any disclosure over how sensitive, and what kind of headroom exists to lower assumed prices. Given the prices used appear to be vulnerable to accelerated decarbonisation and falling demand, this information becomes important to informing the market about these companies’ resilience to price shocks and provides a basis for planning and director accountability. Without it, there are risks that write-downs could surprise the market unnecessarily, and improper capital deployment in the meantime<sup>17</sup>.

It is, however, also important to stress that more detailed auditor reports should not detract from auditors’ responsibility to say that a set of accounts fails the true and fair view test. This is an absolute judgement that is vital. Simply flagging aggressive assumptions to shareholders is not

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<sup>16</sup> <https://www.ft.com/content/9482944c-8e8e-11e9-a24d-b42f641eca37>

<sup>17</sup> Please see Landell-Mills, “Are oil and gas companies overstating their position?”, Sarasin & Partners LLP, August 2018.

enough. Auditors still have a duty to call out misleading accounts and withdrawing their unqualified opinion.

Related to this, we would welcome commentary on how key judgements impact the company's stated distributable profits and reserves. For instance, while IFRS requires a neutral mindset, capital maintenance rules require a prudent mindset. The capital maintenance regime also requires that the accounts include items like foreseeable losses and liabilities that are hard to measure or uncertain in timing, which would tend to be left out of IFRS accounts. Likewise, capitalised development costs are supposed to be treated as losses for the purposes of calculating distributable profits/reserves. It is vital that shareholders get comfort that distributable profit and capital are being properly calculated.

As already highlighted, it is important that these numbers are not just audited, but also disclosed.

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

Please see response to Q25 above.

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

This is a good question. In theory, it should be shareholders demanding better disclosure that should disincentivise boilerplate disclosure. We believe that shareholders need to be prepared to vote against auditors that fail to deliver high quality disclosures.

The problem we find is that shareholder scrutiny is today weak, and investors regularly vote for auditor reappointment even when there are signs of audit failure, e.g. where illegal dividends have been uncovered. It is possible that better disclosure will help attract increased investor scrutiny (as they will get value from reading auditor reports), and then resources will follow, e.g. proxy agencies will start looking at this information etc. With more scrutiny, standards should rise.

We would expect, however, that this could take time. In the meantime, we would favour greater scrutiny by the revamped regulator, ARGA. Importantly, ARGA should publish any negative findings they make on specific companies. This will help channel investor and public scrutiny, again increasing pressure for improvements.

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

We believe the heavy influence of the audit firms themselves in setting accounting and auditing standards is a major reason for weaknesses with our accounting and audit system. Please also refer to the introductory remarks on this.

In the end, the audit firms are a vested interest group with commercial interests that can run contrary to the interests of investors and the public. This fact has too often been overlooked as governments, investors and other stakeholders have sought "expert" input on sensitive decisions such as the rules governing how companies draw up their accounts. Audit firms have been generous in providing this expert input, but there are real dangers associated with the influence this brings them.

One example of why auditors may not act in shareholders' or the public's best interest is their fear of litigation. This (understandable) concern has in our view caused the audit industry to seek to reduce the scope for judgment for which they can be directly held to account.

This has been achieved by redefining the audit goal as about complying with standards and less about providing an independent judgement as to whether accounts provide a true and fair view. We have described in our introductory remarks how the audit industry has sought to do this by restating the audit opinion so it conflates the true and fair view with compliance with IFRS. In other words, taking these two separate and distinct opinions and combining them into one.

If this were permitted (and so far it hasn't been), this would likely reduce their exposure to litigation. It would also hollow out the very thing shareholders and the public want most from the auditor: their informed and absolute judgement as to whether the accounts offer a true and fair view.

While these opinions have not been merged into one, the problem we have seen is that auditors appear to treat them as if they are one and the same thing anyway. We heard in the auditors' testimony to the BEIS Select Committee inquiry into the Future of Audit, for instance, that they consider compliance with accounting standards to deliver effectively their legal duty under the capital maintenance regime<sup>18</sup>. We hear similar statement very regularly from practicing auditors we communicate with. This is not only wrong, but extremely harmful as it means the auditors are not alert to their broader capital maintenance duties.

#### Chapter 6 – Legal responsibilities

**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?**

The attached position paper “Investors and the public need to know whether profits and capital are real” (June 2019) signed by us alongside other large institutional investors, the UK Shareholders' Association and individual pension fund trustees directly tackles this question.

Rather than repeating the material in that paper here, suffice it to say that auditors have a central role to play, and a legal duty already under the Companies Act 2006, to ensure that directors are complying with the capital maintenance regime (look in particular at Part 23 CA06, and s837).

The auditor should not be signing Opinions that directors' accounts meet the true and fair requirement under the law, without having first established that the accounts adhere to capital maintenance rules, including showing what distributable profits and reserves are, and thereby establishing that they are sufficient for any proposed dividend to be legal.

As regards the capital maintenance rules, it is required that companies track and disclose their realised profits (profits earned in cash or near cash) as well as their non-distributable reserves, which in turn must include foreseeable losses and liabilities even where these are not certain in magnitude or timing. Because these disclosures are not required under IFRS, they demand additional disclosures, and place additional restrictions on dividends.

With respect to the question on “other matters”, if they do not have a bearing on the level of distributable reserves or profits, then they may be dealt with under other parts of the act. However, it is important to be clear that auditors should be thinking about second order impacts of probable events.

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<sup>18</sup> See specifically: <http://parliamentlive.tv/Event/Index/6829d379-d193-4db2-8ad2-17830685dd5c> - from 10:34am for c10 min testimony from the mid-tier firms; and from 11.39am for 10 min on capital maintenance with Big 4 chief executives.

For instance, in the event that a company is convicted of bribery, there auditors should consider the immediate fines and sanctions that could be imposed, but there could well be harmful reputational impacts that cause the company to lose material amounts of business or be restricted from certain markets. These should be considered also as they also have a bearing on the capital strength of the business.

**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?**

We have detailed in the Investor position paper mentioned under Q29 (June 2019) the inconsistencies between capital maintenance rules and IFRS. These are not merely “perceived”, as suggested in this question. The audit industry, the Government and the standard setters all acknowledge this gap. Indeed, this is why the audit industry has drawn up TECH 02/17 Guidance for how directors should calculate their realized profits and distributable reserves in accordance with the Companies Act 2006 from their IFRS accounts. In February, the International Accounting Standards Board published a paper highlighting the need for directors to now rely on their IFRS accounts to meet national capital maintenance and solvency rules. IFRS were simply not designed with these rules in mind.

To answer the question about whether the gap between IFRS and capital maintenance rules impedes the auditor from meeting public expectations, the answer is yes. But it is far more serious than not meeting public expectations. The inconsistencies between IFRS and capital maintenance rules has led to confusion, in our view partly generated by flawed guidance by the audit industry and repeated by the FRC. This, in turn, appears to have resulted in the capital maintenance rules not being properly implemented.

In theory, the divergence between IFRS and the capital maintenance regime is not itself a problem since it merely requires supplementary disclosure to ensure capital maintenance rules are met. The problem arises, where directors consider compliance with IFRS as sufficient to ensure compliance with the law.

We set out in the attached paper actions that the Government should take to resolve the confusion and ensure the proper additional disclosures are met. These include calling for the Government to:

- Produce its own independently verified guidance for adjusting IFRS accounts to calculate realised profits and distributable reserves.
- Ensure that directors are keeping records of their realised and unrealised profits and distributable and undistributable capital.
- Require companies to publish their realised and unrealised profits and capital in their annual audited accounts to shareholders, and how these have been calculated<sup>19</sup>.

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<sup>19</sup> An argument against requiring companies to provide a breakdown between realised and unrealised profit is that it will incentivise management manipulation: executives will be encouraged to engage in end of reporting period sales to boost the reported realised profit number. Once booked, the management then repurchases the same assets, leaving shareholders worse off (post transaction costs etc) versus the situation where such sales did not take place. However, this behaviour is a good example of “window dressing”, which would be prohibited under rules that require accounts to reflect the underlying and ongoing health of the business. Such accounting misconduct should be dealt with through a robust and independent audit, not by reducing transparency to shareholders.

- Ensure auditors are checking that these numbers are reliable, and require that they provide an explicit opinion on their findings, with any relevant commentary, e.g. on key judgements made, in the published annual financial statements.
- Ensure that these disclosures are made for the parent, subsidiary and group accounts, to give shareholders sufficient comfort around the entity's dividend paying capacity and capital strength.

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

Yes. Please refer to the answer to Q30 and also to the attached Position Paper which sets out precisely what disclosures we believe are necessary and indeed already required under CA06.

**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 are not clear as to how auditors discharge this duty, though they clearly have this duty.

**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?**

We would support more frequent and direct communication with specific company auditors. These meetings would need to be in a form that ensures requirements related to the dissemination of material non-public information were properly adhered to. We would favour a format similar to other management or director meetings with shareholders that are open and published online. The rules are there to ensure everyone has equal access to information, not to prevent dialogue between shareholders and their auditors.

It would be important for these meetings to encourage two-way dialogue to ensure that the auditor also hears from shareholders what matters are most material to them, and can take this into account in planning for the next audit. The Audit Committee directors would ideally also be present given their central role in representing shareholders' interests vis-a-vis the audit.

These meetings would not only provide a key opportunity to share more and better information but would provide a basis for shareholders to form a view as to audit quality and hold auditors and Audit Committee directors to account through their vote at the AGM. This would help to restore a key mechanism of oversight that is currently lacking.

The meetings would also provide a valuable opportunity for auditors to connect with their underlying clients. This, we believe, is vital for bolstering auditors' independence from management as they would more readily connect with their clients' interests, versus a situation today where it remains rare to hear auditors describe shareholders as "clients".

Ultimately, however, these meetings and associated disclosures should not detract from the core auditor responsibilities to alert shareholders to accounts that are not meeting the legal standard. This remains the core function of audit.

**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?**



Yes. As per our answer above, we favour greater disclosure of what goes on in an audit, more evidence of how the auditor challenged management on key assumptions, evidence provided to the audit committee, and greater support for the ultimate decisions and opinions that are published. The current culture of secrecy that pervades the audit process opens the door to weaker challenge, conflicts of interests and ultimately weak audits.

**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. The key enhancement we would like to see is fuller graduated audits that set out more detail on how key audit risks were addressed, and how the auditor determined the final outcome was adequate. We believe this could cause auditors and audit committees to think far more carefully about whether their judgements will stand up to scrutiny and reinforce their ultimate job of standing up for shareholder interests.

**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?**

We are of the view that auditors are already responsible for detecting fraud where this could result in material misstatements. This aspect of the auditors' work would seem to be integral to the value the audit brings shareholders and the public. If the auditor is not looking for fraud, who is?

Put another way, if the auditor explicitly states they do not look for signs of fraud, we would see the audit to be of questionable value. Moreover, it would reduce the disincentive for executives to engage in fraud who now have little to fear from the auditor.

It is worth also noting that it is not always clear where aggressive accounting becomes fraud and an explicit desire to mislead. The Metro Bank case provides an example. Here executives apparently misclassified loans (approximately 10% of the loan book) as less risky than they actually were, thereby reducing the capital they had to set aside to cover expected losses. As far as we are aware, however, Metro's auditors PWC have not come in for sanction. Or take Tesco's accounting scandal in 2014. Here executives inflated performance numbers by manipulating reported revenue. In the latter case, the company was fined £129mn by the Serious Fraud Office, but a case against PWC was abandoned by the FRC.

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

It is hard to assess the quality of auditors' efforts in detecting fraud from the outside. This is itself a problem.

It would nonetheless appear that auditors have often lacked a determined and sceptical mindset in their investigation of company accounting. There is no reason to believe this is any different in their approach to fraud. Indeed, in cases like London Capital & Finance, it would seem the alleged fraud was plain to see by the auditor, and indeed the insolvency of the business that resulted visible from a review of the notes to the accounts. It is hard not to wonder whether auditors are as determined as one might expect. In other cases such as misstatements by BT's Italian subsidiary recently, again it was not the auditor that uncovered the deception.

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

We would favour a “sceptical persons” test. Auditors should be sceptical. The question should be, given a sceptical mindset, should the auditor have picked up anomalies and investigated them?

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

Yes. As noted, we see this as integral to the audit process, ensuring the accounts present a true and fair view. This is also linked to the need for auditors to get sufficient comfort around internal controls to be able to say the risks of misstatements or legal breaches are low.

**Chapter 9 – Auditor liability**

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

In our view, auditors’ behaviour (e.g. in seeking to minimise their role in forming a judgement on the accounts versus simply complying with standards discussed in our introductory remarks and under Q28) appears to be heavily influenced by their fear of litigation as well as regulatory action. Reducing the threat of sanction, however, would make matters worse.

The problem has been that because auditors have feared litigation, and in response very effectively minimised this risk. This mirrors their success in limiting regulatory action. The industry’s influence over the standard setting process, the implementation and the enforcement of those standards means that oversight and independent checks on auditors’ work have been light-touch<sup>20</sup>. When it comes to litigation, there have been very few cases we are aware of brought against audit firms<sup>21</sup>. To take a stark example, despite the clear problem with the accounts produced by many banks prior to the financial crisis, we are not aware of any litigation against auditors who signed off these accounts.

While Richard Brooks’ analysis of both the power of the large audit firms, but also their apparent immunity from persecution may be embellished for effect, the core messages bear serious consideration:

*“The big firms have persuaded governments that litigation against them is an existential threat to the economy. The unparalleled advantages of a guaranteed market with huge upside and strictly limited downside are the pillars on which the big four’s multi-billion-dollar businesses are built.”<sup>22</sup>*

We would suggest that, alongside the introduction of a robustly independent regulator with stronger powers to investigate and prosecute failing auditors as proposed by Sir John Kingman, the Government should consider how to reduce obstacles to legal action by harmed parties to whom auditors owe a duty of care. This would help to provide more direct accountability to shareholders

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<sup>20</sup> These weaknesses are now being addressed following both Sir Christopher Clark’s review of FRC sanctions June 2018, and Sir John Kingman’s recommendations.

<sup>21</sup> As we understand it, at present shareholders can only initiate a derivative action where they can prove the company – and its directors – are unable to act. This is a difficult standard to meet and has meant that there have been very few legal actions against auditors.

<sup>22</sup> Extract from Richard Brooks recent book “Bean counters” taken from The Guardian

<https://www.theguardian.com/news/2018/may/29/the-financial-scandal-no-one-is-talking-about-big-four-accountancy-firms>

and would focus audit firms' minds on delivering on their existing duties, rather than seeking to weaken them.

Any move to weaken further auditor accountability, e.g. by providing a safe harbour for auditors, would like make matters worse, not better. Having said that, while we believe that there needs to be direct accountability shareholders, this does not mean sanctions should be disproportionate. There could be scope for total liability to be capped to prevent unreasonable claims, or unintended consequences that could be harmful to the public interest.

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

See response to Q40

**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?**

See response to Q40.

**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?**

See response to Q40.

#### Chapter 10 – Other issues

We do not answer every question in this section.

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

Based on the other responses to this Call for Views, we do not believe audit today provides value for money. Investment analysts hardly ever consider the audit, or who has audited the company concerned. Moreover, adjustments to published accounts are routine, as is a presumption that management accounts need to be treated with a degree of caution. In effect, auditor's role as policeman for shareholders is widely discounted.

This doesn't mean it has no value. As Mr. Tyrie's quote used in our introduction points out, audit is something people may not concern themselves with, but still implicitly rely on. The problem is that audits could be far more valuable than they are today.

**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?**

The introduction of longer-form auditor reports – alongside greater public scrutiny of audits in the wake of high profile scandals – has led to more interest in audit reports. But this remains, in our view, limited. We expect this will begin to change as auditors put more substantive commentary in their reports, and thus offer shareholders material insights that could help them form views on governance and company prospects.

AI may well be a tool used to scan auditor reports also in that search for insight, or 'edge' to help in stock picking. It is not clear, however, whether AI is being used to support stewardship activities, and thus the process of holding auditors and Audit Committee directors to account. This is, in our mind, one of the more important functions of these reports, and something the Government should explicitly encourage.

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

Please see response to Q33. In short, yes we do think there should be more and higher quality interaction between shareholders and their auditors outside the AGM. As noted not only would this be practicable, but it ought to form an essential part of the auditor's due diligence in considering which accounting risks are most material to shareholders. There could be an argument for auditors to also seek other stakeholders' views, like employees, suppliers, etc. in case this throws up potential audit risks.

More regular interactions with shareholders would also bolster accountability to shareholders, and greater empathy between auditors and their underlying clients. Audit Committees should join these discussions, keeping in mind the broader public interest role of auditors, and all information should be made immediately available to the market.

Because many institutional investors hold hundreds, if not thousands of companies, one needs to be realistic about the level of engagement. This is no different to Remuneration Committee outreach to shareholders, and arguable the audit is as if not more important (in the end remuneration tends to be based on audited numbers). As with remuneration, most engagement resource will tend to flow towards companies where accounts are perceived to be more risky.

**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?**

See response to Q52. Yes, investor consultation should help auditors construct their audit plans, but in the end the Audit Committee should retain authority over finally approving this plan (having also heard their shareholders' views, but also considering their broader responsibilities to other stakeholders as set out in s172 CA06).

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

Shareholders rely on the audit precisely because the auditor has access to internal records and executives to kick the tyres on company accounts. It would not be possible to get a similar level of assurance without breaking inside information rules.

**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 are unclear how this would work in practice. Assessing culture is not auditors' specialism. This is more for investors based on conversations with management.

Of course, shareholders may look at the auditor's report on the accounting judgements and assumptions made, or any disagreements with management (if this were disclosed), in forming their view, but we would not wish to see auditors' remit extend beyond this.

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

As noted earlier, they can demonstrate this scepticism through disclosure of greater detail around challenges to specific accounting assumptions, perhaps any disagreements with management and how these were resolved, and detailing how their own sensitivity analysis was conducted. Providing more examples of where the auditor over-ruled management would also build confidence. Finally,

audit partners track records on past audits, and how the companies they audited fared should be made available to shareholders. Any past sanctions, likewise, should be clearly disclosed to shareholders.

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

Yes, greater transparency over how auditors are incentivised is critical to ensuring alignment and building trust.

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

It is hard to judge without great disclosure of audit firms' accounts, including segment breakdown between audit and non-audit. Based on evidence collected by the CMA, audit activities are profitable, and underpin very high levels of remuneration for audit partners. This mirrors evidence collected by the UK Competition Commission in 2012/3.

The question in our mind is less whether audit firms are being paid enough, and more whether the auditors firms are allocating the revenue they receive appropriately. Specifically, there is a concern that too little investment is made into the delivery of audit, to maximise profits distributed to partners. This risk is not to be dismissed given the lack of visibility into the audit process and its quality. It has also been reported that to save on costs, the bulk of audit work is undertaken by junior auditors, who may find it harder to stand up to management, or who lack the experience to determine what might require deeper investigation. In the case of Carillion, the lead audit partner had allegedly spent mere hours on the audit before signing it off.

The lack of investment may not be a result of low audit fees, but rather excessive rent extraction. One way to get more clarity on this question is by requiring audit firms to publish detailed (and independently audited – perhaps by the government audit service) accounts.

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

Yes

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

See response to Q58.

We are not against shareholders paying more for higher quality audit, if this is indeed necessary. We do, however, have serious reservations over whether it is indeed low profitability that has led to lower audit quality, or rather a lack of transparency and thus proper oversight, scrutiny and ultimately accountability.

We would add that we would favour ending the closed shop system that prevents non-qualified auditors from owning audit firms. There is no evidence to show that this system has prevented abuse, and by opening the market, greater competition could help focus minds on better audit quality. This is a matter that was not considered in detail by the CMA, but worthy of attention.