Appendix C to audit market study update paper: the ‘expectations gap’; the purpose and scope of audit

Overview

1. One of the five groups of possible issues we highlighted in our invitation to comment was the audit framework, and the ‘expectations gap’. We indicated that we saw this as being outside our core area of expertise – which is in the way markets operate. That remains our position. But we have heard various views on this subject, and, given our understanding that there is likely to be an independent review into the subject, we summarise these views here and offer a range of issues the review might look at.

2. In response to our concerns about audit quality, respondents highlighted the importance of understanding the purpose and scope of audit before assessing whether audit was failing to meet its objectives. We heard different perspectives on what the purpose of an audit is and whether the existing scope and framework, as well as the application of that framework, was meeting that purpose. A common theme amongst respondents’ submissions was the existence or otherwise of an ‘expectations gap’. At its broadest, the expectations gap is the difference between what the public and other stakeholders expect an audit to do and what an audit is required to do.

3. Respondents submitted a range of views on causes and solutions for this issue. Several respondents emphasised that the gap arises from a misunderstanding about the roles and responsibilities of auditors as compared with company directors.[1] Other respondents argued that the expectations gap was a fallacy hiding a more fundamental problem: that the industry is incorrectly interpreting and applying the existing statutory framework. They argued that there would be no expectations gap if the framework was properly applied.

4. Another set of issues raised were directed at the scope of an audit report. First, the scope of a company’s reporting which the auditor reviews and, second, the backward-looking nature of an audit. We received numerous comments on the increased complexities of financial reports and audit reports. As companies became more complex, the accounting and auditing standards become more complex in response. As audits become more technically complicated, judgment calls are more difficult to make. Further, the increased

[1] Standard Life Aberdeen plc (Standard Life), Response to CMA Invitation to Comment, 30 October 2018, at section B paragraph A(1); Intermediate Capital Group PLC, Daily Mail and General Trust plc. (Intermediate Group PLC), Response to CMA Invitation to Comment, 30 October 2018, at section B paragraph A(1).

complexity of financial reports and audit reports make these documents less accessible to their key stakeholders.

5. Although these issues go beyond the CMA's core remit, they form important context for our assessment of whether the market is working well. As one respondent put it, unless we are clear on the purpose and scope of audit, it is difficult to comment meaningfully on the quality of audit provision.[2] We think that there is a strong case for reviewing the purpose and scope of audit to consider these issues holistically.

Reasons for the 'expectations gap'

6. At one extreme, respondents argued that public concerns about audit are entirely driven by an 'expectations gap'. Audit quality may be high but the problem lies with a discrepancy between what the public expects an auditor to do and what an auditor does.[3]

7. The main categories of argument put forward to explain the 'expectations gap' are listed below.

   (a) Auditors' role and duties vs. company directors' roles and duties.

   (b) Misunderstanding or lack of clarity about the purpose of an audit.

   (c) Scope – extent of audit coverage.

   (d) Scope – fraud.

   (e) Time; backward-looking audits and companies' future viability.

   (f) Form and content of the auditor's output.

Auditors' role and duties vs. company directors' roles and duties

8. Some respondents argued that the expectation gap exists because of a misunderstanding about the distinct roles and responsibilities of auditors and company directors, particularly in the context of a company failure. They pointed out that auditors cannot be held primarily responsible for the failure of a company. Directors have primary responsibility for effective governance

[2] Sarasin & Partners LLP, Response to CMA Invitation to Comment, 1 November 2018, at page 1.
[3] Legal and General Investment Management (LGIM), Response to CMA Invitation to Comment, 1 November 2018, paragraph 2.4 at page 3; Nationwide, Response to CMA Invitation to Comment, 30 October 2018, at pages 1-2; PricewaterhouseCoopers LLP (PwC), Response to CMA Invitation to Comment, 30 October 2018, at page 5.

reporting, preparing financial statements and making judgment calls on the company's future success or otherwise.[4]

9. There is a distinction between the company's accounts and the company's audit and who is responsible for each. It is the company that is obligated to keep accounting records and the company directors who are required to prepare accounts.[5] The board must approve and sign off the company's accounts but only if they are satisfied that the accounts provide a 'true and fair view' of the assets, liabilities, financial position and profit or loss of the company.[6]

10. The company's accounts are prepared using one of two financial reporting frameworks, also known as accounting standards. Accounting standards are the rules as to how transactions and other events should be recorded in financial statements. The two relevant accounting standards are the United Kingdom Generally Accepted Accounting Practice (UK GAAP) and international accounting standards (IAS), also known as international financial reporting standards (IFRS).

11. Most companies are required to have their accounts audited each year.[7] The auditor, in carrying out its statutory function, must have regard to the director's duty to only approve accounts if the accounts provide a 'true and fair view'.[8] The Companies Act 2006 mandates what an audit report must contain. In addition to the Companies Act 2006 requirements, auditors comply with international auditing standards and quality control standards. Auditing standards are different to accounting standards. Auditing standards are the rules used by auditors to conduct their audit. In the United Kingdom, the relevant auditing standards are called the International Standards on Auditing (United Kingdom) (ISAs UK). Part of an auditor's role in conducting the audit is to check that the company's management have prepared the accounts in accordance with the applicable accounting standards. The auditor uses these standards to assess the truth and fairness of the financial statements.

12. Directors and auditors owe distinct duties to different stakeholder groups. Directors are required to act in the best interests of the company in making all decisions and have regard to a wide range of stakeholders when doing so.[9] In contrast, an auditor typically only owes legal duties to a company's existing

[4] Nationwide, at page 1.
[5] Companies Act 2006, ss 386 and 394.
[6] Companies Act 2006, s 393.
[7] Companies Act 2006, s 475.
[8] Companies Act 2006, s 393(2).
[9] Companies Act 2006, s 172.

shareholders.[10] That is because the auditor's report is presented to the company's members, its shareholders, in order to provide assurance that management has properly prepared the accounts.[11] It would be unusual for an auditor to owe any duties to a wider stakeholder group such as future investors, or to the wider public. One respondent stated it would be desirable if auditors' responsibilities encompassed similar obligations to those of directors under section 172 of the Companies Act to consider the interests of wider stakeholders to address the expectation gap.[12] Other respondents suggested that auditors' responsibilities could encompass reporting on specific directors' duties.[13]

13. It is important to recognise that company directors are ultimately responsible for preparing the company accounts and for the financial performance of a company. There might be merit in the argument proposed by one respondent that, because company directors are primarily responsible for the accuracy of corporate information, the directors should be held responsible through a framework of regulatory oversight, equivalent to the Sarbanes-Oxley reforms in the US.[14] However, notwithstanding the role of company directors, auditors play a vital role in ensuring that shareholders can have confidence in the company's financial reporting. This role requires a high degree of challenge and scrutiny on the part of auditors, and a willingness to stand up to company management.

The purpose of audit

14. We heard from some parties that those stakeholders who are familiar with purpose of an audit in the current framework, including the wider corporate governance framework, consider the audit sector was working well and quality is generally high. But for those stakeholders whose expectations do not match the current remit, the system as a whole is perceived to be ineffective. Any change to the purpose and scope of audit will have to consider how that change will interplay with the wider corporate governance framework.

15. The purpose of audit is provided for in law, both statute and common law, as well as in the industry's auditing standards, ISAs UK. The overarching purpose of an audit is to assure the accuracy of a company's financial

[10] *Caparo Industries plc v Dickman* [1990] 2 AC 605; [1990] 1 All ER 568, HL.
[11] Companies Act 2006, s 495(1).
[12] Standard Life Aberdeen plc at section B paragraph A(1).
[13] Intermediate Capital Group plc, at section B paragraphs A(1) and B(24)-(27).
[14] Deloitte, Response to CMA Invitation to Comment, 30 October 2018, at [1.8]; Ernst & Young LLP (EY), Response to CMA Invitation to Comment, 30 October 2018, at [1.3].

accounts for the benefit of the company's shareholders.[15] An auditor provides shareholders with independent and reliable information on the true financial position of the company at the time of the audit. The purpose of an audit is **not** to prevent a company collapsing or to assure the future viability of the entity. The ISAs UK expand on the auditor's objective as being to obtain 'reasonable assurance' about whether financial statements as a whole are free from material misstatements.[16]

16. The Companies Act 2006 requires an auditor to report their opinion as to whether the company's annual accounts:[17]

    (a) give a 'true and fair view' of the state of affairs of the company and the profit or loss of the company as at the end of the financial year;

    (b) have been properly prepared in accordance with the relevant financial reporting framework (being UK GAAP or IAS);

    (c) have been prepared in accordance with the requirements of the Companies Act 2006, and where applicable, the European Commission regulation relevant to publicly listed companies.

17. The Companies Act 2006 also requires other reporting obligations such as on the director's remuneration report and corporate governance statement, where applicable.

Debate about audit purpose

18. We heard from two respondents that the current audit framework, particularly the accounting standards, is failing to deliver a key purpose of audit: assessing whether the company's capital is properly protected.[18]

19. These respondents highlighted that a legal inconsistency exists between obligations as set by the Companies Act 2006 on the one hand, and the accounting and auditing standards on the other. They argued that the Companies Act 2006 sets a robust standard for both what a company's accounts are required to show, and what the purpose of an audit is in relation to reporting on a company's distributable capital. But, they say, accounting and auditing standards fail to meet the Companies Act 2006 standards because the standards do not require the detail needed to justify a

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[15] Companies Act 2006, part 16 (Audit); *Caparo Industries plc v Dickman* [1990] 1 All ER 568, HL.
[16] ISA (UK) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK).*
[17] Companies Act 2006, s 495.
[18] Sarasin & Partners LLP, at page 1; LAPFF, at page 5.

distribution. Because accounts are prepared in accordance with accounting standards, and auditors review the accounts against these standards, the Companies Act 2006 requirements are not necessarily met—a case of company law following the standards, rather than the other way around. [19] As a result, a key purpose of the audit report is lost.

20. These respondents concluded that the expectations gap is a result of the industry's misinterpretation of the existing legal framework. One described the expectations gap as a red herring.[20] They said that if the existing regime was applied properly, the expectation gap would disappear because the statutory framework is robust enough to produce the outcomes stakeholders expect.

21. This particular submission on the purpose of audit has been subject to significant legal analysis in recent years.[21] It seems unsatisfactory that what appears to be quite a fundamental question about the purpose of an audit as required by the Companies Act 2006 can be subject to such debate and difference in legal opinion. We are supportive of a review which examines this debate in detail and resolves in certain terms what the purpose of audit is.

Scope – extent of audit coverage

22. We heard a range of arguments related to the scope of the company's financial reporting that an auditor reviews and reports on. Some stakeholders might incorrectly assume that an auditor reviews the company's entire annual report.

23. The Companies Act 2006 mandates what an audit report must include.[22] The Act requires an auditor to report their opinion on whether the company's annual accounts give a 'true and fair view'. The auditor must also report whether the accounts have been prepared in accordance with the relevant accounting standards. There are other reporting obligations such as the director's remuneration report and the corporate governance statement, if required. In respect of the latter, the auditor reports on consistency and any material misstatements. The ISAs UK confine the scope of an audit opinion to the company's financial statements.[23]

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[19] Sarasin & Partners LLP, at page 1.
[20] The Local Authority Pension Fund Forum (LAPFF), Response to CMA Invitation to Comment; 29 October 2018, page 6.
[21] LAPFF engaged George Bompas QC and the FRC engaged Martin Moore QC to opine on this issue.
[22] Companies Act 2006, s 495.
[23] ISAs (UK) 200, at [A1].

24. We have heard from some respondents that corporate reporting and assurance may need to become broader to better align with stakeholder's expectations. One respondent suggested that corporate reporting should evolve to meet the future needs or shareholders and stakeholders. As new approaches develop, including in respect of non-financial KPIs, assurance should keep pace with those changes, including covering wider aspects of a company's annual reporting. [24] Another respondent suggested that auditors should review and report on wider aspects of a company's annual reporting, including capital and cash reserves.[25]

Scope – fraud

25. A number of audit firms and other respondents cited stakeholder's expectations around fraud detection as contributing to the expectations gap.[26] Respondents argued that there is a misconception that an auditor is responsible for uncovering all fraudulent activity, validates every transaction recorded and audits the entirety of the annual report.[27]

26. The ISAs UK record that the auditor is to provide 'reasonable assurance' about whether the financial statements are free from material misstatement, whether due to fraud or error. But, the ISAs UK also explicitly recognise that an auditor cannot reduce audit risk to zero. In relation to fraud, an auditor cannot be expected to root out all wrong-doing on behalf of management, particularly fraud that might involve a sophisticated and carefully organised scheme to conceal it.[28] An oft-quoted Court of Appeal judgment summarises the auditor's role in detecting fraud, an auditor is 'a watch-dog, but not a bloodhound'.[29] Certain stakeholders might be surprised that it is not the other way around.

Time; backward-looking audits and companies' future viability

27. Another scope issue raised was the expectations gap created by the backward-looking nature of an audit compared with stakeholders' forward-looking concerns about company viability.[30] Some respondents pointed out

[24] EY, paragraphs [20] – [21] at page 6.
[25] Nationwide, at page 2.
[26] Deloitte, paragraph [1.4] at Appendix page 1; PwC, at paragraph [A](2b) at page 5; KPMG LLP (KPMG), Response to CMA Invitation to Comment 30 October 2018, paragraph [1.2] at page 2; Filip Lyapov; Response to CMA Invitation to Comment, 21 October 2018, paragraph [24] at page 9; The 100 Group, Response to CMA Invitation to Comment, 26 October 2018, at AQ1; Moore Stephens, Response to CMA Invitation to Comment, 30 October 2018, at page 2.
[27] The 100 Group, at AQ1.
[28] ISAs (UK) 200, at [A49].
[29] *Re: Kingston Cotton Mills* [1896] 2 Ch 279.
[30] Deloitte, paragraph [1.4] at Appendix page 1; KPMG, paragraph [1.2] at page 2.

that audits are essentially focused on validating a historic position.[31] An expectations gap may arise from a misconception about the extent to which the auditor signs off on the future viability of the company. One respondent put it as follows: 'while the auditor does consider future viability statements, they are not audited to the extent that the public might think; nor are they capable of being so without considerable further work, akin to that needed to report within a prospectus document'.[32]

28. The Companies Act 2006 requires an auditor's report to 'include a statement of any material uncertainty relating to events that may cast significant doubt about the company's ability to continue to adopt the going concern basis of account'.[33] The Act does not define 'going concern'. Accounting standards require directors to prepare financial statements on the assumption that the entity is a 'going concern' and will continue operations for the foreseeable future. Management's assessment of the entity's ability to continue as a going concern is necessarily a judgment call based on a degree of uncertainty about future events and conditions.

29. The auditor concludes whether it is appropriate for directors to use the going concern basis of accounting in preparing their financial statements, or whether a material uncertainty exists.[34] The auditor has to evaluate management's own assessment of the going concern status. This assessment includes reviewing management's process, assumptions and plans for future action, the auditor does not step into management's shoes and conduct the analysis itself. The absence of any material uncertainty about a company's ability to continue as a going concern is not a guarantee of the company's future viability. But stakeholders may conflate the 'going concern' sign-off as providing that guarantee.

30. We heard from respondents that the expectation gap around broader business risks and forward-looking financial information will persist unless consideration is given to the purpose and scope of an audit.[35]

[31] Nationwide, at page 2.
[32] ICAS, paragraph [3.2] at page 4; The Institute of Chartered Secretaries and Administrators (ICSA), Response to CMA Invitation to Comment, 1 November 2018, at page 1; see too ISAs (UK) 200: 'The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conduct the affairs of the company'.
[33] Companies Act 2006, s 495(4)(c).
[34] Companies Act 2006, s 495; ISA (UK) 570 (Revised June 2016).
[35] Nationwide, at page 1.

Form and content of auditor's output

31. Respondents also commented on the binary nature of the assessment of 'true and fair' view and the 'going concern' test. A stakeholder summarised the issue as follows: 'reporting is still essentially based on providing a binary conclusion as to whether financial statements present a true and fair view; as a consequence, adverse going concern conclusions are challenging to report due to the risk that they become self-fulfilling'.[36]

32. Another issue raised was the degree of discretion in determining 'fair value' accounts which are 'useful to the user'. Some respondents pointed to a lack of clarity about whether auditors are meant to challenge the assumptions in these models, or whether they simply have to provide assurance over whether the approach to the modelling is consistent with international accounting standards.[37] Some commentators have said that fair value accounting enables auditors to adopt more of a box-ticking approach.[38] In contrast, one audit firm commented that accounting standards now require significant judgments to be made in almost all areas of the financial statements.[39] This then results in financial statements which are difficult to understand and may further contribute to the expectation gap.

33. More generally, there is a question as to whether the usefulness of company accounts and audits reports is declining over time with the increasing importance of intangibles which are not captured on company balance sheets. We are aware of KPMG's efforts to include 'graduated findings' which provide a view on the caution or optimism in key findings and judgements.[40] Some respondents argued that the scope of audit needs to change to align better with the needs of shareholders.[41] Some respondents said that enhanced auditing standards may be required to address this expectation gap.[42]

Summary

34. These issues are all important; we would support a review to consider whether the purpose and scope of audit needs to change. However, even within the current accounting and audit standards, a high-quality audit should

[36] Nationwide, at page 2.
[37] Reform accounting rules to restore trust in audit, Financial Times, 2 August 2018.
[38] Reform accounting rules to restore trust in audit, Financial Times, 2 August 2018.
[39] EY, at page 12; HSBC, Response to CMA Invitation to Comment, 5 December 2018 states that 'we note that financial statements have become increasingly complex which may leave an expectation gap', at page 9.
[40] KPMG at pages 4, 8, 34 and 39-40.
[41] LGIM, paragraph 2.5 at page 3.
[42] The Association of Practising Accountants (APA), Response to CMA Invitation to Comment, 29 October 2018, at page 3; Duncan & Topliss, Response to CMA Invitation to Comment, 23 October 2018, at page 3.

provide sufficient professional scepticism and challenge to scrutinise the assumptions being made by company managers.

35. There appears to be a level of mismatch between the popular perception of audit and what is required by the statutory framework. There is a risk that even a well-functioning audit market would not deliver what is expected by some stakeholders, including the general public. This expectations gap is detrimental to the audit industry and the wider capital market as a whole. Lack of stakeholder confidence in the audit function has consequences for the proper functioning of capital markets. Further, as some stakeholders pointed out, if audit partners regularly receive public criticism when they are in fact producing the reports required, auditing becomes a less attractive career.[43] Overtime, the auditing profession may be unable to attract and retain accounting talent.

36. However, resolving this mismatch would require a rethink of the role of audit within the overall corporate governance framework to ensure that high-quality financial reporting meets the public's expectation. The extent to which this realignment is appropriate and constructive needs to be considered carefully.

37. There are important questions around how the industry and the regulator interprets and applies the existing legislative regime. It is possible that a different application of the existing framework could increase audit quality and, in turn, better meet public expectations.

38. Standing back, there is a large range of important issues about the purpose and scope of whether the existing framework is able to deliver the audit outcomes stakeholders expect. We are supportive of a review which carefully considers these issues and finds a solution to ensure confidence and clear lines of responsibility for the future of the audit industry.

Proposed questions

39. We have proposed some high-level questions that we think would be worth addressing in any future review on the 'expectations gap' issues identified in this appendix.

    (a) What is the purpose of an audit as it currently stands?

    (b) What should the purpose of an audit be? Put another way, what do stakeholders require from an audit?

[43] ICAS, at page 11.

(c) Does the scope of audit need to change to achieve the desired purpose? If yes, how?

(d) Do the Companies Act, IAS, ISAs UK, or corporate governance roles need to change to achieve this purpose?

(e) Who should auditors owe duties to? Should auditors' duties and liabilities be expanded? Do directors need to bear more responsibility for financial reporting?

(f) Does audit need to align better with the capital distributions regime in Companies Act 2006?