<u>BRYDON REVIEW: Independent Review Into The Quality And Effectiveness Of Audit</u>

<u>Response from Aberdeen Standard Investments - 7th June 2019</u>

As a global investment manager Aberdeen Standard Investments uses a range of tools to evaluate the quality of assets in which we invest on behalf of clients and customers. It is essential we are able to rely on audited company reports and statements as one source of accurate, considered and impartial information. We would therefore be supportive of any and all reforms which lead to an increase in the quality and effectiveness of the audit product. In this context we welcome this review and the opportunity to share our views.

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

Corporate audits undoubtedly serve a wide range of stakeholders but we would argue strongly that the primary targetted beneficiaries are investors who have provided financial capital in the expectation of receiving future returns. This can take the form of share capital (in the case of shareholders), fixed interest corporate debt and other types of finance. Corporate reports and financial statements represent a valuable source of accurate, considered and impartial information for investment/divestment decisions. It is through the audit process that investors gain enhanced confidence in these statements.

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

The audit process should be designed to enhance end users' confidence in financial statements, not the entity itself. It is a matter for investors (and other stakeholders) to form their own view on whether they have confidence in the entity itself based on all the information available, including the financial statements. The quality of all corporate communications, including financial reporting, for which the Directors are primarily responsible, will nonetheless influence judgement on the credibility of the entity and more directly the quality of management and its governance processes.

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?

Yes, it would be helpful for there to be far greater clarity around the purpose of an audit and who is owed a duty of care as there is a statutory deficit in this area. To some degree this vacuum has been filled by case law (e.g. Caparo Industries plc v Dickman) but this is not a substitute for a legislative definition. At a minimum, we would like to see the interests of capital providers (current and prospective) being placed at the heart of any definition.

Q4. Do respondents consider there is an expectation gap?

Yes, it has become clear – particularly following commentary made after the collapse of Carillion and other high profile corporate failures – that there is a gap between many stakeholders' expectations of what an audit should convey and what it is currently designed to deliver. Audit cannot and should not be judged on its success in preventing corporate failure but it should at least provide investors and other stakeholders with sufficient information on which to take an informed decision on a company's financial position and sustainability. We would point out that many active asset managers did not invest in Carillion, in part as a consequence of information gleaned from the annual report and accounts.

The auditors should be encouraged to draw attention to factors which may fall outside of the current scope of an audit or any material judgements on which statements are based. The drive for international comparability has, in our view, led to an undue focus on compliance with IFRS standards relegating to a subsidiary position, judgements over the concept of prudence within financial reporting and the audit process, as well as the process that produces the numbers which are subject to audit.

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

As stated above, expectations of an audit have expanded to be out of line with what audit is currently designed to deliver. The scope of an audit is much narrower than most people generally appreciate. While this can and should be addressed by widening the scope of audit in conjunction with other reforms - such as greater regulatory oversight of company audit committees as recommended by the Competition and Markets Authority - there needs to be a more realistic understanding of what an audit can deliver and what is out of scope. There may well be areas where further assurance services are desirable but these should be distinguished from the statutory audit of financial statements and related information.

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

Yes, we believe there is a delivery/quality gap. The extent of this gap was highlighted by the Financial Reporting Council's most recent Audit Quality Review which identified serious shortcomings in the quality of audit. It is not clear to us however whether this is a gap between existing responsibilities and auditing standards or simply a narrow interpretation or poor execution of auditing standards

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

Audited financial statements/corporate reports are a key source of data for investors and other stakeholders to assess the way an entity is being managed, the risks to which it is exposed and how these are being managed (particularly important for shareholders who bear residual risk). It is therefore essential stakeholders have confidence in the information being presented which depends upon the impartiality and professionalism of auditors and the extent to which they challenge the management and material judgements on which the financial and related statements are based. Larger institutional investors may have other resources available such as in-house research or opportunities to engage with directors but the audit will always have a key role in providing assurance.

Q8. Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?

It should always be the objective of an audit to provide the highest possible level of assurance over the financial statements/corporate reporting even though the audit process and the eventual output will vary widely according to the type of entity, the sector and markets in which it operates and the particular risks to which it is exposed (and other factors). We do not believe it would be desirable, practicable or sensible to operate different levels of assurance between different types of business which would be extremely difficult to define and apply. However, an audit report should explain where an auditor feels unable to provide high levels of assurance. It is also essential that the Strategic Review clearly sets out the business model adopted by the company and that the Annual Report illuminates the risk factors pertinent to both the industry and the company itself. Audit assurance has to be judged in the context of both of these.

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

Yes, we believe the boundaries are sufficiently clear.

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

The extent to which internal auditors can give indirect assistance to external auditors is very tightly controlled. While we agree this is important to protect the independence and impartiality of the external auditors, we believe the findings and conclusions of internal audit are important inputs to external auditors' accurate, considered and impartial assessment of a company's financial position and sustainability. For example, this might include the internal auditors' opinion on risk controls and other internal processes relevant to an entity's cash flow or capital management.

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?

We see no reason to believe current eligibility requirements for external auditors focus too much on independence at the expense of innovation and quality. However, we have some concerns that the audit market lacks choice and competition. As we stated in our submission to the CMA statutory audit market review, we would like to see non-Big Four accountancy firms being more active in the audit market, potentially through selective focus on industry sectors if omnibus coverage is not feasible. We are also supportive of operational separation of audit functions to strengthen their independence from non-audit functions.

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 would be supportive of a requirement on directors to make explicit statements in the Annual Report on their assessment of risk management and internal controls. This is something they are already required to do under the UK Corporate Governance Code. The statement is implicitly covered within auditors' responsibilities under the 'books and records' assessment. A similar requirement exists in the US under the Sarbanes-Oxley regime which could provide useful lessons in developing a stronger controls disclosure regime for the UK.

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

Clarification would be helpful as to which elements of the system of internal control fall within the responsibilities of the auditors. Clearly this should encompass controls over financial reporting accuracy and controls inherent to future viability. It should be possible for external auditors to examine and report on an entity's internal controls and any statements made by directors on the effectiveness of these controls (see above).

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?

This would contribute to a better understanding of the risks faced by an entity and how these are controlled or managed. However, we would be concerned that nuanced impressions which are valuable to management, as well as comments on individual competencies, would be omitted if a public airing of these concerns was required.

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

The collapse of Carillion and other high profile corporate failures demonstrate that inherent caveats within the going concern assumption adopted in the vast majority of financial reports are poorly communicated and therefore not understood. Such statements are, at best therefore, of questionable value. As we mention at various points in this submission, the adoption of international accounting standards has led to a shift towards greater use of fair value accounting with less emphasis on prudence in reporting. It is unrealistic to expect these standards will change as they are set at an international level but we would like to see a greater focus on cash flow reporting both in terms of describing the funding model of the business and as a critical input to understanding the adequacy of capital and cash flow to meet the going concern principle. Auditors should also be required to highlight any shortcomings, material caveats and key judgements relevant to an understanding of the financial position of the company which have been identified or made during the audit process. This approach would help to give stakeholders more advance warning of any developing issues relating to the going concern principle.

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, see previous answer.

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

We do not believe there would be any incremental value in directors making an additional specific statement about the sustainability of the entity's business model. The annual report already explains the sustainability of its business model and how risks are being addressed. We would question whether the viability statement as currently designed is effective in doing this but it could be enhanced by cross referencing to analysis of the company's risk management and control framework.

Q18. Should such a statement be subject to assurance?

We see no reason why a more detailed and criteria-based viability statement could not be included within the scope of an assurance process.

Q19. Who might be capable of giving such assurance?

The auditors are best placed to provide this assurance but they may need to seek expert input on specific areas (e.g. long term contract profitability) in providing such assurance.

Q.20 Is there a case for a more forward-looking audit? What would be the main benefits and risks?

Innovations in audit reporting beyond the already extended audit report could be useful to users of financial statements in gaining confidence around an entity's future prospects. We would question whether a forward looking assessment of a business is part of an audit given that 'audit' conveys an objective and evidence-based opinion and the more forward looking the assessment the more subjective will be the opinion. There is therefore a risk of extending the 'expectation gap' the more the 'audit' seeks to be seen as predictive.

Q.21 Would audit or assurance over financial and non-financial information outside the annual finance statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Assurance on a wider range of financial and non-financial statements (such as KPIs) would be a welcome extension to information available to investors and other stakeholders; but we should not describe this as part of the audit process lest we add to confusion as to the scope of the statutory audit. For example, there are various examples of companies making statements relating to their financial performance that sit outside of the audit process e.g. bank capital ratios, like-for-like sales in the retail sector. There is also an argument for extending the scope of assurance to include factors which can have a significant bearing on investment decisions – such as efforts to reduce its carbon emissions or improve diversity of its board of directors. But we should distinguish this incremental assurance from statutory audit.

Q.22. If so, what information might usefully be subject to audit or another form of assurance and why?

As stated in our answers to Q15 and Q17, we would like to see a stronger focus on cash flow, funding strategy, risk management and control frameworks.

Q.23. Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

Yes, but there is an inevitable interaction between the quality of the process and the final product. It is very hard to achieve the latter without the former.

Q.24. 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?

A disproportionate emphasis on 'completing the audit file' creates a strong risk that the process becomes an exercise in compliance i.e. the paperwork becomes more important than the substance. The process and the regulatory requirements should be designed to deliver a high quality audit. If things are being done simply to meet the perceived requirements of the regulations there is a risk that insufficient attention is given to the desired outcome of a high quality audit.

Q.25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

Graduated findings would bring more value to the audit process and help to demonstrate the level of professional scepticism and challenge which has been applied to statements and any material judgements but we doubt this could be achieved in a way that would be consistent across entities and over time. A better approach would be to continue to expand the audit report which has been a recent major improvement in corporate reporting. This could form part of a package of improvements to the already extended audit reports.

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

Yes, further narrative alongside the opinion would be helpful – see previous answer.

Q.27 What would prevent such disclosures being boiler plate?

Greater disclosure of auditors' discussions with the audit committee would help to demonstrate that auditors have exercised professional scepticism and the appropriate level of challenge to items of judgement in financial statements which are significant or material.

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

As mentioned above, adherence to international accounting standards has shifted the focus of the preparation of financial statements and the audit process progressively from prudence to greater use of fair value. We do not see this as being aligned to the needs of end users who have a stewardship responsibility as their priority. While the dominance of the Big Four accountancy firms has provided the scale to invest heavily in modernising the audit process it is not clear that their dominance is conducive to innovation and development. Smaller firms with specialist industry audit focus might add to process innovation.

Q 29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

It should be the auditors' role to comment on anything that affects financial reporting and statements and consider any compliance/legal risks that impinge upon viability (e.g. operating outside licence permissions); these should be encompassed within the company's risk register review of which we understand is a critical step in audit planning. We do not believe the auditor's role should include a responsibility for expressing a view on whether the directors of an entity are fulfilling all their legal and regulatory obligations; this would be infeasible.

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 are aware of the inconsistency between company law and accounting standards which, as we have noted elsewhere, has shifted from prudence towards more use of fair value. Alignment between company law and accounting standards would be ideal but is not realistic as international standard setters have no mandate to consider individual country capital maintenance rules in developing accounting standards.

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

Yes, we believe this should already happen where material differences exist but further clarity and disclosure in this area would be welcome. It would help to give investors reassurance that a company's dividend policy is supported by distributable earnings.

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 do not feel qualified to answer this question.

Q33. Should there be a 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 believe there could be value in having such meetings providing focus on the audit of a specific company i.e. they should not be solely for the purpose of discussing the auditor's assurance processes. These meetings would have to be done on a group basis (i.e. open to all stakeholders) and care would be needed to avoid the disclosure of price sensitive information. It is essential such meetings are constructive and positive and are not hijacked by special interest groups of shareholders, for example an aggressive activist or short sellers to drive the share price to meet their objectives in a way not to the benefit it of all stakeholders. We would therefore suggest any proposal in this area is subject to a process of consultation.

Q34. Should more of the communication and resulting judgements that occur between the auditor and the audit committee be made transparent to users of the financial statements?

The outcome of such discussion is currently encapsulated within the expanded audit report which could still benefit from greater granularity. We are not supportive of documenting the stages of discussion. The audit is an iterative process and there is a value to that which we would not want to see endangered.

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?

Adding to the volume of information available to stakeholders isn't particularly helpful – it's the quality of the content which matters. However, extended audit reports, updating on past key audit matters and their resolution/mitigation, could be a useful source of information for investors but they need to be clear, factual and genuinely informative.

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?

Auditors already have a responsibility to report any suspicion or evidence of fraud to the company but further clarification on the scope of this responsibility would be welcome. We do not believe auditors should be given greater responsibility to detect fraud as this would be a major extension of their current role and may detract from other aspects of the audit, as well as lengthen the audit timeframe and increase the cost. Auditors' work should be designed to detect fraud material to the financial statements or to viability, but not fraud immaterial to either of those aspects of their responsibilities.

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

We do not feel qualified to answer this question.

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

Yes, we believe it should be feasible to devise such a test. The challenge will be defining criteria that a reasonable person would apply in assessing the auditor's work in relation to fraud detection. For example, what are the circumstances in which it would it be fair and reasonable to suspect the risk of fraud was elevated? Such circumstances would include basic controls such as segregation of duties, independent reconciliation of bank accounts, suspense account monitoring etc.

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

The primary responsibility for ensuring systems are in place to prevent and detect fraud sits with the directors of the entity itself but we believe auditors should be able to examine these controls to satisfy themselves (and the stakeholders in the entity) these systems exist and are fit for purpose and should have a duty to report their findings to the Audit Committee.

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

We do not feel qualified to answer this question but would observe that the fear of litigation normally triggers investment in upgrading controls and processes to mitigate that risk.

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

We are not persuaded that quantifiable limits on liability would lead to an increase in audit quality; indeed the biggest risk to the Big Four audit firms is loss of reputation rather than litigation penalties.

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?

We believe it is reasonable for the end users of audit reports to have some recourse against those who carry out the audit if loss has been suffered and there is possible negligence resulting in that financial loss and the company carrying the primary responsibility for accurate reporting is unable to make recompense. However, we do not believe it would be practicable to extend the auditors' liability to all stakeholders, in part as it would be impossible to define all the purposes for which stakeholders might place reliance on audited statements. The audited statements have to be taken as a whole and a situation where stakeholders claim a single element therein is incorrect or misleading as the basis of a claim would be damaging to the broad body of stakeholders whose investment would be at risk to plaintiffs seeking to claim damages on specific disclosures as the auditors would likely seek proportionate recompense from the company making the erroneous statement. As shareholders we are seeing growing incidence of putative shareholder suits facilitated by 'no win no fee' law firms funded by third parties who will share in any award.

Q43. How might the quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

If it is believed that a disproportionate amount of audit time is spent building the audit files to withstand regulatory and legal challenge around the audit process and that audit quality would be improved by redirecting that time to enhanced testing and challenge, then limiting liability would be worth considering. We do not have evidence to prove that that would be the case.

Q44. To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?

As stakeholders are generally unaware of the extent of PI cover it cannot be a factor in selecting auditors. The critical factors in selecting auditors should be experience, expertise and commitment to protect reputation.

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

In an increasingly digitised world the use of audit technology will become essential.

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

We do not feel qualified to answer this question.

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

For viability statements to have value they need to provide assurance over cash and funding strategy.

Q48. Given that a zero failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

We agree that audit should not aim to create a zero failure regime but it should (as we have stated elsewhere) give stakeholders an informed understanding of the strengths and weaknesses of the entity in which they have a direct investment interest. This means greater transparency around the audit process and output, graduated findings and evidence of professional scepticism being applied to statements or significant matters of judgement articulated in the expanded audit report. The only meaningful way to calibrate the value of audit would be to conduct an extended period of trialling a representative number of companies without an audit and comparing the reliability of financial and other information produced with those companies subject to audit; we do not recommend this.

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

This is a difficult question as there is no experience of companies with no audit or limited assurance reviews to reference the incremental value of audit but broadly speaking we believe audit costs are reasonable. As an investor we would be willing to consider higher fees in return for a commensurate and demonstrated increase in the quality and/or scope of audit.

Q50. How should the cumulative costs of any extension of audit (whether stemming from this Review of other drivers of change) be balanced against the likely benefits of users?

As stated above, an increase in cumulative costs is justifiable if it leads to an increase in the quality and/or scope of audit and gives investors and other stakeholders a more informed view of the strengths and weaknesses of a particular entity. We would separate the statutory audit from further assurance work with the latter being a menu from which companies and their members could select what further work they wanted to have conducted.

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?

As an investor we make extensive use of audit reports as part of the wider range of tools available to us in assessing the quality of the assets in which we invest. We cannot express a view on the extent to which audit reports are used by other investors.

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

Yes, any improvement in the quality of communication and interaction between shareholders and auditors would be welcome. This would complement any direct engagement with the entity's senior management and directors and help to create a more rounded picture of the way in which it is being managed.

Q53. How could shareholders express their *ex ante* anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

Yes, it would be helpful if shareholders and other stakeholders who rely on the audit report as part of any investment decision were able to raise issues or concerns at an early stage in the process. This would likely be done through engagement with company management or audit committee chairs. This would help to ensure the final product was more relevant to the needs of end users. We do not believe it would be practicable for shareholders to approve planning matters for each audit - this is a matter for the audit committee. However, we are supportive of the CMA's recommendations for greater regulatory oversight of audit committees.

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

As an investor we use a wide range of tools to evaluate the quality of the assets in which we invest, of which audit reports are a key component. We also gain assurance from our engagement with the executive management and non-executive directors of the companies in which we invest, as well as making use of third party and in-house research.

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

We do not regard this as an area of expertise for auditors and we do not believe it should form part of an audit.

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

This should be the essence of the discussion between the auditors and the Audit Committee and the Audit Committee should be charged with commenting on this in its Report.

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

Potentially – but this is a matter for the proposed new regulator of the auditing profession.

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

As mentioned above, we believe audit fees are broadly fair but there is a case for higher fees if this leads to a commensurate increase in the quality and/or scope of audit.

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

No. This is a matter for the Audit Committee to consider.

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

Profitability of the audit function needs to be sufficient to attract the necessary talent.

Aberdeen Standard Investments

Aberdeen Standard Investments is the investment arm of Standard Life Aberdeen plc and manages £505.1bn* of assets, making it the largest active manager in the UK and one of the largest in Europe. It has a significant global presence and the scale and expertise to help clients meet their investment goals. *as at 31 Dec 2018