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Submitted electronically to: brydonreview@beis.gov.uk

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Dear Sir Donald

Independent review into the quality and effectiveness of audit

1. Chartered Accountants Ireland (the Institute) welcomes the opportunity to respond to this important consultation. The Institute has more than 27,000 members worldwide, almost 6,000 of whom are in the UK, and is a Recognised Supervisory Body (RSB) under Schedule 10 of the Companies Act 2006. As such, our membership includes statutory auditors registered in both Ireland and the United Kingdom.

2. The Institute has also engaged with the other two key consultations/studies relating to the UK audit sector, namely the CMA's Statutory Audit Services Market Study and the Independent Review of the Financial Reporting Council by Sir John Kingman. We have also responded to the Department of Business, Energy and Industrial Strategy (BEIS) consultation on the Kingman recommendations. We consider it imperative that the package of measures addressing the UK audit sector be coordinated as far as possible, with audit quality as the foremost priority.

3. In developing this response we have held discussions with some senior members in the audit profession, public interest entity finance directors and audit committee chairs.

4. Many of the themes in the Brydon review, and indeed in the Kingman and CMA reviews, have been reflected in previous studies and reviews[1] into reforming audit:

   - Changing expectations of users of financial statements;
   - Definition of users/beneficiaries of audit;
   - Recognising the interests of a wider group than shareholders;
   - Redefining the role and scope of audit;
   - Involvement/passivism of shareholders in the process;
   - The increasing role of corporate information being reported outside the annual financial statements;
   - The impact of auditor liability;
   - The role of audit committees;

[1] For example, the 1992 Auditing Practices Board (APB) discussion paper 'The Future development of Auditing – a paper to promote public debate'; 2008 submission by the Chair of the UK Auditing Practices Board to the US Treasury Advisory Committee on the Auditing Profession.

- The binary nature of audit reporting; etc.

5. That many of these issues remain as prominent today indicates that solutions are not easy to find and implement. There is clear evidence available, however, to support the view that the capital markets value the contribution of independent statutory audit to the functioning of the system. It is therefore incumbent on all relevant stakeholders to make best efforts to find appropriate solutions/enhancements, given the continuing importance of corporate reporting and statutory audit to the capital markets system and society in general.

6. The UK is widely recognised as having led many of the key developments in auditing standards and practice in recent years, such as in the area of the disclosure of key audit matters discussed later. It is therefore entirely reasonable to consider that initiatives arising from this review, and the other UK reviews mentioned above, may drive enhancements to the audit process and the audit sector internationally. It is critical, however, given the global nature of audit, that initiatives that introduce differences in the UK compared to international best practice are justifiable, and also manageable from a practical perspective. The inconsistent application of the EU's mandatory audit firm rotation rules and auditor independence rules across EU Member States is an obvious example of where international differences can cause very significant difficulties for international audit networks.

7. The scope of the review is very wide ranging. We have therefore focussed our comments below on some of the most important aspects from our perspective and have not attempted to answer all 60 questions. Our comments at this stage in the process are also by necessity very high level and we look forward to engaging on more specific and detailed proposals in due course as the review progresses.

8. We have organised our comments under the following headings:

   I. Audit quality
   II. Addressing the expectations gap
   III. Enhancing and communicating directors' responsibilities
   IV. Auditor reporting – graduated findings
   V. Users of financial statement audit
   VI. Systems of internal controls and reporting
   VII. Distributable reserves
   VIII. Fraud
   IX. Shareholder engagement at AGM with management and auditors
   X. Auditor liability
   XI. Other comments

I. Audit quality

9. We welcome your comments in the foreword that "[n]ot everything is broken and many audits are conducted to a very high quality. In many areas the UK has led the world in the development of audit and I am mindful not to discard what is good in the search for what is better." We consider that this is a very important starting point for your review, and indeed for the various other reviews into the audit sector.

10. Audit quality is the priority and must be at the forefront of all proposed initiatives arising from the various UK reviews. Audit quality is at the heart of this review and that is to be welcomed. We are supportive of initiatives which will enhance audit quality. Our view, as expressed in the abovementioned responses, is that

audit firms, particularly those auditing public interest entities, are very focussed on enhancing audit quality and the global networks are investing very substantial amounts annually on improving their audit methodologies. Work is on-going at international level with regular engagement between the networks and the International Forum of Independent Audit Regulators (IFIAR) on improving the outcomes of audit inspections. A relatively small number of high profile corporate failures, leading to investigations into the audits carried out on those companies, should not detract from the significant efforts being made in this regard, nor be extrapolated to a conclusion of substantially falling standards of audit quality generally, or indeed a sector in crisis, as it is being portrayed in much of the UK media.

11. The value of audit is often perceived in terms of confidence in financial reporting, the absence of qualifications or other modifications of the audit report. Yet, whilst itself being essentially focussed on historical financial information, it provides comfort that the financial statements provide a reliable starting point for companies' forward looking information and communication. Much of the value of the current audit is in the challenge provided by the auditor to the directors and the interaction between the auditors, the directors and the audit committees. Enhancing the communication of these elements of the audit process should go some way towards closing the expectations gap.

II. Addressing the expectations gap

12. It could be argued that the audit expectations gap in the UK is currently at its widest, following high profile corporate failures such as Carillion, Patisserie Valerie, BHS, London Capital & Finance etc in recent years. In our view, the challenge of addressing and reducing the gap to an acceptable, manageable level will be twofold:

    - Evolving the scope and purpose of the financial statement audit and/or introducing other forms of assurance that address **reasonable expectations** of society effectively and appropriately; and

    - Communicating the value of audit effectively and educating society with regard to **unrealistic expectations** – in particular the perception that an audit opinion is a guarantee of the future health of the company and the appropriateness of business models adopted and/or decisions taken.

Reasonable expectations

13. Our discussions have led us to the conclusion that the primary driver of the expectations gap is corporate failure, in circumstances where recently issued audit opinions gave no indication of any impending catastrophic risk. High levels of media or political attention does not tend to be paid to the audit, and expectations of the audit, where corporates miss income and profit targets, with consequent impact on share prices and dividends. That is part of the normal risk attaching to being an equity investor and which is often the natural consequence of a robust audit.

14. The call for views addresses a wide range of topics and potential areas for change – widening the scope of audit, additional forms of assurance, addressing law and regulations, in particular around distributable reserves, etc. The key question from our perspective is which area or areas would represent the highest potential to effectively address the audit expectations gap by meeting reasonable expectations of society. Given that the focus on the gap tends to arise most acutely following a high profile corporate failure, we believe that the issue of viability is critical and would be the most fruitful area for a fundamental reconsideration.

15. Following a significant corporate failure, much attention is paid to the most recent 'clean' audit opinions, in particular those which do not highlight going concern issues, issued in the period prior to the collapse. The distinction between the financial reporting concept of going concern as a basis for accounting, and the longer term viability of a company, is not well understood.

16. The introduction of the requirement, in the Corporate Governance Code and the Listing Rules, for a viability statement a number of years ago has not noticeably improved this situation. The viability statement has evolved to become somewhat binary with its language quite 'boilerplate'.

17. The viability statement is currently subject to the same level of audit focus as the 'other information' accompanying the audit financial statements, in accordance with ISA (UK) 720 *The auditor's responsibility relating to other information*. That is to say, the auditor reads the viability statement for consistency with the knowledge gained by the auditor during the course of the audit and reports whether there is anything material to add or draw attention to in the directors' viability statement. The ISA 720 approach does not allow for the level of rigour and challenge that is otherwise applied to the financial statements.

18. We believe that there is considerable potential to enhance company reporting on the viability assessments carried out by the directors, that audit committees should be more involved in reviewing and reporting on their review of the director's assessment, and that a framework could be put in place to support the auditor giving enhanced assurance on the company's process in undertaking the viability assessment by way of public reporting. This may involve a form of reporting on the assessment of the key assumptions underpinning the viability assessment and views on the degree of risks inherent in the company's circumstances.

19. Work of a similar nature and with a similar objective currently takes place in the context of rights issues and we consider that such an approach could be adapted appropriately for use in annual corporate reporting cycles. Frameworks could be established to ensure that such reporting and assurance work is tailored to the circumstances of the company and avoids a boilerplate approach.

20. Auditing firms currently undertake private assurance engagements outside the scope of statutory audit, such as 'skilled person' reporting, many of which will focus primarily on forward looking information, both to meet regulatory requirements and for other purposes. In an Irish context, there are a number of such engagements which have been developed by the profession in collaboration with the Central Bank of Ireland to address deficiencies which have come to light, particularly in the aftermath of the financial crisis – e.g. auditor assurance engagements in the banking and insurance sectors.

21. We also believe that a separation of assurance work on viability, and associated reporting, from the financial statement audit would help to make clearer for stakeholders the distinction between going concern as an accounting concept and the longer-term viability of the company.

22. There are many significant challenges to be addressed in designing and implementing such an enhanced approach to viability assessment and reporting. Of primary importance, given the very nature of topic, would be to pay great care and attention to the methods and manner of any corporate and/or auditor communication on viability, to avoid the significant risks of self- fulfilling prophesises. There is likely to be resistance amongst corporates to public grading/rating of assumptions and judgements involved, and there would need to be a thorough cost/benefit analysis to adopting a grading/rating approach. These are similar challenges to those set out in paragraph 32 below on graduated audit findings.

23. Designing and implementing an effective system will take a lot of hard work and involve key stakeholders working together to identify solutions that at the same time address reasonable societal expectations, user needs and are workable from an assurance perspective. An effective and workable solution will involve the alignment of requirements on directors, audit committees and auditors.

24. Auditors will understandably and reasonably be nervous about providing public comfort on viability statements and any forward looking information. However, it may be possible to mitigate any perceived risks by requiring any report to be addressed to the directors rather than the shareholders and by explicitly imposing a liability cap of a multiple of fees for the work done on such engagements.

Communication and engagement

25. We would argue that there is currently not a single, uniform audit expectations gap; that audit practitioners, audit committee chairs and members, finance directors, investment managers and sophisticated investors all understand the scope and purpose of the audit as it is currently constituted. Politicians, members of the media and members of the general public would appear to be less aware of these issues. This view was borne out strongly in a symposium Chartered Accountants Ireland hosted in October 2018, 'The value and future of audit', in which audit practitioners, audit committee chairs, finance directors and investment managers participated.

26. As such there remains a significant communication challenge to ensure that the scope and purpose and inherent limitations of an audit is better understood generally, both currently and in the future on the implementation of whatever changes arise from the work of your review and of the other UK reviews. In order to effectively and sustainably address the expectations gap, changes to corporate reporting, governance and audit processes would need to be communicated and explained in a manner which can be clearly understood by the different groups of stakeholders mentioned above. The communication of the value of changes implemented following this and other reviews vis-á-vis the existing situation would be key. Stakeholders will have to be willing to engage at a deep level with the information communicated. As the value of audit is essentially derived from the trust of stakeholders in the corporate reporting system, in the absence of effective engagement and communication, it is hard to envisage the benefits of any significant changes to the system being fully realised.

27. In this context of communication and engagement, we believe that there is already some very rich content contained within the annual financial statements and audit report of PIEs, including the information reported by the company on principal risks and uncertainties and critical judgements and estimates in the financial statements, as well as information provided in the extended audit report on key audit matters. There is an on-going challenge for reporting entities to ensure that this information receives the prominence it deserves and that awareness and appreciation of the value of the information to stakeholders generally is increased.

III. Enhancing and communicating directors' responsibilities

28. In line with the above comments, we consider that proposed changes arising from this and other on-going reviews should not solely focus on audit and the deliverables from the audit process. We consider that a critical success factor for this review will be the enhancement of directors' and audit committees' responsibilities and reporting obligations and better communication of respective responsibilities of management and directors and auditors. We agree with the sentiments in paragraph 23 of the call for views

regarding the primary responsibility of directors with respect to corporate reporting, and indeed for corporate failures.

29. The review needs to take a holistic view of the corporate reporting environment and consider the inputs of other key stakeholders in the process. The reporting responsibilities of management need to be enhanced, as does the involvement of audit committees. For example, certain disclosure requirements currently apply to auditors under ISA (UK) 570 *Going Concern*, yet equivalent requirements are not imposed on directors by way of the relevant financial reporting framework.

30. In the past, certain changes to auditing standards have been implemented to attempt to address identified weaknesses or gaps in the reporting requirements imposed on directors. As such, the scope of the audit has evolved significantly from its origins as being a process to assess the reliability of the financial statements. The evolution of the auditor's responsibilities with regard to other information published with the financial statements is a clear example of this. We consider that this has further added to the audit expectations gap, causing further confusion as to the precise role of the auditor.

31. More detailed and comprehensive requirements on directors will enhance corporate reporting generally and will also provide the basis for more effective audit and/or other assurance engagements. Aside from the issue of going concern, viability statements and assessments discussed above, this issue would also be pertinent to proposals such as the introduction of an internal controls regime in the UK (akin to the SOX regime in the US) and to explicit responsibilities with regard to the prevention and detection of fraud. Auditor reporting/ assurance opinions of any kind require a framework in place for management reporting, against which the management processes and reporting can be assessed.

32. In addition to enhancing these requirements, more explicit, thorough and clear communication, both to the readers of financial statements and to the wider stakeholder community, of the relative responsibilities of management, directors and auditors is also considered critical to dealing conclusively with the expectations gap.

IV. Auditor reporting – graduated findings

33. We consider that the developments in auditor reporting in recent years have been very beneficial. The introduction of commentary on 'key audit matters' (KAM) and discussion of materiality issues provides rich information for users of financial statements. These have moved the audit opinion away from boilerplate language, if not fully from a binary opinion. We consider that, in the context of this review, it would be very beneficial to understand the extent of the awareness and use of this information by users of financial statements. There is a sense that the market has not fully appreciated the value of this information.

34. We would support further innovation/experimentation that would enhance the value to stakeholders of the audit report. There may be scope to further develop the KAM approach, such that for example auditors may comment on developments in KAMs year on year. Such innovation/experimentation may also be by way of a graduated findings approach. Some of the key challenges in progressing to graduated findings would include:

    - Resistance from audited entities to having their key judgements graded, with concerns about consequential impact on market sentiment;

- Identifying the actual benefit to be obtained by stakeholders by implementing a grading scale for audit opinions, vis-á-vis the increased costs that such a system is likely to incur, arising from the obvious level of subjectivity in language used;

- Developing the type of language to be used which will achieve the aims of graduated findings while at the same time not unduly influencing market movements. As with any system of grading, there is a significant risk that market participants such as the media may overly focus on a headline grading, e.g. optimistic, without reading the grading in the context of the overall commentary provided.

35. We also consider that audit committees could play an enhanced role in the area of KAMs and potentially graduated findings. Audit committees reporting on their own assessments in this regard could be a very powerful force for improved corporate reporting.

V. Users of financial statement audit

36. We note the call for views makes reference to the IFRS framework identifying the primary users of financial statements as existing and potential shareholders, lenders and other creditors. We acknowledge that wider stakeholders, also including government and the general public, have an interest in audit quality and the audit report on financial statements. We consider, however, that the primary users of the audit report on financial statements are, and should remain, the body of shareholders of the audited entity.

37. Legally widening the scope of the auditor's duty of care to other stakeholders such as employees, funding providers and other creditors and the wider public would, we believe, be a very complex undertaking. Auditors would have to take the perspectives of such stakeholders into account in the audit work undertaken and in the audit opinion. The perspectives of such stakeholders can vary significantly, so it is very difficult to see how auditors could take all those perspectives into account. Take for example a company which has very aggressive terms of trade with its suppliers – how is the auditor to balance the profitability perspective of the company with the interests of those creditors?

38. Any extension of those to whom the auditor owes a duty of care would certainly have to be accompanied by a revision of the auditor liability regime. It is currently legally permissible under UK company law for companies and their auditors to agree on a limitation of liability, though these provisions are not used in practice. Such an approach to limitation of liability would not be workable with regard to any proposed wider duty of care.

VI. Systems of internal controls and reporting

39. Some of our contributors have extensive experience of implementing and maintaining a SOX environment. Whilst implementation difficulties in the initial years were recognised, so also were developments over time which have resulted in more streamlined, focussed and effective systems of internal controls.

40. The obligation on directors to sign off on such systems of internal control proved a significant driver in the implementation and enhancement of those systems over time. The requirement for auditors to provide assurance, based on a detailed reporting framework, on the directors' assessment could be valuable to the market.

41. It was, however, pointed out that there is potential for the introduction of a SOX-like requirement in the UK to actually exacerbate the expectations gap. This is due to the fact that such a system is designed to ensure good

accounting and financial reporting and operates over financial reporting of essentially historic financial information. It is not designed to address or 'fix' corporate failures. As such, very clear communication of the purpose and objectives in implementing such a regime would be necessary so that market participants do not have unrealistic expectations of the impact of the regime.

42. The implementation of such a regime would of course introduce significant further costs into the system and a rigorous cost/benefit analysis should be undertaken. Lessons learned from the US experience would be vital in ensuring that a proportionate approach appropriate to the UK environment is taken. On balance, our view is that further work/evidence is required to justify the case for the introduction of a SOX-regime in the UK.

VII. Distributable reserves

43. We consider that the issue of distributable reserves contributes to the expectation gap in that generally users will consider reserves to be available for distribution to the equity holders. Better transparency over distributable reserves will make some contribution to closing the gap.

44. We would be supportive of the accounting standard setters addressing the issue of distributable reserves. Directors are obligated under UK law as it stands to assess the availability of reserves for a particular distribution and we believe that it would be appropriate for companies to be obliged to make disclosures of this nature. Such disclosures would then also be by definition information that is subject to the audit and covered by the audit opinion.

45. It should be pointed out, however, that the requirement for such disclosures may well present challenges to some companies, particularly those which are long established. Directors are required to satisfy themselves that there are sufficient distributable reserves present to allow for a particular dividend to be made. During our discussions it has been noted that this is not necessarily the same process required to calculate and disclose precise figures, particularly after many years of trading. The current ICAEW/ICAS technical release *'Guidance on realised and distributable profits under the Companies Act 2006'* runs to over 170 pages, indicating the level of complexity that can be involved.

VIII. Fraud

46. As mentioned above, the starting point for this discussion is the primary responsibility on management for the prevention and detection of fraud. Directors could be required to report more explicitly on how they have fulfilled their obligations in this regard. Indeed, the introduction of an internal control regime could be expected to make a positive contribution to fraud prevention and detection.

47. As regards the considerations of fraud in the audit, paragraphs five to eight of the applicable standard, ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, clearly set out that there is a responsibility on auditors to obtain reasonable assurance that there the financial statements do not contain material misstatements due to error or fraud. The paragraphs then discuss the factors that heighten the detection risks relating to fraud – sophisticated frauds involving collusion of senior management, frequency and nature of the manipulation (e.g. judgement in accounting estimates). They recognise that there is an "unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the [standards]".

48. We consider that auditor obligations regarding fraud, as established in ISA (UK) 240, are appropriately drawn. Clearly communicating the respective responsibilities of management and the auditors remains important in the context of the expectations gap. Again, the expectation amongst wider society appears to be of a 100% detection rate, which is not achievable in the context of a financial statement audit.

49. If the market values it highly enough, there may be merit in exploring the possibility of designing a separate assurance engagement specific to the issue of systems of fraud prevention and detection within a company. This may be ambitious, with such an engagement inevitably involving high risks to the assurance provider and consequently high costs to the company. Again, issues pertaining to liability in relation to such an engagement would need to be resolved.

IX. Shareholder engagement at AGM with management and auditors

50. In principle we would agree with the concept of better, more open and transparent company and auditor dialogue with shareholders at the AGM. We believe, however, that an appropriate framework for such dialogue would have to be designed. So, for example, it would be appropriate for the auditor to discuss and explain the approach to the audit, the key audit matters etc but questions specifically relating to the financial statements and the specific accounting treatments should be directed to, and answered, by the finance director.

51. Contributors have, however, questioned whether there would be real value to be gained, or whether there might be more value to be gained through enhancement of communications in the context of the other areas under review. Questions were also raised as to how such an approach would be balanced between larger and smaller shareholders. Indeed, it was suggested that a better question might be how significant shareholder concerns could be more effectively communicated in a timely fashion to the auditor.

X. Auditor liability

52. We welcome the inclusion in the terms of reference for the review, and in chapter 9 of the call for views, of the issue of auditor liability. We believe that the review provides the appropriate opportunity and timing for a review of the UK liability regime. EU law on statutory audit places no impediments on reforming the liability regime and other European countries have implemented regimes based on proportionality.

53. We stated in our response to the CMA, specifically by reference to the proposals with regard to joint audit, that it would be essential that any move to mandate joint audit would have to be accompanied by a move to proportionate liability. However, we have also long called for a move to proportionate liability generally.

54. We do not assert that the implementation of a proportionate liability regime would resolve all the challenges that audit currently faces, but we do consider that it needs to be a part of the package of reform for the sector. As it stands, firms are more likely to be concerned by the reputational damage caused by being associated with a corporate scandal/failure (as suggested in the call for views).

55. Whilst calling for proportionate liability to be implemented, we would certainly agree that any extension of the scope of audit, particularly into providing assurance over more forward looking aspects of reporting, such as viability assessments and statements, should not be subject to the current unlimited joint and severable liability regime, as indicated in paragraph 121 of the call for views.

56. The call for proportionate liability is also linked to the call to ensure that directors' obligations, with regard to corporate reporting, fraud and other aspects of this review, are strengthened; and that company and directors are held accountable for failures in their work and are also subject to regulation to the new regulator, under the Kingman proposals. Coordinated enhancements across the corporate reporting environment are needed, not just a focus on what an audit can or cannot do differently.

XI. Other comments

57. Question 60 asks if the audit function is sufficiently profitable to sustain a high quality audit industry. We continue to support the maintenance of multi-disciplinary firms on the basis of audit quality and the ability to call on high quality specialist expertise as required for a particular audit. We also stated in our CMA response, submitted in January 2019, that assertions in that consultation about evidence of audit function profitability were too simplistic and ignored the cross functional use of staff to smooth out seasonal staffing requirements. We also noted the very significant investments in audit quality and audit methodologies on a global basis by the larger networks. We do not believe that there is sufficient evidence to support the assertion that audit only firms would be sufficiently profitable to maintain the necessary levels of investment in audit quality.

58. If market participants perceive sufficient value, additional assurance engagements, separate from the financial statement audit, could be designed for other aspects of corporate reporting, such as non-financial information, non-GAAP measures and KPIs, sustainability reporting etc. As for all audit/assurance engagements, there needs to be a detailed framework in place for such reporting, against which performance can be measured and assurance given.

59. The current UK position with regard to the use of the work of internal auditors under the auditing framework, being more stringent than the international requirements, was noted during our discussions. The critical importance of independence in the external audit context was acknowledged in this regard. However, contributors also acknowledged the value that a high quality internal audit function can bring to the management of the company and to the work of the audit committee. They felt that, certainly with regard to the larger PIEs, it must be possible to enhance internal audit processes and requirements, and at the same time review the rules under which external auditors determine their ability to rely on the internal audit work, such that the internal audit function could provide effective support to the external auditor without impinging on independence.

Concluding remarks

60. As mentioned earlier, we welcome the focus on audit quality in this review. We consider that the auditing profession stands ready to make positive changes to appropriately address some of the key reasonable societal expectations of audit. We also believe that the timing is very opportune to strengthen the obligations on directors and audit committees, holistically improving the corporate reporting environment.

61. Given the nature of the call for views, with the wide range of areas addressed, we assume that there will be further phases of more detailed consultation on specific proposals. We look forward to engaging again on those more detailed proposals in due course.

62. We would be delighted to meet with you and your team to discuss our comments, or indeed any other aspects of the review.

Yours sincerely

Conall O'Halloran
President

Barry Dempsey
Chief Executive