Chartered Institute of
Internal Auditors

7 June 2019

Sir Donald Brydon
Brydon Review Secretariat
Orchard 1
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Victoria Street
London
SW1H 0ET

Submitted via email to: brydonreview@beis.gov.uk

Dear Sir Donald,

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

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes the opportunity to contribute our views to the Independent Review into the Quality and Effectiveness of Audit.

The Chartered IIA represents internal audit professionals in organisations spanning all sectors in the UK and Ireland, and it champions the contribution internal audit makes to good governance, strong risk management and a rigorous control environment leading to the long-term success of organisations.

The Chartered IIA is happy to discuss any of the comments included in the response.

We are happy for our response to be published.

Yours sincerely,

Dr Ian Peters MBE
Chief Executive

Chartered Institute of Internal Auditors

Independent Review into the Quality and Effectiveness of Audit: written response from the Chartered Institute of Internal Auditors

Introduction

The Chartered IIA welcomes the opportunity to contribute our views to the Independent Review into the Quality and Effectiveness of Audit.

The Chartered IIA represents over 10,000 internal audit professionals in organisations spanning all sectors of the economy, including most FTSE companies, across the UK and Ireland. We champion the contribution internal audit makes to good corporate governance, strong risk management and a rigorous control environment leading to the long-term success of organisations.

Given the internal audit profession's role within our major companies in promoting good corporate governance and our position as part of the wider audit profession, we clearly have a significant stake in ensuring a well-functioning and high-quality external audit sector. We also believe that internal audit can and should play its role in addressing the weaknesses highlighted by recent corporate failures.

There are a total of sixty consultation questions as part of the call for views. We have only responded to those questions that are of most relevance to the work of the Chartered IIA and the internal audit profession.

Overall comment

There is a well-established principle that the responsibilities of external auditors are closely related to those of company directors. For example, the existing responsibility of external auditors to give an opinion on the truth and fairness of the financial statements is matched by the underlying responsibility of the company directors to prepare financial statements which give a true and fair view.

Whilst we believe measures are now required to improve external audit quality and effectiveness, we would observe that many of the recent high-profile corporate collapses associated with 'external audit failures', have also been characterised by deficiencies in the governance, risk management and internal controls of the audited companies involved.

We are not well placed to comment on whether the external auditors should or could have done more to detect those deficiencies, but we do think that the company directors should have done more to make it less likely that those deficiencies would occur and remain undetected.

Therefore, along with measures to improve external audit quality and effectiveness, we believe that more should also be expected of company directors in relation to the effectiveness of governance, risk management and internal controls. We believe the best way to support company directors in meeting those higher expectations is by well-resourced internal audit functions which operate in accordance with professional standards. For example, there may be a case for introducing into the UK a more specific responsibility on company directors in relation to internal controls over financial reporting such as is mandated by the Sarbanes-Oxley Act in the USA, and we have therefore welcomed the forthcoming Government consultation on this.

We remain sceptical about whether the responsibilities and scope of external audit should be expanded but believe the principle that directors should be responsible for governance, risk management and control should be maintained. Thus, if external auditors are given greater responsibilities in relation to the prevention and detection of fraud, for example, then so too should company directors.

If the responsibilities of external auditors and company directors are to be expanded, then it would follow that the scope of internal auditors should also be expanded so that they can fully support company directors in their expanded responsibilities.

In this context we would like the review to be made aware that the Chartered IIA produced a Code on Effective Internal Audit in the Financial Services Sector in response to the financial crisis and we are currently preparing to consult on an equivalent code for all private sector organisations. This work is being undertaken, under the direction of an independent committee being chaired by Brendan Nelson the Audit Committee Chair of BP.

In conclusion, we believe this review provides an opportunity not just to improve the relevance and effectiveness of external audit, but to also act as a stimulus for director-led improvement in the effectiveness of governance, risk and internal controls, supported by the work of professional internal audit functions.

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

An external audit should be conducted for the benefit of an organisation's shareholders and other stakeholders. Other stakeholders will include employees, suppliers, regulators, customers and the wider public.

However, we believe that an external audit should primarily be conducted for the purpose of the organisation's shareholders. But given there is a public interest element to the exercise, an external audit may also be of value to a broader group of stakeholders. This is even more so in an age of growing 'corporate stakeholderism', with far greater emphasis on the need for transparency and accountability from business, particularly from companies that are deemed to be Public Interest Entities (PIEs).

An external audit is of value to users by giving them assurance that the numbers being referred to in the business's financial statements and reports are 'true and fair', and by doing so this can, in turn, help to provide users with a level of confidence around the financial viability of the organisation.

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

We believe the core purpose of an external audit is to provide users with assurance that the financial statements are 'true and fair'. As a consequence of such assurance this may well help to enhance the confidence of users in the business being audited, however that is not external audit's core purpose but a by-product of it.

Shareholders, company directors and stakeholders seeking confidence in the sustainability of a business would be wise to adopt a balanced approach by seeking views and opinions from a range of information providers, rather than being encouraged to rely solely on the opinion of the external auditor – which only offers an opinion related to the financial statements.

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?

We believe there could be value in amending UK law to provide greater clarity on the purpose, scope and remit of external audit. Thereby providing greater transparency around what an external audit is and what it is there to do (and possibly more importantly what it is not there to do).

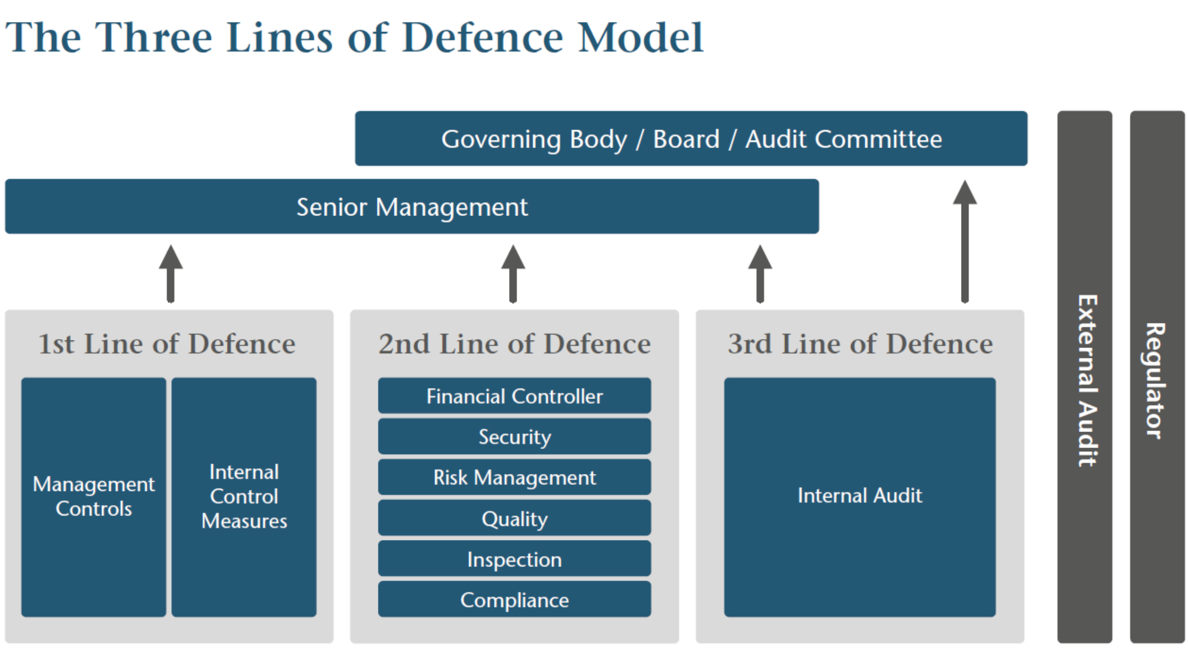
An additional or alternative option could be to undergo a refresh of ISA (UK) 200 which is already fairly comprehensive in setting out the purpose of an audit, and for whom it is conducted. Any update should reflect the lessons learnt over recent years.

Q4/Q5. Do respondents consider there is an expectation gap? If so, how would respondents characterise that gap?

We believe increasingly that the expectations of external audit are currently too high and that this has led to an expectation gap. The key areas contributing to this expectation gap are summarised neatly in the review's discussion paper.

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

Our view on the role of external audit within the wider assurance framework can be best explained through the 'three lines of defence model", something which the Chartered IIA endorses and promotes:



Under this model internal audit is shown as the third line of defence, providing comprehensive assurance on the effectiveness of internal controls, governance and risk management, with a primary reporting line to the Audit Committee.

External audit is considered as effectively a fourth line of defence, located outside the business, with a limited mandate to provide assurance - specifically that the financial statements are ‘true and fair’.

External audit only looks at historical financial records during that process, so is of limited use in assessing how well senior management is managing the organisation’s risks. The role of internal audit, on the other hand, should be to provide assurance on the effectiveness of risk management, internal control and governance across the business.

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

Broadly speaking we believe that under the present arrangements the boundaries between internal and external audit are sufficiently clear and that it is of fundamental importance that these boundaries are maintained.

Both internal audit and external audit are essential for the effective governance of an organisation and it is vital that both are independent, objective, properly resourced and work according to their respective standards, as well as for each to have its own clear roles and responsibilities. But it must be recognised that they perform very different functions within the assurance framework and should report separately to the board / audit committee.

In encouraging clear boundaries and independence between the various functions within an organisation’s assurance framework, the Chartered IIA endorses and promotes the “three lines of defence model” (see above). This clearly demonstrates the boundaries between the various functions.

In essence, external audit provides assurance that the financial statements are ‘true and fair’, so it audits the financial information. Internal audit provides a holistic assurance on governance, risk management and internal controls across the organisation which will also include the rigour of key financial controls and risk management.

Policymakers must fully understand and take the differences between internal and external audit into account when developing new policies. In helping to maintain the boundaries and in promoting better understanding of the two professions amongst stakeholders, we believe it would be helpful, wherever possible, for legislative and regulatory references to “audit” and “the auditor” be specific as to whether they are referring to external or internal audit.

Despite the need to maintain clear boundaries and independence from each other, it is beneficial for both internal and external audit to have constructive and fluid two-way dialogue.

However, in maintaining clear boundaries regulators rightly recognise that the role of internal audit in relation to external audit needs to be strictly controlled in order to ensure independence, and objectivity. But they also need to recognise that internal audit’s work has a much broader remit, covering risk, internal controls and governance as well as specifically internal financial controls. The more the internal audit function’s organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors then the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas.

For this, and for wider conflict of interest reasons, we support ISA (UK) 610 which governs how external auditors may use the work of internal auditors and offers clear guidance on the rules of engagement between the two functions.

Whilst the ISA standard does allow internal audit to directly assist the external auditor, we believe that in helping to eliminate potential conflicts of interest, ensuring clear boundaries and strictly maintaining the independence of both internal and external audit, the practice of internal audit directly assisting external audit should continue to remain prohibited here in the UK.

If internal audit were allowed to directly assist external audit this would risk diverting internal audit resource, thereby weakening corporate governance by reducing the amount of time available to provide those responsible for governance with assurance on governance, risk management and control.

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

External auditors should be able to use evidence obtained from the work performed by internal auditors to inform their work, as long as they comply with the clear rules and standards, particularly those outlined in ISA (UK) 610.

As a general principle, whilst external auditors should be able to use evidence and reports obtained from the internal audit function, in order to assist them in their audit work, they should not place 100% reliance upon such evidence and should ensure they maintain their own independence, objectivity and professional scepticism in drawing conclusions from it.

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 directors having to make a more explicit statement in respect of risk management and internal controls and for these to be subject to audit.

We would observe, however, that there are already some companies where directors are expected to complete and sign a control risk self-assessment statement (CRSA) which internal auditors will use to support work undertaken in each director’s area. Internal audit will also audit the robustness of the CRSA statement and provide an assurance, supported by evidence, as to the accuracy and completeness of the statement. This practice is currently voluntary and is not currently a regulatory requirement.

But there could be value in making CRSA’s a regulatory requirement for directors of listed and other relevant public interest entities. Perhaps as part of the Corporate Governance statement that appears in the annual report and accounts.

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

We are sceptical as to the need to extend external auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control, but agree that it would be helpful to provide greater clarification of the responsibilities for both external audit and internal audit in this respect.

We believe that if internal audit is given sufficient status and authority to do its job, then there may not be a need to further extend external audit's scope in this area.

In this respect it would be helpful if the UK Corporate Governance Code was further strengthened to make it a clear requirement for premium listed companies to have an internal audit function and that, that function should follow the Chartered IIA's standards and Internal Audit Code of Practice. This includes the requirement to have an independent External Quality Assessment of the internal audit function at least every five years.

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?

As external auditors are already required to report to audit committees their views on the effectiveness of relevant internal controls, in promoting greater transparency and accountability of an external auditors' work we would support these views also being made public.

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

We believe the case for a more forward-looking external audit is fraught with difficulties and challenges. The basic and core purpose of an external audit is to provide assurance that the financial statements are 'true and fair' based on the previous year's financial records, it is therefore by its very nature a historic exercise. It would be beneficial for external audit to raise its bar and focus on delivering its existing core function to a high standard.

There is also a significant risk of duplicating the work of internal audit. For example, internal audit already audits a broader range of key risk areas that can offer an indication of the long-term health and sustainability of a business. This can include topics such as corporate culture, environmental, modern slavery, social and governance metrics, along with issues concerning gender equality and pay reporting.

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 fraud?

We believe that stakeholder expectations of external audit's role in fraud detection are higher than the requirements defined in UK law and external auditing standards. This is reflected in the current media discourse on the future of audit and on high-profile corporate collapses, with external auditors being heavily criticised for not detecting fraud, most recently in the collapse of Patisserie Valerie.

Equally, it is also important to point out that it is not the job of internal audit to look for fraud either. Instead it is internal audit's job to ensure that appropriate and effective internal controls have been put in place by senior management to detect and prevent fraud. Often in the audit process internal audit may discover fraud, but like with external audit, it is not internal audit's job to pro-actively seek to detect it.

So, it is senior management's job to ensure that appropriate controls are in place to detect and prevent fraud, and internal audit's role to provide assurance to the board that such controls are in place and effective.

However, if external auditors were to be given more responsibilities in relation to the detection of fraud, then we believe company directors should also be required to do more in relation to the prevention and detection of fraud.

Q.39 Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

At present it is internal audit's job to provide an assurance as to the effectiveness of the controls that have been put in place by management to detect and prevent fraud. This will involve testing the design and operation of the internal controls and associated fraud detection systems.

Q45/Q46. 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 what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

We can only provide comment in relation to internal audit, but these views are likely to be relevant to external audit.

New technology is increasingly being harnessed within internal audit functions, in particular the use of data analytics is becoming more widespread.

The benefits of using data analytics are clear, they allow for total-population testing instead of random or judgemental sampling, they improve assurance (although still don't always provide 100% assurance), provide greater audit coverage and can increase efficiency resulting in time and cost savings over the long-term.

Critically, the use of data-analytics and technology within internal audit functions that use it has enabled a greater focus on new and emerging strategic risks by moving away from the more routine internal audit tasks which can then be automated to a greater degree. This enables internal audit to add greater value to the business.

In this context it should be noted that the increasing use of technology and data analytics has major implications for, and could play a key role in, the development of a strengthened framework around internal controls in the UK, learning lessons from the operation of the Sarbanes Oxley regime in the US. In particular, the use of data-analytics can remove the need for specified transaction sampling sizes completely, allowing, where appropriate, 100% of transactions to be tested.

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

The revised UK Corporate Governance Code places greater emphasis on the need for directors to seek assurance on corporate culture than was previously the case, and this is something that the Chartered IIA has welcomed and actively supported. In fact, internal audit functions are increasingly engaged in auditing corporate culture and providing boards, audit committees and senior management with assurance on this.

However, we are unconvinced and have concerns around the idea of external audit also offering assurance or an opinion on corporate culture. Not least as there would be a significant risk of duplicating the work of internal audit and this is not an area of expertise for external audit. Widening external audit's scope to include providing assurance on corporate culture would also risk diverting external audit from focusing on its core purpose.