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By email: brydonreview@beis.gov.uk

Dear Sir Donald,

Independent review into the quality and effectiveness of audit - Call for Views

On behalf of Croda International plc (the FTSE100 global speciality chemicals company), we have considered the questions raised in the Call for Views and thank you for the opportunity to respond.

Our response is appended herewith. In addition, we would encourage that all parties work to achieve a consistent framework, between your review, that of the Kingman Independent Review of the Financial Reporting Council and ongoing work by BEIS. We would also encourage appropriate phasing of the implementation of new ideas and changes to current practice, in order to make this effective and manageable for UK business.

We would welcome the opportunity to discuss our views and comments further with the Brydon Review team if deemed helpful.

Yours sincerely,

Alan Ferguson
Chair of Audit Committee

Jez Maiden
Group Finance Director

CALL FOR VIEWS – RESPONSE TO QUESTIONS RAISED

- **Definitions of audit and its users** – who should the audit be for and do we need a formal extension of the audit report? (3 questions)

  Q1: For whose benefit should audit be conducted? How is it of value to users?
  Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in 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?

  The audit has to be for the benefit of the shareholders as they pay for it and vote on the appointment of the auditors. However, it has to be recognised that society places some responsibility on the auditors as the success or failure of a corporate can have a big impact on other stakeholders, such as employees, pensioners etc. Undoubtedly a clean audit opinion sends a message of confidence in the company; however, it should not be seen as a guarantee of future success.

  In considering the different areas of the annual report and where audit can be most valuable, we would note that the audit provides greatest confidence in the **historic** performance of the company, particularly the financial performance and, to a lesser extent, the strategic progress of the business, given that the latter is also subject to some review by the auditors. Shareholders, and the equity capital markets more broadly, are significant users of the historic financial statements and should be able to rely on the audit. Many of the other users of the accounts rely more on the commentary and non-financial indicators, upon which the audit is less able to give support, due to the judgemental, **forward looking** and broad nature of these areas; therefore, the audit is likely to be less useful for these users than for shareholders.

- **The "expectation gap"** – does the audit meet the requirements of its users? Should it be more forward-looking? (3 questions)

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

  There is undoubtedly a perception that there is an expectation gap, and there may be a real one, and so this needs to be addressed. Once the scope of the future audit is agreed, it must be made clear what that actually means, so that all stakeholders can understand what comfort they can draw from an audited set of accounts. Also, in the accounts, there needs to be clarity over what has been assured by the auditors and what hasn't.

- **Audit and wider assurance** – what is the role of audit within the wider context of business assurance? Should external auditors use the work of internal auditors? Should it go beyond the financial statements? (5 questions)

  Q7: What should be the role of audit within wider 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?
Q9: Are the existing boundaries between internal and external audit clear?
Q10: To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?
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?

The external auditor is one of possibly many assurance providers to the Board of a corporate; for example, there can be health and safety auditors, internal audit and QA/QC teams, all of whom provide valuable assurance. The relationship between internal and external audit is an important one, as a corporate wants to make sure they are complimentary, not overlapping or duplicative in the work carried out. This is becoming ever more important as data analytics grows as a tool for providing assurance through both internal and external audit. This is something the CFO, Head of Internal Audit and Audit Committee spend time managing. If external audit can rely on internal audit, that's useful and should not be excluded by audit regulation. However, this is not essential; indeed the Audit Committee may wish to focus internal audit on other areas than supporting external audit.

There is an inevitable difference in the level of assurance provided between business sectors – in companies with obvious revenue recognition (eg shipment of physical products) and IT systems to support 100% testing of transactions through data analytics, the audit should be more straight forward and the findings less open to interpretation. However, where a high degree of judgement and estimation is required, the audit will inevitably be testing whether the results presented are within reasonable bounds.

We do not consider that auditor independence restricts innovation or quality of the audit.

- **The scope and purpose of audit** – what should the role of the auditors be regarding the internal controls of an entity, its going concern and its viability? (11 questions)

  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?

  The disclosures have come a long way over recent years but if more can be done which adds value, then corporates will do it. However, to audit some subjective judgments on the risks a business faces would be difficult and auditors already comment on risk disclosures etc.

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

  Clarified.

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?

We are not sure this will add value but it is something that can be considered.

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

We do believe that the going concern assessment over a relatively short time period (ie c12 months) does provide a focused test for the Directors on the ability of the company to continue to trade in the short term (which is less the case in the Viability Statement) and therefore the going concern test/statement is of value.

However, increasing transparency has challenges. There is a risk with more disclosures in certain circumstances that creditors withdraw support and the company rapidly goes into administration. However, providing greater granularity over the reason for the directors' judgement is worthy of consideration.

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

We have supported the FRC Lab in its work to make the viability statement more useful to stakeholders and less 'boiler-plate' in nature. Due to the wording required for the viability statement "….meet its liabilities as they fall due", the statements generally cover a three year period when some business cycles are longer than this. A review of the wording required might help these statements become more valuable to shareholders.

Q18: Should such a statement be subject to assurance?

No. Providing assurance over forward looking statements is difficult and the work involved to assure them will be akin to a working capital statement. We fear that statements will therefore end up covering a short as time as possible, rather than being useful to stakeholders.

Q19: Who might be capable of giving such assurance?

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

It's very hard to assure matters in the future and so, whilst it sounds an attractive option, we are not convinced as to its merits or deliverability.

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

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

We note that, in recent years, auditors have spent more time considering these areas in the context of the annual report and increasing this work is definitely something that should be considered. Investors look at KPI's/non-financial metrics when assessing a company's prospects and value, and having these assured has merit. Given the range of different KPIs and non-financial metrics, which are often specific to a company or sector, the methodology for such metrics should not be overly prescribed. Some areas, such as our own engagement in sustainability reporting, are still very much work in progress, with standardised frameworks and reporting in their infancy.

In the other areas, payment practices do not seem worthy of external audit (although the directors might require internal assurance over these as they are published) and we feel there is nothing to be gained by an audit of the half year results, other than time delays and cost.

- **Audit product and quality** – what are the key enablers of audit quality, both in the audit process and the audit product? How is this quality communicated in the audit report and how is it enabled by the regulator? (6 questions)

Q23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

We would consider that effectiveness and quality are inextricably linked. Value is a separate matter.

Q24: Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgment?

We have heard that this is the case. An excessive focus on documentation should not be allowed to replace professional scepticism and management challenge at the heart of the audit. We firmly believe that the regulator should communicate with the Audit Committee Chair when scoping their inspection work and once the work has been concluded. These inspections have value to Audit Committees.

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

It will give more flavour and over time you will see if there has been a change in way judgments are being formed, which should be helpful to readers. The approach to graduated findings should be consistent across audit firms although the findings need to be sufficiently specific to the company and the audit findings not couched in excessive 'risk' language by the auditor.

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

The audit report has been significantly extended and this, together with graduated conclusions, probably means its best to pause before further changes are made. If there was a need for further narrative, we would support putting that in the Audit Committee Report, which is a much more freeform report and so less likely to drift into boilerplate.

Q27: What would prevent such disclosures becoming boiler plated?
Given the nature of the audit report, it's almost inevitable that it will have significant elements of boilerplate in it.

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

- **Legal responsibilities** – how do the responsibilities of directors and auditors interact? What about in areas where more precision may be required, such as capital maintenance? (4 questions)

  Q29: What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?
  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?
  Q31: Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?
  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?

  It is primarily the responsibility of the company and its directors to ensure compliance with overall laws and regulations. The auditor provides a valuable input to the more detailed area of accounting standard compliance.

  With regard to distributable reserves, we would be comfortable to enhance and expand disclosure, if a common understanding of requirements was achieved by regulators and investors.

- **The communication of audit findings** – could greater transparency aid the understanding of the audit process and the auditor's perspectives, whilst avoiding unexpected consequences? (3 questions)

  Q33: Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?
  Q34: Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?
  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?

The audit report has been significantly extended. It seems this has been well received and we certainly supported this. There has also been discussion on the auditors giving graduated findings in their report and, whilst this has some possible unintended consequences, it's something we would support. This will result in a new "language" as the auditors describe where each judgment is on whatever the scale it chooses to use.

It's not clear to us what further disclosures in the audit report would be helpful but it's worth noting that the Audit Committee Report has also been significantly extended over recent years, although this has not received much comment, either positive or negative. It would seem to us that if shareholders require more information on, say, the significant accounting judgments, then this report could accommodate that. After all, it is the Audit Committee which is accountable to the shareholders.

On this basis, we firmly believe that, if investors and other users require greater dialogue on the audit, the Chair of the Audit Committee should be the first point of contact. Shareholders can already speak to the Chair if required. The Chair has the understanding and business knowledge to answer questions, whereas the auditor's knowledge is necessarily more limited in scope. In addition, the Chair is authorised to speak on behalf of the company, whereas there would be likely to be more professional restrictions on an auditor.

- **Fraud** – is it reasonable and feasible to expect auditors to play a greater role in detecting material fraud? (4 questions)

  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?
  Q37: Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?
  Q38: Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?
  Q39: Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

  Whilst it is primarily the responsibility of the company and its board, auditors should be able to detect material frauds. This is an important part of reducing the 'expectation gap' in the audit. However, a 'reasonable person' test may be difficult to build, given that a fraud may not have a material impact on the financial statements but could result in significant impact on the corporate and its reputation.

  In terms of the auditors' reporting on systems to detect fraud, this leads down a 'SOX' or 'SOX lite' route. The question here is whether there is evidence in the US that frauds have become less prevalent since the imposition of SOX. There is certainly evidence that a heavily detailed system of controls and anti-fraud documentation similar to SOX results in a costly, complex imposition on companies and auditors, which may not be to the advantage of the UK capital markets and their agility.

- **Auditor liability** – would changes in this area and radical thinking aid an expansion of assurance? (5 questions)

Q40: Is the audit profession's willingness to embrace change constrained by their exposure to litigation?
Q41: If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?
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?
Q43: How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?
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?

We don't see how limiting liability is going to improve audit quality. Equally, extending those to whom auditors are liable will just make them exceedingly risk adverse and highly unlikely to make any statements, especially forward looking ones, other than boiler plate.

- **Other issues**, including technology, proportionality, shareholders, culture, and cost (16 questions)

  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?

  The use of technology in audits is increasing rapidly and should be a positive thing in that whole transaction populations can be reviewed, rather than just samples, which should give greater assurance. This is an important addition, although not a replacement for, an experienced, knowledgeable auditor.

  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?

  Audit technology primarily increases the assurance provided on the existing scope, rather than on potential new scope, areas.

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

  The audit should be seen as adding value to a primarily backward-looking assurance of the company, added to other components available to stakeholders to assess the risk of potential future failure.

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

It's a cost of doing business and the important thing is to ensure it's a quality piece of work, as this way the greatest assurance is given to the board and ultimately the shareholders.

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

If we felt we could get more value from the audit by spending more, then we would do that.

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?

In our experience, we receive few questions from shareholders on the audit report, although greater dialogue would be encouraged.

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

The Audit Chair is always available to meet with shareholders. After 8 years on the Croda board, our Chair has not had any approach from them to discuss the work of the Committee or of the auditors and so you have to question if any interaction is warranted. In addition, there are some challenges to overcome in any direct communication between investors and auditors, as noted above.

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

Shareholders should address those issues to the Audit Committee, otherwise what is its role? The Committee agrees the audit plan and, if shareholders have issues, then they must go through the Audit Committee.

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

Hopefully they get assurance from the work of the Audit Committee, on their behalf and as their proxy, which is reported on in some detail in the Annual Report.

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 company, rather than the auditors, is better placed to comment on culture. However, greater use of graduated findings and ranges of estimates and assumptions could give users an understanding of the auditors' view on financial reporting culture.

Q56: How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?
That's very hard to do. The shareholders should be relying on the Audit Committee to judge whether that is the case or not.

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

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

We view the cost as appropriate for the business. However, the focus is on audit scope and quality, rather than cost. The market is appropriately competitive and this ensures fees are appropriate.

Q59: Would users of financial statements wish more detail on the make-up of audit fees?
Q60: Is the profitability of the audit function sufficient to sustain a high-quality audit industry?