

QUALITY MUST BE GUIDING LIGHT FOR AUDIT REFORM

THE CBI RESPONSE TO THE BRYDON REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

The CBI welcomes the opportunity to provide input to this timely review on the role of audit and the ways in which it can be improved. The CBI sees this as an opportunity to re-position the role and value of audit as a cornerstone of UK competitiveness.

This response aims to set out an ambitious vision for the UK audit market that is informed by the views of CBI members. The CBI speaks for some 190,000 firms, including the companies which procure audit services, their suppliers, investors who rely on the UK audit market to inform their investment decisions as audit firms themselves.

The findings of the Brydon Review will be a valuable contribution to wider discussions about the UK's audit market. The CBI believes it is important to determine what the future of audit should be, and then organise an effective and competitive market around that vision. This is important with concurrent proposals for structural and regulatory changes also being considered. All these proposals should be considered together to ensure a package of practical, holistic audit reforms which work for all businesses in a global economy.

The central objective of audit reform must be to improve quality. The UK has a world-leading reputation on corporate governance, and audit plays a big part in this. We start from a position of strength. But there are real opportunities to make the audit product more effective, and to strengthen the UK's corporate governance regime, in a way that underpins the interactions between companies, auditors and investors.

In considering changes to the audit product and market, it is important to consider the wider economy and the international context. With Brexit uncertainty unlikely to diminish in the short-to-medium term, the UK's position as a stable, predictable economy remains under threat. The UK's audit profession *is* world-leading. As such, it is vital that audit reforms do not put UK at a competitive advantage by diverging from international standards. The goal must be to craft the best audit product possible whilst provide firms with continuity by using international standards as the foundation.

Recent business failures have highlighted both an expectation gap and a delivery gap which exists regarding the role of audit. This has prompted searching questions about the extent to which audit products are relevant to complex, modern businesses and the inter-connected world in which they operate.

CBI members believe that audits are integral to having trust and confidence in business. So, the impact of failures *cannot* be understated. When companies do fail, the impact can be devastating for employees, suppliers, pensioners and customers. Audit *cannot* be expected to prevent businesses from failing; and striving for no business failures isn't the objective anyway. Nor should audits be expected to provide a cast-iron guarantee of future business performance, as this would be unrealistic. What audits should do is provide enough detail and scrutiny to be confident in the current health of a firm. And they could evolve to provide more forward-looking insights to help inform judgement about a company's prospects.

The CBI is proposing three elements of reform to help deliver these objectives:

- 1. Strengthen audits to close expectation and delivery gaps**
- 2. Bring forward-looking elements into scope to help inform opinion about a company's prospects**
- 3. Ensure that companies and other stakeholders step up to their responsibilities**

Strengthen audits to close expectation and delivery gaps...

Recent, high profile corporate failures have led to suggestions that auditors should have done more to identify signals of company distress and / or taken more proactive roles in communicating potential problems to investors and other stakeholders.

We believe that a stronger focus on distributable profits, future revenues under fair value accounting and when & how revenue translates into cash would help to build a more accurate picture of a company's health.

One specific area to review is whether more could be done to check for any fraudulent activity. Auditors have access to much of the necessary information to detect potentially fraudulent activity. It therefore seems feasible that within their role as independent scrutinisers, they might also look to detect instances of wrongdoing or heightened risk for the company. Auditors taking a more active role in this area could further help address public concerns about the relationship between auditors and their clients. To support this, it is important to strengthen whistleblowing mechanisms for auditors to provide clear processes when company practices or controls need to be flagged in the most extreme cases.

We also believe that it would be beneficial for auditors to have to assess and report on the audit committee's effectiveness.

Tightening the financial information for consideration by auditors, enhancing their role within fraud detection and encouraging comments on both management and risk management quality, are all options for reform which should be considered. Importantly, the core objective should be to introduce practices that increase the transparency and accuracy of audits so that the conclusions reached provide greater assurance.

Recommendation: Auditors should confirm that they have sought to identify fraudulent activity in their appraisal of the company's accounts and internal controls and report their findings.

Recommendation: Strengthen whistleblowing mechanism for auditors to raise concerns about a company's practices or controls.

Recommendation: Auditors should assess and report on the audit committee's effectiveness.

Bring forward-looking elements in scope to help inform opinion about a company's prospects...

A key area in which CBI members think the audit product itself could be enhanced is to bring some forward-looking elements within the scope of the audit. These provisions would allow auditors to consider more contextual elements and provide a more nuanced analysis of a firm's current position and prospects. This would in turn be useful for stakeholders. Giving any impression that auditors would provide any form of guarantee for future performance should be avoided, though there are several areas in which a forward-looking approach might increase audit quality.

Learning lessons from the financial services industry, CBI members believe that the largest and most complex companies could be subject to some form of stress testing. These results would then be used by auditors to inform their assessments. Understanding how firms might adapt to varying economic environments or external challenges, would be beneficial for audit stakeholders and provide a more tangible understanding of the firm's position or fiscal health.

As well as providing information to both investors and the public, stress testing could also prove valuable for firms when flagging areas of potential risk. For the auditor, this additional information would supplement their wider judgements about the company. The parameters of stress testing would need to be carefully considered, though the additional levels of assurance such a process could provide would likely be beneficial to stakeholders.

Finally, CBI members identified scope to expand the statutory audit to ensure it is increasingly forward-looking. As with stress testing, such a forward-looking element has the potential to provide an increasingly contextual understanding of a firm's prospects and strengthens the audit product overall. The options here could be to extend the length of time for the going concern statement, or more likely to include viability statements within the scope of the audit. This would allow auditors to develop a clearer understanding of the assumptions being used by the firm which in turn would enable them to build a picture of the principle risks and dependencies facing the company. With such additional contextual information, auditors may also be better positioned to provide a detailed analyses of a firm's overall risk management practices.

Recommendation: Large and complex companies should perform stress-tests that are then scrutinised by auditors. Consequent results should further inform the auditor's assessment.

Recommendation: The scope of the statutory audit should be widened to make it more forward-looking and viability statements should be audited, to provide a sense of a company's prospects.

Recommendation: Auditor's assessments should comment specifically on the effectiveness of the company's risk management practices.

Ensure that companies and stakeholders meet their responsibilities

Whilst enhancing the audit product should be a key focus of Government reform, improving audit more widely will require all stakeholders to adapt to new processes and step-up their responsibilities.

One option under consideration is whether the UK might benefit from adopting elements of the US Sarbanes Oxley (SOX) regime. The CBI does not believe that a wholesale adaption of the SOX regime would be appropriate for the UK. But we do believe that there are aspects of it that would be beneficial, specifically those areas around internal controls.

We encourage the government to consult with stakeholders on whether to require additional responsibilities being placed on firms' senior executives to confirm that they are satisfied with the internal controls across the business. This additional, individual responsibility should – if adopted – be designed and implemented in such a way that preserves collective board responsibility.

The CBI also encourages government to consider reforms that increase the meaningful engagement opportunities between audit stakeholders. Enabling increased conversation about a firm's audit process, and wider financial or management practices, could in turn help to increase transparency and understanding for investors. Audit Committee chairs should also play a primary role in leading and convening these discussions.

Recommendation: The new regulator should seek to consult on changes to company law that place additional responsibilities for executives for internal controls, informed by these elements of Sarbanes Oxley in the United States.

Recommendation: Audit Committee chairs should undertake regular engagement with shareholders or stakeholders, facilitating an open exchange on a company's internal accounting practices and the key aspects of the statutory audit, such as tendering, management and reporting.

Recommendation: Investors and shareholder representatives should undertake regular engagement opportunities to develop a sound understanding of a company's approach to risk management, payment practices and financial accounting.