The Chartered Institute of Management Accountants®

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

6 June 2019

Dear Sir Donald,

CIMA Response: Independent Review Into The Quality And Effectiveness Of Audit

Thank you for the opportunity to consider issues around what the purpose, scope and quality of an audit should be in the UK. Attached is our response to your call for views into the quality and effectiveness of audit.

The purpose of an annual report is to provide shareholders and potential investors with relevant information about the performance and stewardship of a company. The auditors are required to express an opinion on the truth and fairness of the financial statements, and whether the annual report overall is consistent with the financial statements. The annual report is a statement at a point in time, and does not contain a forecast.

The performance of companies over time is relevant to society particularly around issues such as pensions, employment, the protection of the environment, and for the provisions of services – some of them within the public sector to name a few. The financial health of large companies and public interest entities can have a material effect on both individuals, wider society and the economy in general.

The general public appear to presume an audit gives assurance and confidence in the viability of an organisation. This represents a major gap in the definition of an audit in legislation and standards. This gap needs to be addressed and we hope this review goes someway to help close this gap.

The work of auditors is normally undertaken in accordance with statute, regulations and standards. It is always undertaken in accordance with defined terms. Without a clear definition it is impossible for the auditor to be clear on the terms of reference for their work and what their potential liability may be.

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Audit liability has been a significant issue for decades. The sole focus on the auditor for corporate failure is unfair as there are normally many contributors to such a failure, including poor corporate governance from the boards of companies and their directors.

An audit of the financial statements provides confidence to investors, analysts, regulators and rating agencies that the position reported is in accordance with both financial and auditing standards. The audit also provides the directors a basis for ensuring their management information is robust. As the audit focuses on the controls and risks, it also provides input into the financial controls and risks that directors and management rely upon.

Recent corporate failure has increased the focus on audit quality. We welcome this focus and review into the purpose, scope and quality of audit and believe audit quality can be improved, but the expectation gap needs to be closed and the purpose of an audit needs to be clearer and more widely understood.

We also believe that with the introduction of Integrated Reporting it is possible that as more organisations take up this approach there will be greater assurance going forward on the state and viability of organisations.

In our response we have stated that:

- any changes to the definition of audit needs to comply with international law and standards,
- the expectation gap needs to be closed,
- integrated reporting should be more widely adopted to help bring greater assurance,
- the viability statement and definition of 'going concern' should be reviewed.

The standards and processes around financial reporting have been developed over decades. They provide the company, its board and the auditors with a pathway to the preparation of a comprehensive, balanced and transparent financial report. However, there is no equivalent set of processes and standards to prepare and assure the overall annual report. Initiatives exist to address this shortcoming, but more should be done. There are opportunities to improve the quality of financial reporting and its assurance.

Yours sincerely,

Andrew Harding
Chief Executive - Management Accounting

Department for Business, Energy and Industrial Strategy

Independent Review into the Quality and Effectiveness of Audit

Consultation Submission from
The Chartered Institute of Management Accountants
June 2019

For further information contact
Ross Archer
The Helicon, One South Place, London EC2M 2RB
[redacted]

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About CIMA

The Chartered Institute of Management Accountants (CIMA), founded in 1919, is the world's leading and largest professional body of management accountants.
CIMA helps individuals and businesses to succeed by harnessing the full power of management accounting – not just accounting for the balance sheet, but accounting for business.

CIMA operates in over 176 countries and has over 80,000 members in the UK. We provide continuing professional development services, fund academic research, develop thought leadership, monitor professional standards, maintain a code of ethics for members, and work with external tuition providers and assessment services to provide the best study and examination experience.

Together with the American Institute of Certified Public Accountants (AICPA), we established the Chartered Global Management Accountant (CGMA) designation in 2012 to provide members with a new level of resources and recognition.
The CIMA syllabus draws on the unique CGMA Global Management Accounting Principles and CGMA Competency Framework to empower individuals with high-level abilities to help them achieve sustainable success in both business and finance.

CIMA Response: Independent Review Into The Quality and Effectiveness of Audit

Chapter One – Definitions of Audit and its Users

Question 1) For whose benefit should audit be conducted? How is it of value to users?

The primary beneficiaries of audit should be investors or potential investors, including those with a responsibility for creating wealth in society at large, e.g. pension funds. However, audit should be conducted in the wider public interest too and public interest tests should be based on size and impact of the company.

Question 2) Should the audit be designed to enhance the degree of confidence if intended users in the entity or just in the financial statements?

Confidence in the entity and the financial statements are interdependent. This is because all of the activities of any entity will ultimately impact its cash flows.

The annual report of a company and its financial statements are the responsibility of the directors in reporting their stewardship of the entity. The audit should be structured to maximise the support in the confidence of the entire annual report.

Increasingly, investors expect more than an audit of financial statements and the audit market should respond to this.

However, any changes would have impacts with increased costs of audits, the need for standards to report non-financial assets and have implications for audit liability. Before any changes take place careful consideration is needed as well as a cost/benefit analysis.

Question 3) 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?

It is critical that any change is made to avoid conflict and unintended consequences with international legislation and standards. We would support a review of UK law that looked at how it could be amended to provide greater clarity while keeping it in line with international norms. More guidance issued by the proposed new regulator in this space would be welcomed.

Chapter Two – The 'Expectation Gap'

Question 4) Do respondents consider there is an expectation gap?

Yes we do believe there is an 'Expectation Gap'. The public believe audit provides greater assurance than it technically does. The public have a view that audit provides assurance for the ongoing viability of an organisation. There is a belief in the wider public that auditors should be able to spot where a company is at a heightened risk of collapse or difficulty. This is very different to the definition of an audit in legislation and standards.

We believe that there is a need whilst addressing the definition of an audit, what it does and its purpose; there is also a need to provide wider education on what audit is and what it does and does not do to the public.

Question 6) 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?

Quality is the key issue to focus upon. While we don't see any issue with quality of audit in the UK, there are always opportunities to improve on best practice.

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Chapter 3 – Audit and Wider Assurance

Question 7) What should be the role of audit within wider assurance?

The role of audit within wider assurance should be to maximise the extent of assurance over matters that can be quantified in accordance with standards and definitions, and to form an overall opinion on the truth and fairness of the report, subject to clear positioning on audit liability.

Primarily responsibility for stewardship of an entity rests with its directors.

We would like to see a move to integrated reporting. The International Integrated Reporting Council define integrated reporting as:

"A process founded on integrated thinking that results in a periodic integrated report by an organisation about value creation over time and related communications regarding aspects of value creation.' Integrated reporting brings together material information about an organisation's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It provides a clear and concise representation of how the organisation demonstrates stewardship and how it creates value, now and in the future."

Question 9) Are the existing boundaries between internal and external audit clear?

We believe the profession view the boundaries as clear.

Question 10) To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

Both internal and external auditors need to have confidence and trust in each other's work. We believe that the requirement for an external auditor to use the work of internal auditors as contained in the current auditing standards are appropriate.

However, the external auditor must have the ultimate responsibility for an external audit report.

Question 11) Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality if the audit product?

The profession needs to have high standards and therefore there is a tradeoff that is necessary and inevitable.

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Chapter Four – The Scope and Purpose of Audit

Question 15) Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

The alignment of the definition of "going concern" and the Viability Statement should be reviewed.

Question 16) 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"?

The key issue is for the directors to recognise the challenges to viability sufficiently far enough ahead to take effective action. The auditor should have sufficient knowledge of the business and the external environment to be in a position to alert the directors to such a risk in a timely fashion.

There is an opportunity as the UK leaves the European Union for the UK to stop following some EU audit regulations and directives that force mandatory audit firm rotation (MAFR). We believe MAFR is not in the public interest and harms audit quality. It limits the audit committee's ability to determine the best audit firm for the company. MAFR undermines the key audit committee responsibility of overseeing the external audit process and selection of an appropriate audit firm. It does this by eliminating the one firm that previously the audit committee decided was best to provide audit services to their company. This can man an auditor ha limited knowledge of the business they are auditing, especially early in the rotation period.

Question 17) Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

A viability statement that has been prepared professionally, prudently and comprehensively should state the sustainability of the business over the given timeframe. Critically, if the business model has changed directors should outline how and why this is significant. In reviewing viability statements we have noted that risk management processes have often not been disclosed or even taken place. We would encourage this review to consider the use of the COSO Framework from the United States which acts as a tool for helping businesses to assess their risk appetite and their sustainability over the longer term. It may also be helpful to develop guidance on risk and internal controls as recommended by the Kingman Review. The statement 404 required by the Sarbanes Oxley Legislation may be worthy of consideration as this has strengthened managements assessments of internal control under reporting requirements in the US. We would also encourage statements to consider the role of the Audit Committee in risk assessments.

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Question 18) Should such a statement be subject to assurance?

The statement should be the responsibility of directors and the assurance should be in line with our answer to question 17 relating to the viability statement.

Question 19) Who might be capable of giving such assurance?

Many frameworks exist but the CGMA Business Model framework produced by the Association of International Certified Professional Accountants is one example of what could be used as a basis for testing assurance. We attach a copy of the framework for reference.

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

As we stated in our answer to question 7 we would like to see moves to more integrated reporting and within that would like to see a variety of metrics for example: environmental, health and safety, employee retention, social media are some areas that could be subject to some form of assurance.

Chapter Five – Audit Product and Quality

Question 25) What additional benefit might a switch from a binary opinion to a more graduated disclosure of auditor conclusions provide?

Graduated disclosures and conclusions could be more meaningful to users and it would be welcome. However, a graduated approach is, in practice likely to provide a subjective opinion and increase complexity. There would need to be clear and understandable definitions and criteria in place for differing graduations.

Chapter Six – Legal Responsibilities

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

Auditors should report on the extent that reported information complies or not with reporting regulations.

Question 31) Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

We believe they should.

Chapter Seven – The Communication of Audit Findings

Question 33) 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?

We would like to see other stakeholders engaged with and understanding the audit report. However, we believe the primary the focus should remain on investors and potential investors of companies. Any changes with regards to broader direct stakeholder engagement would need careful consideration and should not be avenue for the 'public' to unreasonably question the auditor and their report.

Connecting value generation for the long term

A practical guide to the
CGMA Business Model Framework

Chartered Global Management Accountant (CGMA®)

CGMA is the most widely held management accounting designation in the world. It distinguishes more than 150,000 accounting and finance professionals who have advanced proficiency in finance, operations, strategy and management. In the U.S., the vast majority are also CPAs. The CGMA designation is underpinned by extensive global research to maintain the highest relevance with employers and develop competencies most in demand. CGMA designation holders qualify through rigorous education, exam and experience requirements. They must commit to lifelong education and adhere to a stringent code of ethical conduct. Businesses, governments and nonprofits around the world trust CGMA designation holders to guide critical decisions that drive strong performance.

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Association of International Certified Professional Accountants

The Association of International Certified Professional Accountants (the Association) is the most influential body of professional accountants, combining the strengths of the American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA) to power opportunity, trust and prosperity for people, businesses and economies worldwide. It represents 650,000 members and students in public and management accounting and advocates for the public interest and business sustainability on current and emerging issues. With broad reach, rigor and resources, the Association advances the reputation, employability and quality of CPAs, CGMA designation holders and accounting and finance professionals globally.

aicpa-cima.com

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Introducing the CGMA Business Model Framework

We believe the focus for all organisations should be achieving success over the long term and creating value for all of their stakeholders. To achieve this they need to meet the needs of their customers and other stakeholders, including society as a whole. The critical stakeholder is the long-term investor, but their return is dependent upon meeting customer needs in return for their capital. Our Framework is a practical manifestation of this philosophy.

About this paper

This brief document is designed to be a practical guide and toolkit that helps boards, senior executives and support staff quickly and easily gain an understanding of their organisation's business model.

In particular, it describes how they can use the CGMA Business Model Framework to prepare for board discussions and decisions. It gives a background to the rigorous and relevant research on which the Framework is based and highlights why management accountants will find it of particular interest and use.

The paper presents the Framework in diagram format and describes how to relate the Framework to your organisations' activities. Finally, it lists the salient questions at the heart of the tool with a brief explanation as to why these are important.

By answering these questions, you can do more than rapidly define the current business model – you can also redesign the business model to rise to the opportunities and challenges your organisation will face in the future.

Critically, following the methodology described in this document will help you mitigate the risks that businesses commonly face when reshaping the business model.

Research background: rigorous and relevant

Business models have been an integral part of economic and trading behaviour for generations, but the business model as a conceptual framework has only gained particular stimulus since the advent of the internet in the late 20th century. Today, an organisation needs to build a complete picture of its business model before taking action. This understanding is critical in our view to strategic success.

However, we believe that most current Business Model Frameworks are far from comprehensive and do not support the management accountant specifically.

That is why we have created the CGMA Business Model Framework, based on extensive academic work conducted over the last two decades, coupled with a global consultation that took evidence from over 100 leading practitioners in the management accountancy field.

The CGMA Business Model Framework

An organisation needs to build a complete picture of its business model before taking actions. This understanding is critical in our view to strategic success.

Our Business Model Framework shows how board decisions and management actions work together to create value in the context of these wider stakeholders. Customer value is the most important aspect, but a sound understanding of the Framework means understanding wider stakeholder value. The Framework shows how other stakeholders benefit from customer derived value.

Our extensive global research suggests that businesses need to develop greater clarity, understanding and definition around their business model. This Framework helps to do that, as well as deliver an improved understanding of how value is created and shared with stakeholders. This understanding needs to be dynamic and extend from the past into the future.

Rather than a generic model, we have adapted our Framework to focus on wider stakeholder value and the role of the management accountant in generating value. The revised Framework brings together additional considerations, such as the structure, scale and culture of an organisation, with the financial metrics. In combination, this gives the board a tool which shows the connectivity involved in value generation across the organisation.

The tool also shows the flow through to strategy and performance measures that are critical to long-term success.

Defining success

Ultimately, the key to success of using this tool is that the board understands its risk appetite as it relates to the business model. If the board is happy with this risk and understands the connectivity of key decisions and activities and their ability to generate value, then it can be satisfied that it has fulfilled its duties.

Benefits of the CGMA Business Model Framework

The primary benefits of the CGMA Business Model Framework revolve around the organisation's ability to define, create, deliver and capture value for its key stakeholders as necessary over time (see diagram below).

Using the Framework makes it easy to:

- **Define**: customers, investors and other stakeholders define the value that is important to them. Using the Framework, the organisation can identify all stakeholders, find out their needs and create solutions that meet them – whether financial or social, natural or intellectual.
- **Create**: based on these definitions, organisations can harness key resources and relationships to create the products, services and experiences that their stakeholders want from them.
- **Deliver**: increasingly demanding and sophisticated stakeholders receive value when the outputs of value creation deliver favourable outcomes, such as revenue, security, satisfaction, loyalty etc. To deliver value, organisations need to segment customers and understand the channels via which to serve them.
- **Capture**: in the private sector, value is captured when revenues engineered by the value chain exceed costs. In the public sector, it depends on whether the benefits achieved by a service are greater than the costs of delivery.

Figure 1 shows the key questions organisations should ask at each stage of the value chain.

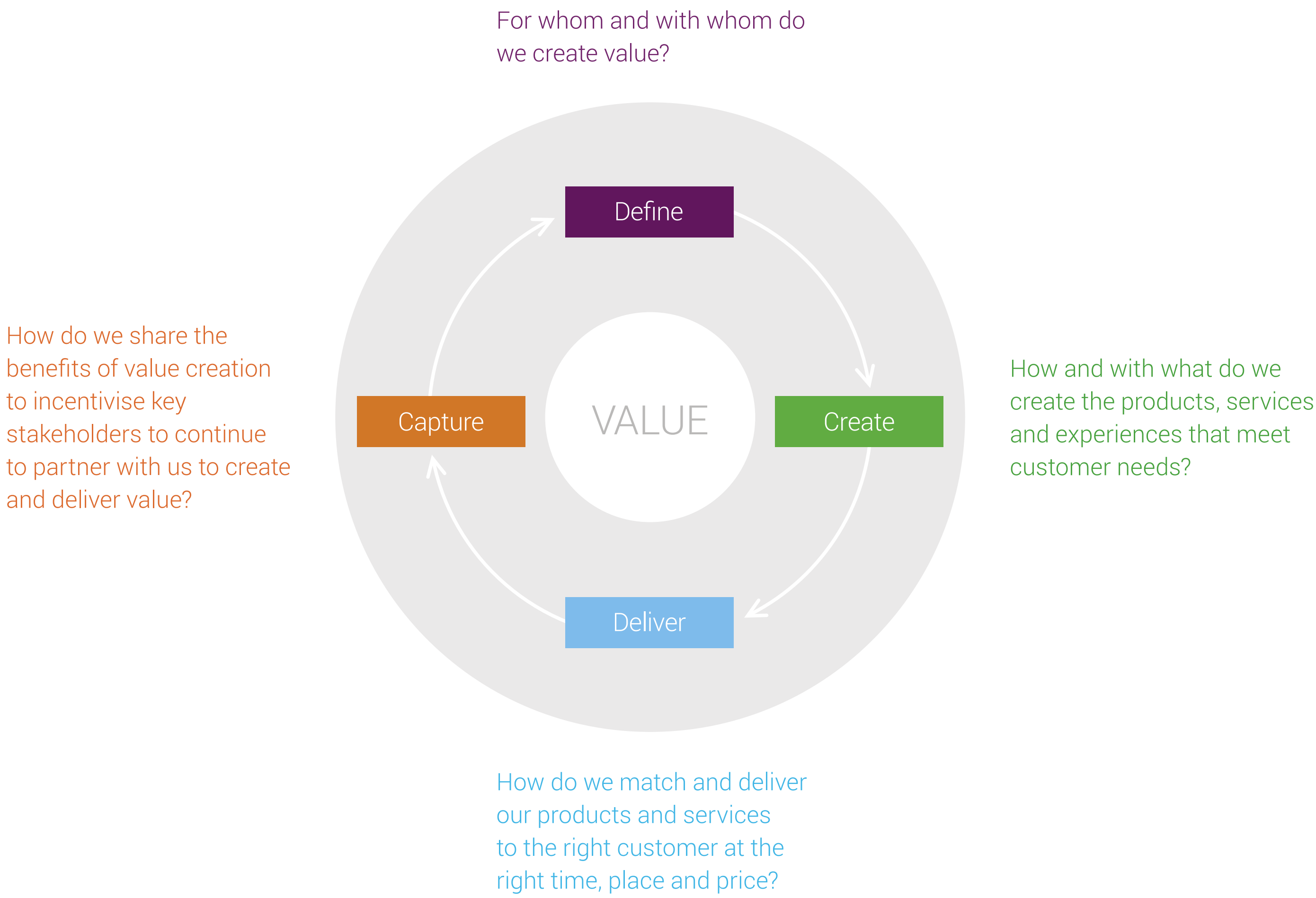

Figure 1: Elements of the Business Model

The relevance of the Framework to the wider environment

We believe these benefits are particularly important today in a global external environment, where multiple external factors are creating risks and opportunities for organisations' business models. These include:

- the shift of value from the balance sheet to intangible assets such as intellectual property, customer base and brand. These now account for over 80 per cent of total corporate value, compared to less than 20 per cent 40 years ago
- changing investor approaches towards long-term investment
- balancing the need to focus upon the short term while focusing on long-term success
- demonstrating trust through a focus upon open and accountable leadership and values
- business and government working together to win public trust and promote value
- operating in a global, interconnected environment, alongside the risks of a return to nationalism in some countries
- the impact of technology – automation, data, cybercrime and security
- infrastructure availability, such as broadband and transport links
- diversity and often conflicting regulation, including taxation
- skills and talent shortage
- changing societal norms
- addressing the challenges to the natural environment.

These opportunities and risks give rise to a complex environment and can often overlap or conflict with each other. It is for this reason that a business model needs to reflect this ecosystem.

How do you apply the Framework?

The following toolkit helps senior decision-makers and support personnel – both groups possibly including management accountants – to understand the organisation's current business model. It should help you to avoid taking decisions that only lead to profit in the short term, and potentially to ultimate corporate failure.

We expect it to be particularly interesting and useful for management accountants, as they are uniquely placed to have an integrated overview of the organisation's business and finance operations.

You can use the model to improve decision-making at board level. It should ensure that all board decisions are taken with a full understanding of their potential to affect value and the inevitable risk trade-off. No decision is ever risk free, but improved decision-making should mean greater economic output, improved productivity and wealth generation for all.

In other words, using the toolkit helps to mitigate risk – not to eradicate it altogether.

The questions in Key Resource One on page 6 should be applied to understand the **current** position of the business. Using our model, they break down the business into four core elements – **Define**, **Create**, **Deliver**, **Capture** – which connect together to lead to value.

The Framework firstly allows you to consider and list all material activities as they relate to value in the context of wider stakeholders. Secondly, each decision on the activities listed may then be considered in light of a number of key questions. These questions are listed in Key Resource Two

Once you have defined your current position, you can apply the Framework to **future** decisions – including those related to making changes to your organisation's business model. You can do this by considering every decision in the light of the further key questions (again relating to Define, Create, Deliver, Capture) listed in Key Resource Two, on page 7.

Key resources
– using questions to make decisions

Key resource one

The questions that help you understand what activities are relevant to your current business model

Define

- What is our purpose as an organisation?
- Who are our key stakeholders?
- How should we prioritise our stakeholders?
- What are the needs of our stakeholders?
- What is our value proposition?

Create

- For whom are we creating value?
- With whom do we create value?
- For what purpose are we creating this value?
- How are resources procured?
- How do we turn these into products/services that customers desire?

Deliver

- To whom are we delivering value?
- How do we deliver value to customers at an appropriate cost?
- How do we get the value to the intended recipients?
- How can technology help us deliver value?
- How do we engage customers in value delivery?

Capture

- For whom do we capture value?
- How do we capture this value?
- What will we do with any residual value generated?
- How will we share surplus value amongst our stakeholders?

Key resource two

The questions that help you mitigate risk in future decision-making

Having established the activities relevant to your current business model, the next step is to ask a number of future-focused questions when the board is making material decisions about its key activities. These relate to considerations beyond short-term financials that seek to establish how an organisation's brand, reputation, long-term success and customer loyalty will be affected.

The following questions have no 'right' answer but exist only in the context of the business. They seek to ensure that the implications of material decisions are fully understood and that any trade-offs are accounted for and their negative consequences are mitigated.

How to apply the Framework to future decisions

By grouping board activities under the four key headings of Define, Create, Deliver, Capture, the diagram on page 8 features the organisation's most business-critical and material priorities, with a critical importance for the organisation's future success and existence. This is a powerful tool for helping to decide if an activity should start, change or cease.

How to use the diagram:

- Visualise the specific activities of your business. Populate each relevant box with them, and ask questions to identify how they create value over time for which stakeholders
- Where an activity appears to be irrelevant, obsolete or producing insufficient value, consider making a change
- When the board decides that an action has broadly positive consequences on value, it should continue
- Once you have completed a box, move on to the next and, again, ask questions relating to each activity
- Once all actions in all boxes are complete, you have the building blocks of your organisation's value generation. The board can then decide how to distribute value between stakeholders – as pay, profit, products, services, investment and CSR.

Future activities: the questions to ask

Define

What would the effect of this be on the various stakeholder groups?
An understanding of the impact on stakeholders is critical to understanding how a decision may play out.

Does this activity have wider community or social value?
It is important to look beyond the value generated through profit.

Would this damage the environment?
Increasingly, organisations need to look at environmental factors to ensure that their model is sustainable.

Create

Would this decision undermine trust in the business as articulated in the company's values?
Research shows that trust in business is at an all-time low. As trust is earned through interaction with stakeholders, it is critical that decisions should seek to build this trust. This means not only acting ethically, but also delivering what you say you will.

Would this be considered ethical by wider society? How would this be perceived? Would negative press affect the brand? If made public, would these activities damage the brand?
Transparency often shines a light on decisions in a way that may not be obvious to a smaller group. A wider perspective can bring decisions into focus and helps ensure that the business stays aligned to the zeitgeist.

Would this breach the spirit of our regulatory framework?
Often the spirit is more important than the letter. Frameworks exist to ensure a level playing field across sectors. The rules are often underpinned by ethical and societal values, meaning that thought should be given as to whether breaching the rules puts long-term value creation at risk.

Are we creating unnecessary additional complexity?
Past crises have developed because that board has not understood its business model. As a result, inappropriate changes in the business model have fundamentally undermined how the business creates value. This can lead to a much higher risk profile that might be assumed. If the board does not understand this risk, then the company may be vulnerable.

Deliver

Would customers continue to transact with us in the long term?
The method of delivery and the experience of the customer will typically determine whether repeat business can be generated.

Would this build a healthy relationship with the customer?
The business model has value at its heart. This value is created initially for the customer. However, a number of wider stakeholders can share in this success, including workers, communities, the environment and shareholders. Activity should seek to preserve and distribute this value in a fair manner.

The brand could be damaged if an issue comes to light that detracts from the reputation of the business. Bad practices could involve tax avoidance, contractual obligations with staff or workforce issues.

Is this genuinely innovative?
In a competitive environment, it is important to understand where organisational USPs exist and how easy it would be for a competitor to copy them. This can be described through the reporting framework and is often built up over time. The uniqueness of the model can also guarantee success into the future, so the board should constantly monitor the market to understand how potential threats to the model might emerge, often through technological advances.

Capture

How can we measure the value of this activity?
This question seeks to ensure that activities remain under review and are continually considered in the light of new developments in the business.

How can we align our strategy with our business model?
The company strategy should be the tool for keeping the business model relevant and up-to-date. By seeking a strategy that refers and develops the business model, the board should build its understanding of value creation.

How should our value be shared among our stakeholders?
The decision on sharing surplus is fundamental for any board.

Report author:

David Hackett
Corporate Governance Risk & Reporting –
Management Accounting

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Professional Accountants

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May 2018

ISBN number 978-1-85971-857-5