Tel:+44 (0)20 7486 5888
Fax:+44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London
W1U 7EU

Private and Confidential

By email
brydonreview@beis.gov.uk

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

7 June 2019

Dear Sirs

Independent review into the quality and effectiveness of audit - call for views

We welcome this review into the quality and effectiveness of audit and the opportunity to provide our views on the questions asked by this independent review.

Overall we believe the review should think about the auditor's role being more responsive to user's needs in relation to a particular entity. In today's world the user needs of the financial statements, and the auditor, varies greatly. Not just between small private and large listed entities, but also across and within the LSE listed market where the sophistication of entities, business risks and different sectors often mean users want very different things (even differing with the same entity at different economic or corporate life cycles). The current model sets the scope of audit and the auditor's role almost the same across the board and is therefore not responsive to user's needs for any individual entity at any particular point in time. Ideally there would be a 'core and more' where all entities had to have an audit or a certain scope but for others, whether under the direction of regulatory requirements or user demand, the auditor's role would be expanded to meet user's needs and provide value, but in a cost effective way that is responsive to specific needs.

Definitions of audit and its users

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

In the narrowest sense, for statutory audits, Section 495 of the Companies Act 2006 states that the auditor "…must make a report to the company's members on all annual financial statements of the company…", and hence it is this primary user of the financial statements that auditors address their audit report to. In this respect the audit is primarily aimed at providing assurance on the financial statements for use in stewardship.

Even from the Companies Act perspective though, it is clear that the actual users will extend beyond the members; Section 423 for instance requires copies of the annual financial statements to be sent to the members, debenture holders and everyone entitled to attend the AGM, and Section 441 requires them to be filed with the registrar for the purposes of public publication.

As the annual report and financial statements are publicly available, the range of people and organisations that gain benefit and value from the audit goes beyond this narrow group of users; trading partners, employees, pensioners, Government, NGOs are just some of the people who use annual financial statements and rely on the audit to assure them. In addition the content of the annual report and financial statements are conflated with wider corporate reporting disclosures that are not subject to audit. For many of these people and organisations differentiating which content of the annual report and financial statements is subject to audit is not well understood and, even when it is, it is confusing to users. In today's world, it is in the use of the financial statements by this wider range of users that the significant public interest lies.

For these users the audit is at the centre of an oversight and regulatory ecosystem that builds trust and transparency. It is the strength of this ecosystem that enables the efficient allocation of risk capital, provides reliable information for loan financing, enables fair and efficient trade, and provides the confidence for long term investment.

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

The number and types of users and how they rely on and use the financial statements has grown over the years as the annual report has expanded to become a 'catch all' for a number of miscellaneous reporting requirements in addition to the financial reporting requirements. This additional information is of interest to different stakeholders, however much of this is not subject to audit. We believe this inclusion of a wide range of audited and non-audited information has added to creating confusion as to who the annual report and financial statements are produced for and therefore for whose benefit the audit is conducted.

Although the wider users of this additional information are not who the audit report is addressed to, this is where significant parts of the public interest lies. Whilst acknowledging that there are wider users of the financial statements, we believe it is important to anchor the primary users of audit as the members. This allows auditors to plan the audit with the addressees of their report in mind, maintaining the continuity of the legal and liability framework.

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?

Although the auditors have a number of complementary responsibilities aimed at the complete annual report and certain elements of the entity's business, the main thrust of audit is currently aimed at the financial statements. Although this is clear in law and regulation, it is also clear that this is not readily understood by users and indeed falls short of the extent to which many of them want the auditors to be involved.

Put simply in lay terms, our dialogue with users indicates that they want auditors to be involved in: 'checking the financials are right', 'checking that the control environment is sound', 'checking for management fraud', and 'giving some confidence that the company is going to continue in existence'. There is clearly much to do to both properly scope such services to provide value and to craft an appropriate legal and liability framework to enable the supply. However, we are of the opinion, that until these three basic demands are addressed the expectations and value gap will remain.

Although auditors do have a wide range of available skills that would enable us to perform a far wider role than we currently do, we firmly believe that any increase in scope should be rooted in increased demand from the users, or because of a compelling public interest. This is where there is an overlap with the Future of Corporate Reporting project to consider what users want from the annual report and financial statements. This needs to be answered before determining how the audit is able to provide assurance over the areas that are of interest and therefore of value to users.

Looking at the role of auditors outside the UK shows that a number of countries do see significant value in auditors performing additional services in areas such as internal controls and corporate governance.

The 'Expectation Gap'

Qu 4: Do respondents consider there is an expectation gap?

Yes, but this gap is not new, the most significant 'gaps' seeming to be in the work the auditor does in connection with going concern and fraud. The narrative and actions following recent corporate failures have highlighted this gap, particularly given that the finger seems to be pointed at the auditor as much, if not more so, than the directors and senior executives who surely must be ultimately responsible for the failure. It is not the auditors who brought about the failure although they may have failed to highlight the possibility that it could occur. The key areas where we consider that there is a gap are going concern, fraud, laws and regulations, corporate and management behaviour, and executive pay.

Auditors and regulators have attempted to educate the users over many years as to what an audit is, but even if was considered worth continuing to pursue this line, we consider that we need to be listening to what the market is demanding.

Qu 5: If so, how would respondents characterise that gap?

There is a gap between what people want an audit to have done, typically when something goes wrong, and what they want before the issue arose (the hindsight gap). There is then the gap between what people want any audit to do and what it can reasonably do (the knowledge gap). Finally there is the gap between what it is reasonable for an audit to deliver and what is actually delivered, which you have defined as the delivery gap.

These components of the expectation gap are perhaps best illustrated by going concern. If a company fails the question inevitably asked is "where were the auditors"? The role of audit is not to stop companies with flawed business models failing but to ensure the warning signs are drawn to the attention of users to prevent the hindsight gap occurring. If the business failure was signposted then the educational gap is relevant but if the warning signs were there, and the auditor did not identify this, then it is the delivery gap.

In relation to going concern these gaps are exacerbated by an apparent mismatch between the demands of the financial and corporate reporting standards and those of the auditing standards. The former anticipates financial statements being drawn up on a going concern basis in all but the rarest of circumstances. It will be difficult to solve the audit issue without some consideration of the accounting. The accounting guidance is relatively simplistic in that it states that financial statements are "normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future….". We agree that this basis of preparation is the most appropriate, except for the most obvious cases where the company cannot continue in existence. The questions is whether there should be more disclosure where there are signs that the risks to going concern are increasing.

The UK Corporate Governance Code (the Code) requires directors to draw to the attention of readers some of the nuances around the going concern assumption. This refers to the board determining the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives. It requires that in annual and half-yearly financial statements, the board should state whether it considers it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements. Taking account of the company's current position and principal risks, the board should also explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

Without the Code the nuances of going concern reporting is left to the auditor and their report.

Another example is the disclosure of distributable and non-distributable reserves. The accounting standards and Companies Act, which drive financial statement disclosures, do not require such a disclosure yet this is what appears to be demanded by the market.

In order to be able to address these gaps it will therefore be necessary to consider the disclosures that the company is required to make in the financial statements first. The assurance that auditors can then provide in these areas comes second.

In relation to fraud we consider there is a lack of clarity regarding the "gap" as to whether the user is expecting auditors to spot every fraud or focus on those where management has perpetrated the fraud. This is explored further in our response to Qu 36.

Qu 6: Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are met?

Recent corporate failures, and subsequent investigations of the auditor's work, have demonstrated that in some cases a delivery gap does exist. This has been confirmed by the profession itself in the public hearings that have subsequently taken place with firms acknowledging that they are not satisfied with audit quality within their own firms. The findings of regulators in terms of audit reviews would seem to support this, although this focuses on one aspect of audit quality namely being the documentation of the audit process. By international comparison the UK has been a strong performer but recent scrutiny may have brought this into question and it is vital that we return to a position where the UK is seen as best in class.

The level of complexity and judgment in accounting standards has probably not helped the situation in recent years, with significant judgments involved in arriving at the numbers being presented for audit, and there may be instances where the auditors have actually gone through and met the provisions of the relevant auditing standards yet managed to reach, what the benefit of hindsight has shown, to be the wrong conclusion. This is where we can arrive at a mismatch between a firm seemingly meeting its responsibilities in the eyes of the regulator but not in the eyes of the user.

Audit and wider assurance

Qu 7: What should be the role of audit within wider assurance?

There is a whole ecosystem of assurance, a large part of which is performed on a continuous basis from within the company, including the design and operation of systems and key controls, internal audit and the governance structure.

Systems and controls are designed by management with internal audit ensuring they are being applied during the year. The annual audit of the financial statements is the third line of defence and therefore has a very specific role but it is performed at a point in time, once a year. Whilst the financial statements do incorporate a great deal of forward looking information and predictions, it is primarily concerned with historical information.

Qu 8: 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?

The current objective of an audit is for the auditor to obtain reasonable assurance that the financial statements, as a whole, are true and fair. Currently there is no concept of subsidiary levels of assurance given to individual amounts or disclosures in the financial statements. There are certain business sectors and certain financial statement areas that are inherently more uncertain than others. Areas that rely upon assumptions of future events are fundamentally different from verifying historical transactions in terms of the level of certainty. At the moment the opinion we give is that there are no "material misstatements" but the amount of work that gets done to get that position varies depending on the level of risk (ie uncertainty) involved so arguably there is already a difference in the level of assurance provided on a risk versus a non-risk area.

The audit framework only recognises one level of assurance and therefore risks giving false assurance. Most users are not capable of differentiating 'different levels' of assurance, they equate audit with "correctness". Given the expectation gap that already exists in relation to the work of auditors and the level of assurance that that work presents, creating different layers of assurance risks further increasing that expectation gap.

However, we do see value in providing different levels of assurance to the different users of the annual report and financial statements. Due to our concerns above we question whether the external auditors are best suited to providing all of this and whether other parties such as internal audit could provide assurance, at a different level than through an external audit, on certain information that would be of value to users.

As the assurance is provided by a different party it would be clearer that internal audit are providing a level of assurance that is different to that provided by the external auditor. For example areas where internal audit could provide assurance include climate change and equal pay reporting. For this to be most effective the Audit Committee report should explain their role in the oversight of internal audit and explain how internal audit maintains its independence from management. The review may also want to consider whether the regulatory regime for internal auditors can be relied upon to support the level of assurance being provided by internal audit. This would raise the profile, importance and accountability of internal audit to the company's overall control environment, potentially also giving some assurance over fraud, particularly at the operational level.

To ensure that it is clear to users as to the level of assurance being provided the annual report could be marked up on each page to show the level of assurance provided. There may also be digital solutions than could be employed to make it clear the level of assurance that is being provided by each page/section of the annual report. Alternatively information that has not been assured by the external auditor could be contained in a separate report, for example, certain audit firms are required to prepare a Transparency Report which, amongst other requirements, includes reporting on how they have complied with the Audit Firm Governance Code.

Qu 9. Are the existing boundaries between internal and external audit clear?

We believe that the boundaries are clear but that this is not understood by many, particularly when internal audit is outsourced to other large accountancy firms or other third parties. The work that internal audit does is performed for different purposes for very different users. Therefore it is important that the boundaries between internal audit and external audit continue to be maintained.

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

The work that internal auditors perform is very valuable as it is performed throughout the year and across a much wider range of risks in the business. However in the current regime the work performed by internal audit is underplayed and lacks external visibility.

External auditors routinely consider the results of the internal auditors work to assist them in their risk assessment when planning their audit work on the financial statements. To take this further and to be able to rely on the work of the internal auditor the external auditor is required to perform a considerable amount of work. In many cases, it is more efficient and effective for the external auditor to perform the work themselves. Independence considerations also impose restrictions on the ability of external audit to rely on the work performed by internal audit. External audit placing reliance on internal audit also creates a risk that various parts of the assurance ecosystem start to rely upon each other creating fragility.

However, in a SOX type environment, we recognise that management would use internal audit to test their controls and then, in some cases, use the external auditors to provide assurance. The responsibilities of internal and external audit would need to be absolutely clear for this to work effectively.

Qu 11. 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?

In the current environment the independence and objectivity of the auditor are regarded as paramount. There is a real public perception issue that accounting firms use audit work as a way of securing additional services and that they are too close to management. Ultimately audit is a trust product that will continually be undermined unless independence is secured.

The scope and purpose of audit

Qu 12: 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?

Users are interested in directors' risk management and the control environment and whether it is robust enough to prevent the company failing, to enable complete and accurate financial reporting and to prevent and detect fraud.

A statement by directors, for all listed entities, in these areas is a good and appropriate step forward to emphasise to users their already existing responsibilities in these areas. We believe that such a statement should be subject to assurance, and that for the largest entities that this should be provided by the external auditors. The question of whether the statement should be audited is therefore one of the degree of public interest. It is therefore appropriate that a level of proportionality is applied so that only the largest entities (eg FTSE 350) are required to obtain auditor sign off. If the definition of PIEs is expanded there may be other large entities that this might also be applied to.

Qu 13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

Any extension for auditors to provide assurance over this should only be made where firstly directors are required to make the statements referred to in Qu 12 and for them to be held accountable. An audit of this statement would be a separate and substantive piece of work as has been seen in the US.

It is also important that the auditor's reporting requirements are designed so that the value to users is clear and does not add to the expectation gap.

Qu 14: 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?

Auditors reporting their views on the effectiveness of relevant internal controls is different to the auditor formally assessing the effectiveness of the company's system of internal control. Auditors therefore express these views largely as a result of observations they have made on the effectiveness of controls during the conduct of their audit work as opposed to carrying out testing to confirm they are effective. Auditors are not required to test all of these internal controls. As these views are not necessarily supported by specific audit procedures over these internal controls these views should not be made public.

Public reporting by auditors on the effectiveness of internal controls should only take place if the expansion of responsibilities in both Qu's 12 and 13 are implemented.

Going concern

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

In our view the current going concern (and viability) reporting and the related auditing requirements are not, overall, fit for purpose. They are suitable for evaluating the basis that the financial statements should be prepared under but are not fit for purpose for the wider use that users want from the auditors work on going concern.

The tools available to the auditor are too blunt and the audit requirements are not sufficiently aligned to the accounting requirements. The auditing standard requires the auditor to assess whether the going concern disclosures given by the directors are adequate to achieve fair presentation even where no disclosures are explicitly required by the applicable accounting framework. This is highly judgmental and relies on the auditing, rather than the accounting, standards to drive greater disclosures.

The separate going concern and viability reporting requirements create confusion as to the auditor's responsibilities over these two areas. To improve clarity to users it may be more useful to present one statement that covers going concern and business resilience over a longer period. These should also be linked to the disclosures on principle risks and uncertainties as these could have an impact on going concern.

Qu 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"?

As going concern is a fundamental principle in the preparation of financial statements there is a need for greater transparency, but this should firstly be through the directors' disclosures in this area. The accounting framework for all entities should require directors to disclose the potential risks to going concern and how they have mitigated these risks. This type of information, on an ongoing basis, would provide valuable information to users on the effectiveness of the directors in managing these risks.

The directors going concern assessment is performed at a point in time, once a year. We question whether this should be required to be performed on a more regular basis to be of more use to users. The critical point is that, when a company is approaching risk of distress, the warning signs are there but these could increase or decrease from year to year.

We consider that one year is too short an assessment period and reinforces the expectation gap in allowing a scenario where at a point in time an entity could be assessed as a going concern for the next 12 months but then 15 months later it isn't. However, an extension beyond 12 months does increase the level of uncertainty and any reporting would need to be clear that as the time horizon increases the amount of assurance that auditors can give reduces.

Viability

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

Improved clarity about the directors' responsibilities in this area, ie they are responsible for running the business and securing its continuing success, is really important to help address the expectation gap. After a corporate failure there is a perception that the audit either caused or could have prevented corporate failure. Neither is realistically true.

Viability statements have not been as effective as had been envisaged. Management have complied with the requirements but have not gone into the breadth and depth that is really useful to users as they have been reluctant to say anything that they will be criticised for. In addition there has been a lack of accountability as investors have not pushed for improved disclosures and there is no robust regulatory regime to enforce this. These statements have therefore become boilerplate showing how good ideas can be stifled.

There is also overlap and confusion between going concern and viability. If the going concern assessment was extended beyond 12 months then the need for a separate viability statement would fall away and this overlap and confusion could be reduced resulting in more coherent reporting.

Users are primarily interested in the resilience of the company's business model to deal with changes in its internal and external operating and economic environment. Improved disclosure by directors in this area helps users to assess the risks so that they can reflect that in their investment decisions.

Qu 18: Should such a statement be subject to assurance?

Assurance over this statement should only be required where the corporate reporting and accounting framework requires directors to make these statements and, most importantly, for them to be held accountable.

Qu 19: Who might be capable of giving such assurance?

Clearly the audit firms have the skills to be able to provide this type of assurance. However, as noted in our response to Qu 16 as the length of time after the approval of the financial statements increases the level of assurance that can be provided is reduced. Any reporting by auditors in this area would need to be clear about the level of assurance being provided. Our response to Qu 20 explores this further.

Unaudited information

Qu 20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?

Even though the legacy statutory audit is grounded in a true and fair view of historical financial information the auditor already has to consider a significant portion of forward-looking information which is critical to the current financial reporting framework and hence the auditor's opinion. This forward-looking information manifests itself through aspects such as fair value measures, description of risks, and the assessment of the appropriateness of the going concern assumption. These considerations are not incidental to the auditor's opinion, they form a critical part of it, albeit they are not always obvious to users.

Nevertheless we frequently discuss with users the need for audits to be more forward looking. Many of these conversations centre around the knowledge gap (referred to in our response to Qu 5) but they often progress to the desire for auditors to be more focussed on assurance related directly to forward looking information, often in the areas of financial forecasts and going concern.

Providing that the corporate reporting model is enhanced to provide the levels of forward looking information that users need and want, then we would be keen to explore the possibility of performing additional procedures thereon. The exact nature of these procedures and the levels of assurance that can be performed will depend upon a number of factors including the nature of the information and the inherent uncertainty. It is important however to stand back and critically consider the identifiable value that such procedures will bring and whether these will in fact meet users expectations.

Forward looking information is by its very nature concerned with predicting events that might or might not happen and hence includes an element (sometimes a significant element) of uncertainty, which no amount of scrutiny by the audit can eliminate, or perhaps even reduce. In most instances we believe that users require more detailed, perhaps far more detailed, information reported by the directors of what those risk factors might be and the views and assumptions that the directors have made, in these instances the value of the auditors might be to objectively confirm that the directors did indeed use their stated assumptions and that disclosures are balanced and fair in the eyes of the auditor. In the context of going concern this could be delivered in the form of a far more detailed explanation of the model that the directors have used to consider business continuance, the principal assumptions made and an explanation of how sensitive the business continuance consideration is to these assumptions. The audit, particularly through graduated audit reporting, could then add value by objectively confirming these statements and ensuring the narrative and the sensitivities portray a fair and balanced view.

It is important to appreciate though that the future is uncertain and no amount of disclosure or assurance will reduce this uncertainty, but rather it will allow such uncertainty to be better understood and appreciated. If this is the wish of users then there is great value in pursuing this path but, if the need of users is to eliminate such risk, then following such a path will only lead to increasing the expectations gap.

Qu 21: 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?

Financial and non-financial information outside of the financial statements (either within or outside of the Annual Report) is becoming increasingly important to stakeholders. We hear users frequently state the need for this information to be more consistent, more balanced and verified; that is, although it is increasingly important, it is falling short of users' needs. In reality this gap is due to a combination of the lack of an effective preparation and disclosure framework for preparers to follow, and the lack of any external scrutiny. Where disclosure is given on a voluntary basis the lack of a reporting framework results in a large variation of approach by providers. Assuring all disclosed financial and non-financial information outside the annual financial statements by the external auditor would be a disproportionate action with very significant cost implication.

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

We are conscious that there is a large volume of corporate information that is disclosed by entities, some of which is quite important to the users and some which is less so. Different users will also place importance on the particular information that is useful to their needs so it will vary from user to user. We therefore suggest that there will be a need to engage appropriately with users in order to ascertain the information that is useful to them, the level of assurance required and the need for any external assurance thereon. As noted in our response to Qu 8, for some information, the assurance might be able to be provided by internal audit. Subsequent to this there will also be a need for a mechanism to give absolute clarity as to which information is and is not assured, and by whom. One obvious way to do this may well be for the Annual Report to evolve into a document in which all information contained within it is assured (by the auditor) with a separate report containing the non-assured information.

We note though that the compendium of information that might be valuable to be assured is unlikely to be a fixed population; we expect that it will change over time (perhaps in line with the economic cycle, or as business models evolve), be different from industry to industry, and depend upon users' needs and concerns over the specific audited entity. There are however likely to be subjects that are common to large number of organisations, irrespective of industry, due to their pervasive importance to users, such as business continuance, directors' remuneration and perhaps certain social capital aspects such as carbon and sustainability.

Audit product and quality

Qu 23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

We agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process for the purposes of this review. There is a tendency for these to be considered hand in hand as demonstrated that where a value gap is identified, regulators and others, first look for performance gaps, particularly around going concern and fraud.

The effectiveness of an audit should be judged on whether or not it has achieved its objective. Currently the objectives are around obtaining sufficient evidence to enable the auditor to express an opinion. There are various questions to be considered in relation to this "opinion" primarily whether it is sufficiently broad in the subject matter that it covers (not just certain aspects of the annual report) and does that opinion go deep enough into the subject matter?

Within the existing framework there are a number of aspects of audit quality and the inherent value the audit delivers. The audit could have identified significant adjustments to the results, the auditors could have fought a brutal battle with management to book impairments, the auditors could have identified aggressive accounting policies to the audit committee none of which were effectively documented in a way that regulatory, or even internal quality control, audit reviews could easily follow. Regulatory findings can be difficult to interpret since they often do not specifically indicate that an audit has been ineffective, rather that a small number of over 1,000 requirements has not, in someone's opinion, been met. You could have a relatively poor quality audit assessment but the real value is that the auditors were there, and this in itself had the effect of moderating management's behaviour. These points demonstrate the danger of using one measure of audit quality.

There have also been a few occasions where an audit received a satisfactory quality rating from the AQR but accounting treatments were subsequently challenged by the CRRT. This suggests that, whilst the audit process may have been followed, questions have been unanswered regarding the appropriateness of the accounting treatments that have been opined upon.

The quality of the audit product and effectiveness of the audit process are often dependent on the quality and effectiveness of the finance function preparing the financial statements for audit. To some extent this reflects some of the concerns which are currently trying to be addressed – the directors do have a responsibility for the corporate failures that have occurred and they also have a role to play in the delivery of good quality information and appropriate participation in the audit process. It is therefore important that the framework to hold directors to account is strengthened.

Qu 24: 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?

Audit firms have focussed on improving their regulatory scores (as in other countries) and generally that is a good thing, however, the core issue is that an audit is a credence good where its true quality is unknown at the point of consumption. This difficulty leads to the use of inaccurate proxies such as using the AQR scores by the same firm as an indicator of quality.

The audit file should explain the matters that required judgment and how the auditor has exercised this and reached their conclusions. This should not be about "completing the file" but having a record of the auditor's work that supports the conclusions reached. However, the quantum of requirements noted above and mindset to ensure that "all the boxes have been ticked" can result in a lack of focus in key areas.

Returning to a point we make in Qu 23 above, in order to enhance justifiable confidence in audit, it might be worth distinguishing between whether the audit has been ineffective, in that the opinion may be unsound, or that whilst all of the formal requirements have not been met the opinion remains sound. Clarity in this regard will become even more important when the regulators are required to publicise their findings on individual audits.

Binary nature of audit

Qu 25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

An auditor reaches their audit opinion by considering all of the audit evidence that has been gathered and evaluating this using the auditor's training, knowledge and experience. An auditor's opinion is therefore not perfectly binary (there may be a range of conclusions that the auditor could legitimately reach based on the evidence presented and their experience).

Switching away from a binary audit opinion and giving more disclosure of how the auditors has reached their conclusion may therefore contribute to reducing the expectation gap.

It is difficult to envisage a successful outcome to this review that does not involve creating auditor reports that are more useful, interesting and widely read than today. Therefore the audit partner who should be responsible for writing this report should seek to ensure that the report is informative, insightful and opinionated. Not only should investors want to read the audit report but boards and management teams should also be very interested, and we would anticipate significant discussion and debate.

The audit opinion has a role but should not be the dominant area of focus. Ultimately the auditor has to reach a conclusion and indeed, terms within agreements such as banking covenants often directly refer to the audit opinion and the need for it to be unqualified, so there are significant and wide ranging implications for not having a definitive opinion. However there are clear benefits to users in being able to understand the journey to reach that conclusion.

Qu 26. Could further narrative be disclosed alongside the opinion to provide more informative insights?

There is a very strong case to have far more freestyle narrative than is currently the case. The audit report should reflect the individual character of the author in the way that chairman's statements often do. They should reflect the journey of the audit, what has improved or deteriorated, opinions on how approaches compare with industry norms and areas which involved subjective judgement.

It may be clearer to frame the audit report as a letter to the shareholders, from agent to principals, which sets out what the audit team found, what they saw and their views on these findings as opposed to a standardised, legalistic report.

Qu 27. What would prevent such disclosures becoming boiler plated?

There are reasons specific to both the auditor and audited entity which could lead to a dampening down of opinions tending towards boilerplate disclosure which would not create the types of audit reports that users want to read.

To avoid this there needs to be 'safe harbour' type protections for auditors who want to explain how they have used their knowledge and experience, together with the audit evidence, to reach their opinion. Real value will probably only be achieved when the individual auditor is encouraged to give their most judgmental insights. The risk environment for these must be proportionate since by their nature they will be subjective and open to different interpretation. Unless the environment is proportionate, the downside litigation and regulatory risk will drive these to being safe, objective and relatively risk free.

The board of the audited entity could also dampen down the auditor's enthusiasm to be opinionated. The control and dissemination of information not publically available is an area that boards should rightly be concerned about. In practice there are subtle ways in which influence can be exerted.

The lessons from the introduction of the extended audit report and viability statements are illustrative. One audit firm experimented with graduated findings however this did not build momentum and did not create a competitive advantage. There are numerous companies who were publically and privately vocal with regards to their misgivings. As a consequence all of the firms adopted a broadly consistent approach. With regards to the introduction of viability statements a number of companies looked at the time horizon being adopted by peers and opted for consistency thus creating a self-fulfilling cycle. In both cases there was limited pressure from investors to ensure change built momentum.

Qu 28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

The increase in regulatory scrutiny has indubitably had a net positive impact in terms of increasing audit quality as measured by the dimension of process and documentation. However this net positive outcome does involve some negative aspects. Audit firms have become tighter on compliance and documentation at the expense of broader thinking about the business model and unstructured enquiry that is more instinctive rather than written in a checklist.
During the same period the accounting standards have changed fundamentally. The replacement of historical cost with fair values has introduced much greater subjectivity in a number of financial statement areas. The role of the auditor is therefore less about "is the answer factually correct?", but increasingly where on the spectrum of potential outcomes the assumption sits. This is highly judgmental and it is possible that two auditors presented with the same facts, circumstances and audit evidence could reach a different conclusion within that spectrum. These two important influences have collided round an audit report that gives a binary answer and that can be directly traced through to detailed, pre-planned audit programmes and checklists. There is a very real risk that binary style audit opinions give false certainty and do not reflect the true fragility of forward looking assumptions.

Legal responsibilities

Qu 29. 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?

The auditor's role in determining whether the directors are complying with laws and regulations is an example of the expectation gap. The sheer volume of different laws and regulations a large multinational company has to comply with will often be so wide that inevitably they will not be in full compliance with every aspect. The auditors role should rightly be focused on areas where potential financial consequences arising from non-compliance is financially material or the overall consequences are so serious as to warrant disclosure. However in today's world of social media the damage to a brand or product line from a relatively minor area of non-compliance can be extremely difficult to judge. Inevitably if the damage to the brand results in a loss of value the question will be asked, where were the auditors?

Qu 30. 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?

There is a perceived inconsistency between accounting standards that increasingly rely upon fair value accounting and company law. However, this inconsistency is probably too nuanced to be the focus for public expectations. The key issue is whether a company is paying dividends that it cannot afford and thereby favouring one group of stakeholders at the expense of others and in extremis endangering the viability of the business to support the short term share price. As the auditors are the agents of the shareholders it is business viability that is most relevant to shareholders. In relation to the affordability, any distribution to one stakeholder group must by definition reduce the security of another, however, there are mechanisms other than audit that address this.

Currently the responsibility on preparers and auditors is focussed on the reserves of the parent company and whether reserves from group subsidiaries have passed through the group structure. The requirement to disclosure distributable reserves may create greater prudence or they may create even more complicated structures to prevent dividend blocks. A far more powerful tool is to require both boards and auditors to consider whether this dividend, or more relevantly this dividend policy, is affordable in cash flow terms given the context of the business model and variables outside of management's control. This has a very clear linkage to the role of audit in relation to going concern and specifically the time horizon.

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

There is an inconsistency between accounting standards and company law that result in gains that are recognised but not realised accumulating in reserves that are not distributable. The differences between the two can be significant and build up over time. Furthermore these differences are not a homogenous group in terms of how they unwind and accounting standards determining the treatment of these reserves have changed over time. There are a number of entities that would find this a significant exercise to go back through every year and recalculate these reserves and, even then, the outcome may not be auditable within materiality. At the end of this extensive exercise the reserve split could be disclosed but to what end? There may be better ways to solve the core issue. Where entities have kept poor records over time the review should first consider how entities might pragmatically calculate their historic distributable and non-distributable reserves prior to requiring them to be disclosed.

Qu 32. 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?

Auditors currently have limited tools regarding the adequacy of accounting records. There is a binary disclosure in the audit report if the records have not been kept but this is rarely used and typically in extremis where subsequent rectification work proved insufficient. This does not address the relative quality of the accounting records including how many corrections were required by management either at their own instigation or identified by the audit process. The volume of correcting journals is frequently a good proxy for how challenging the audit process has been where the accounting records have not been as good as they should be. Whilst this information is reported to and discussed with central management in terms of component operations and with the audit committee it is not typically part of the auditor's public report.

The communication of audit findings

Qu 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 support increasing the level of open dialogue with users of the annual report and financial statements as this would contribute to reducing the expectation gap. However we do not believe that AGMs are necessarily the most useful forum as they are often not well attended, are not recorded and take place a number of weeks after the annual report and financial statements have been issued.

To give more transparency a more useful and timely forum might be for the auditor to take part in the full year results presentation. This forum is often held via an online webinar, is generally recorded and the transcript is placed on the company's website which would give all interested users access to the auditor's insight. However, this does raise a question of timing as this result's presentation often takes place at the time of the preliminary announcement before the final annual report and financial statements, including the audit report, is published.

For the largest companies it might also be of benefit to investors for auditors to also participate in the half year results presentation and to present an update to their key audit matters from the full year.

Qu 34. 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?

We note that in the public sector Audit Committees publish the auditor's report to the Audit Committee on their website. A similar approach could be taken in the private sector. However, because of the need to avoid disclosing price sensitive information, this could increase the risk that the auditor's report to the Audit Committee becomes boilerplate and bland.

The public sector also has a formal facility for users to ask questions about the financial statements and to make objections in writing to the external auditor. Dealing with objections can take a long time to resolve, delay the finalisation of accounts and increase costs, however, there could be some benefits from this type of system that could be considered for the private sector to improve the dialogue between auditors and users.

Qu 35. 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?

In our response to Qu 26 we have suggested a more freestyle and opinionated narrative audit report, maybe in the form of a letter to shareholders, including commentary on improvement or deterioration from previous reports, which may be of more value to users and could address trends.

Fraud

Qu 36. 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?

There is an expectation gap in relation to fraud detection. There are typically two different types of frauds, an operational fraud perpetrated by one or more employees for financial gain that will, in the majority of instances, include quite modest amounts, the second type is perpetrated by management to manipulate results (sometimes by using increasingly aggressive policies and assumptions) often with a view to increasing the share price and ultimate valuation. Areas of the financial statements that involve high levels of estimation, uncertainty and judgment are often where there is the greatest opportunity for management to manipulate results. An audit is not the best tool within the assurance ecosystem to detect operational fraud but it should be the best tool to detect management fraud. However it is important to recognise that an operational fraud can manifest itself in such serious financial distress that it undermines the viability of the business. This is best prevented by a strong control environment which auditors need to test and report upon. Internal audit also have a very important role to play in preventing and detecting fraud, particularly at an operational level.

Qu 37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

The responsibilities are clearly set out in ISA 240. The revision of ISA 540 regarding the audit of estimates is a positive step as it addresses some of the challenges regarding the audit of estimates which as described above is a key element in management manipulation type frauds. The issue of the fraud expectation gap is unlikely to be found in the auditing standard.

Audit firms have the skill and competence to close the fraud expectation gap but it would be at a level and scope of work (with associated costs and timescales) that would not be appropriate to be included within a financial statement audit or applied in a non-risk way to all companies.

Qu 38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

Frauds are often highly complex and require detailed investigation by forensic accountants to get to the bottom of them. Therefore, in most cases, a reasonable person test would not be effective.

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

Again it is important to separate smaller operational frauds, larger operational frauds with more serious consequences and deliberate management manipulation. The audit is not the right assurance tool with regards to small operational frauds. For larger operational frauds, particularly those that continue over an extended period and involve falsifying balance sheet positions there must be a failure in the control environment. The auditor should consider and evaluate the control environment as part of the risk assessment and therefore could report on the effectiveness of design. However frauds are often complex and involve collusion so there cannot be a high level of assurance from the auditor that the control environment would prevent all significant operational frauds.

In relation to management manipulation type frauds there is scope for greater assurance over the controls and processes involved in reaching key areas of judgement. In practice it is larger more complex entities that will have greater formal structures and processes.

Auditor liability

Qu 40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

A cornerstone of this review and improving the audit product must be to have audit reports that users consider worthwhile reading. It is only with this platform that a dialogue between auditor and shareholder can develop further. In order to be worthwhile reading, audit reports must be insightful and opinionated. Therefore there must be safe harbour provisions for expressing informed opinions, clearly these opinions have consequences and should not be made recklessly but the risk of having to justify every phrase in a court process will create a tendency toward the bland.

As important, if not more important than the risk of litigation, is the risk of regulatory reprimand and sanction. It is important to public trust that audit firms performing sub-standard work are punished at a level that acts as a deterrent. However, the enforcement process needs to be fair, professional and speedier than the current regime.

Qu 41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

The primary issue is not the quantum of litigation or regulatory fine but the likelihood of an initiation of the action itself. Individual actions are not driven by whether a legal claim or fine is large or small they are driven by has the audit team done the right thing or could the firm and individuals be exposed to a claim or enforcement action. Actions and claims that are successfully defended still have the potential to ruin careers.

At the organisational level the quantum of liability, combined with the likelihood, drives risk appetite and whether specific audit assignments should be accepted.

Qu 42. 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?

Auditors are engaged by the shareholders to perform an audit in line with standards that are written from the perspective of shareholders. It is impossible to know what interests other stakeholder groups may have and for what purposes or even whether the accounting framework provides the relevant information. By opening up auditor liability to a wider stakeholder group, assurance statements would have to be so heavily caveated that there is a risk of undermining their benefit.

It is reasonable to predict that a widening of the stakeholders able to rely upon the work of auditors, without a relevant established body of case law, will lead to a significant increase in the number of legal claims and, in turn, lead to either a reduction in the number of market participants or stifle attempts at innovation in reporting.

Qu 43. 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?

As explained in response to other questions the actions that drive audit quality are not driven by the quantum of auditor liability. For the audit to provide wider assurance on new areas and for the audit report to be more opinionated there needs to be safe harbour provisions notwithstanding the fear of liability is a key driver of audit quality.

Qu 44. 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?

To date we have not had difficulty obtaining indemnity insurance on acceptable terms. We have placed significant focus on audit quality and protecting our reputation which is reflected in our premium levels. However we understand, based upon advice, that the insurance market is reassessing the longer term price of cover for the profession generally based upon more recent claim history and pricing is beginning to harden.
Professional indemnity insurance is a major cost for all accounting firms and there must be a level at which the so called Challenger Firms seriously consider the cost benefit analysis of greater market participation in the top end of the audit market.

Other issues

Technology

Qu 45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

Although it varies from audit to audit and firm to firm, generally, technology is extensively used in audits today; the most sophisticated technologies tend to be used by the largest audit firms on the complex and/or largest audits.

Although it is often the emerging audit technologies such as Artificial Intelligence and data analytics that grab the headlines, it is without doubt the core audit tool that is the most essential part of undertaking the large global audit that requires auditors from many countries to coordinate their activities, work in real-time as a team, to tight deadlines and produce audit evidence to the quality expected by regulators. Although a limited number of audit tools exist as off-the-shelf packages, the most sophisticated that enable truly global collaboration, are proprietary software packages developed by only the very largest networks and are very significant items of investment; costing many tens of millions of pounds. The proprietary tools enable application of the network's individual audit methodologies, enable real-time collaboration, incorporate complex levels of security and quality control, drive consistency throughout the global audit, and provide a mechanism to integrate complementary technologies such as data analytics, language translation etc.

Equally essential are the IT experts deployed as part of audit teams to design and perform procedures on the audited entity's ERP and proprietary IT systems. Corporate IT systems in the largest organisations are extremely complex and in an increasing number of audits the work performed by the IT specialist auditor is central to the audit strategy. The recruitment of specialist individuals, combined with a portfolio of IT tools are key to this capability. As business and finance continues to evolve (eg crypto currency), we anticipate a time in the not too distant future when such expertise is required not just for the largest, most complex audits.

More recently, as the volume of transactions has mushroomed and technology has become ever more powerful, there has been a flurry of innovation surrounding data analytics, process mining, artificial intelligence and robotic technologies. A number of these have already gained widespread deployment amongst the largest firms - such as the use of data analytics in the audit of journals – whilst others are targeted at more discrete challenges – such as stocktakes – or at more specialist industries such as banking and finance.

Answering the question as to whether these technologies provide you with higher degrees of assurance is not entirely straightforward. An audit has always been designed to provide the user with 'reasonable assurance' on the financial statements as a whole and the use of technologies has not changed this. On the other hand though, the use of some technologies such as data analytics, enable the auditor to examine the entire population of items, thus eliminating any sampling risk which may result in more assurance being able to be taken from that one particular audit test and eliminate the need to perform other complementary audit tests.

The more common position however is, in the absence of the latest technologies, it would be simply not possible to audit many of today's large and complex entities, certainly to the timescales that are required by stakeholders. Even for many entities that are not generally considered complex, the levels of data are now often overwhelmingly voluminous and, for instance in the audit of journals, we now adopt sophisticated analytics in the majority of our audits.

Qu 46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

As a firm we employ a wide range of sophisticated technologies outside of our audit business and we expect these, and other emerging technologies to play a central role in evolving the scope of the audit to meet the future needs of users. Although there is much speculation on future technologies, the power of current technologies used outside of the audit should not be underestimated. As a flavour: currently our forensic auditors use a powerful toolbox of technologies, expertise and skills to provide a wide range of services including investigations into fraud and accounting or operational anomalies. Equally our corporate financiers use technologies to provide services related to challenging both complex business and financial models, and our IT specialist use a wide range of technologies to provide both assurance and investigation in the areas of cyber and information technology. A number of these technologies and services are used to some extent in external audit service but their use as standalone services or internal audit services (where the user is more able to choose the exact scope of the assurance service) is more extensive and advanced.

Aside from the above, which are mature subject matters for the application of new technologies, we also anticipate an increasing need for assurance in new emerging areas such as crypto, climate, sustainability, culture and supply chain.

The relevance of information and assurance is a key consideration in the cost/benefit decision. This decision is not only dependent on the subject matter but also the timeliness of the provision of the information or the assurance. This is one area where new technology is having a big impact. Investigations and assurance services that in the past would take many months can now be accelerated and performed in weeks or days; all of a sudden the information is more timely and has far more value.

The vast majority of these technologies, skills and expertise are available at the moment and they could be used in the current external audit to bring value to users. The real question here however, is which technologies and services would users derive the greatest benefit from, and hence would like provided as part of the statutory audit, or if separate from the audit, still provided by the auditor.

As is clear from the above, these services are usually complex and involved. They all have a cost associated with them and in some cases they can take a significant amount of elapsed time to set up and complete; applying them all to every large audit would seem indiscriminate, not proportionate and is likely to provide poor value to at least a number of users; it is also not to be underestimated the limitation to supply of resources available to the firms. A mechanism is therefore needed to enable these technologies and services to be provided just to those audits where they would provide the most value to the users.

Proportionality

Qu 47: Are there aspects of current audit procedures or output that are no longer necessary or desirable?

The IAASB has recently issued a discussion paper on the 'audit of less complex entities' which is seeking views on how to address some of the challenges that exist in applying the current ISAs. We considered it a positive move that the IAASB changed the focus of this discussion from small and medium-sized entities to less complex entities as this recognises that small doesn't necessarily mean simple (and vice versa). This would appear to be good starting point for the debate around the appropriateness of the existing ISAs and whether or not some up-front simplification of the standards is in order that can be applied to less complex entities to assist with proportionality.

Subject to the considerations of the IAASB and the wider work being done currently on the future of audit we envisage innovation being key to the debate as opposed to wholesale change to the audit process. There are probably a number of "accepted" audit procedures which would benefit from re-thinking, not least to take account of some of the changes in IT e.g. could sending drones be seen as the equivalent to attending a stock count, could the accessibility of information on-line (with the appropriate rigor in place around access) assist in various confirmation processes as a precursor to blockchain where a large number of entities will confirm their balances with each other at a specific point in time?

Given that this debate is already being considered by the IAASB we do not propose discussing it further here.

In relation to output the core elements are the audit report, reports to those charged with governance and management letters. We would not regard any of these elements as being superfluous, the issue is whether the content delivers the value that is demanded.

Qu 48: Given at a zero failure rate is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

Companies will fail or have prior year restatements or be subject to management reporting fraud. That is inherent in any capital markets regime and where any human intervention is involved. The value of audit can only be judged compared to what would happen if auditors were not present. We consider that not only would these negative events occur more frequently but they may also come as a greater shock to investors and these would need to be priced into the risk/return.

What is achievable is a regime where risk is better understood and more accurately priced, where equity prices do not overshoot because investors react badly to a risk that has taken them by surprise.

Qu 49: Does today's audit provide value for money?

One of the current challenges is being able to demonstrate to users what would happen if the auditors are not there. The introduction of KAMs into the audit report has improved the visibility of what auditors do but much remains hidden e.g. there is no requirement to disclose the extent to which the audit has resulted in adjustments to the financial statements or where the auditors have recommended improvements in controls.

Earlier within this response we have raised the point that we consider that there are aspects of financial reporting that are also relevant to the current debate. Some investors have indicated that the preliminary announcement is the key document for them, and indeed this independent review questions whether all notes to the financial statements need to be audited. Conversely recent additions to the ISAs have been to increase the rigor around the auditing of certain notes due to investors regarding these as important, suggesting diversity in views.

Audit firms are not making super profits. The increased regulatory burden has not been passed on in price increases resulting in challenging margins for firms to manage. The costs of pitching for new audits and shadowing years on appointment, which have been increasing significantly in recent years, have not been built into current pricing.

Qu 50: 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?

The key area where there seems to be considerable interest in extending the audit is in relation to forward looking information and in particular around going concern. One of the challenges with extending reporting in this area is that it is difficult to look into the future with any certainty so the enhanced reporting would require more granularity in relation to the various risks and associated sensitivities which exist – and all of this needs to start with management's view. The other factor to consider is that all that would be required is one factor which possibly hadn't been foreseen by the preparers (maybe at a sector level) for these assessments to need urgent updating. Does an extension of reporting in this area therefore require not just further depth to the reporting but an increase in its frequency?

Whatever the case the cost v benefit consideration would require measurement in the same way as suggested in our response to Qu 48.

Shareholders

Qu 51. 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?

We acknowledge that there is a lack of direct dialogue between auditors and shareholders and therefore audit firms have little data on which to evaluate how shareholders are using these reports.

Qu 52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

As noted in our response to Q's 33-35 a more useful and timely forum than the AGM might be for the auditor to take part in the full year and half year results' presentation.

Qu 53. 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?

As indicated by the expectation gap, shareholders do not have a sufficiently high level of understanding of audit to be able to usefully shape and approve the audit plan. However there could be some benefit in shareholders being able to express their concerns that the auditor can then reflect on in agreeing their audit plan. Increasing the level of direct dialogue via the full year and half year results presentations could enable that dialogue to happen.

Qu 54. What assurance do shareholders currently obtain other than from audit reports?

As noted in response to Qu 51 there is a lack of direct dialogue between auditors and shareholders and therefore audit firms have little data on which to evaluate what other assurance shareholders are obtaining other than from audit reports.

Culture

Qu 55: In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

In carrying out any audit the auditor does take a view on the culture of the entity in order to set an appropriate strategy for the financial statement audit e.g. management's attitude to proposed audit adjustments may have an impact on where performance materiality levels are set. However, this does not lend itself to easily reporting on the culture of the entity.

Any reporting on culture would need to be comparable between entities and to that end some form of code, setting expectations against which entities could be measured, would be needed. Without this there is the potential for any reporting to be highly qualitative in nature and depending on the precise nature of the proposed reporting some form of safe harbour principles may need to be agreed.

If it is a more qualitative approach that is required it is likely that the expertise to perform such a review lies outside the skill set of the professional accountant at the current time.

The FCA has introduced the Senior Managers and Certification Regime which is targeted at the culture of its firms. It is possible that a similar model could be introduced in the mainstream corporate world which auditors could report against.

The Banking Standards Board has been carrying out an annual assessment of culture, behaviour and competence and is effectively a sector survey. It may be possible to introduce something similar for, say the FTSE 100, under the supervision of the Listing Authority but this would undoubtedly be a costly exercise.

Qu 56: How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

The closest that the profession has achieved so far in demonstrating this outside of the entity itself is in the KAMs. However, to date this has had its limitations. Audit scepticism will be demonstrated most clearly in client meetings and in reporting to those charged with governance.

Ways in which auditors may be able to improve demonstration of scepticism would be to:

- enhance KAMs reporting further, but thought would need to be given to whether safe harbour provisions need to be brought in depending on just “how honest” the reporting is intended to be
- make the report to those charged with governance available to the shareholders, however this may run the risk of these reports becoming more boilerplate
- include “auditor’s question time” at the AGM (or other forum as mentioned earlier such a results’ presentations), as with the first suggestion some form of safe harbour provisions may be required

Qu 57: Should the basis of individual auditors’ remuneration be made available to shareholders?

We do not consider that the basis of an individual auditors’ remuneration would necessarily provide useful information to shareholders, assuming this is the remuneration of the signing auditor.

There are likely to be a number of variables at play, not least other roles that individual may hold within their own organisation e.g. head of an office or business unit, which would impact on their reward. The size of firm will also be relevant given the variability in charge-out rates, overheads and profitability of different organisations.

Information concerning the basis for determining partners’ remuneration is required to be set out in a firm’s Transparency report, where the latter is relevant. It would seem more helpful to include a cross-reference to that report and potentially consider enhancing disclosures within that document where an individual’s remuneration could be put in the context of his/her fellow partners. It is this comparative measure which is more likely to provide an indication of the firm’s culture.

It should also be borne in mind that for Public Interest Entities there is always likely to be more than one partner involved in the audit and the question of reward v behaviour is as relevant to them e.g. engagement quality control partner, specialist partners, partners involved in consultations etc.

An alternative approach may be to require some form of disclosure that benchmarks the audited entity's fees against its nearest competitors. Availability of the relevant information may be an issue without some form of assistance from the regulators to ensure that up to date information was available for any reporting cycle and would probably need to be based on budgeted fees, with comparative amended the following year.

Cost

Qu 58. Do respondents view audit costs as generally too high, about right or insufficient?

Audit fees have not generally increased in line with the increased complexity of regulation or changes in the regulatory environment. If going forward, the audit is required to deliver even more, particularly in relation to going concern and fraud and increased auditor reporting, at a sufficiently high level of quality, then costs will need to increase to be able to deliver this.

Qu 59. Would users of financial statements wish more detail on the make-up of audit fees?

Users have rarely asked the firm to provide a breakdown of its audit fee. Users have been more concerned through the tender process of ensuring that they are getting a quality audit. The pricing of audits is complex and is dependent on a number of factors. One of the drivers behind providing more detail to users would be to enable them to compare the level of audit fees across entities. Given the inherent complexities, it would be difficult to achieve a break down that would enable meaningful comparison to take place.

Qu 60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

There are a number of individual audits, for a variety of reasons, where the price does not support a high quality audit. The audit firms are not reducing their work but incurring losses on these contracts. This impacts on the profitability of the profession as a whole and as a consequence the level of investment in innovation and product innovation is less.

We look forward to being able to continue to contribute to the development of the future of audit as the review progresses

Yours faithfully

BDO LLP

BDO LLP