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7 June 2019

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Dear Sir

Quality and effectiveness of audit - Call for Views

EY welcomes the *Independent Review into the Quality and Effectiveness of the Audit* and the related Call for Views document issued on 10 April 2019 ("Call for Views") We share some of our views in this letter and provide detailed responses to questions in the attached appendix.

EY regards the importance of this Call for Views in equal measure to the recent Kingman review, CMA market study, BEIS select committee inquiry and FRC's ongoing review into corporate reporting. They are all interconnected in the way they investigate and seek improvements to different aspects of the capital market ecosystem (i.e., corporate governance, reporting, auditing and the related regulatory system). In particular, the value of audit is inextricably linked to the relevance and usefulness of information provided in the annual report and accounts, therefore improvements can only be optimised if management, boards, audit committee members, regulators and auditors all play their part to the full in delivering future reforms. We believe it is important that the FRC's Future of Corporate Reporting project leads to innovation and simplification in corporate reporting, to focus on relevant, decision-useful and trustworthy information for shareholders and broader stakeholders.

The abovementioned reviews were instigated in response to a breakdown in society's trust in business and the ecosystem that supports an active capital market including management, boards, auditors and regulators. The UK is not alone in this respect. Across the globe there is a growing desire for business to do more to restore and build the trust of its stakeholders and wider society. EY believes that the UK's corporate reporting framework needs to respond to this and provide a more complete picture of long-term value creation.

EY sees a future where varying forms of assurance are offered by multiple providers, not just the statutory auditor, giving a broader range of stakeholders (e.g., employees and suppliers) a greater insight to their companies. This would be achieved with clear and reliable information about a company's resilience to risk and its ultimate viability, signaling as early as possible if that viability is under threat.

Even without the recent corporate scandals that led up to the UK reviews, there are many different powerful forces such as globalisation, climate change, changing demographics and rapid technological disruption that affect the place of business in society and how it generates value for the long term. How well companies navigate these megatrends will determine to what extent their stakeholders trust them. Governance, reporting and assurance play an important part in facilitating that trust and we believe these need to adapt quickly in ways we describe in this letter.

Whilst this long-term vision for the future of audit is being developed, EY is committed to playing its part by supporting the innovation of audit to meet users' needs and expectations more effectively. To this end we advocate several reforms, some of which we regard as particularly noteworthy and are highlighted below:

- Purpose - the audit should be for the benefit of stakeholders generally, not just shareholders, therefore its purpose needs to be redefined with appropriate consideration to the auditors' limitation of liability.
- Viability - disclosures in relation to the going concern assessment and viability reporting should be more specific, with assurance provided on the models and disclosures supporting the viability statement.
- Fraud - a framework should be introduced for companies to report against, and related audit procedures more specific.
- Shareholder engagement - we support the introduction of some form of "annual assurance meeting" which should require the direct participation of the audit committee chair, external auditor and internal auditor.
- Simplification - We need to make it easier for users of an audit opinion to understand what level of assurance is provided on which aspects of the annual report and accounts and other forms of corporate reporting.
- Technology - auditing standards should be updated to encourage a greater use of technology in the delivery of assurance.
- Accountability - management certifications (with meaningful sanctions for inappropriate certification) are needed on the content of the annual report and accounts and internal controls over financial reporting (and potentially internal controls more broadly).

We are committed to supporting the reform of auditing in the UK, as part of a series of overall improvements to the ecosystem mentioned above. The attached appendices contain our responses to specific questions in the Call for Views, together with suggested improvements. We would be pleased to discuss our response and answer any queries, and if there are views and related evidence you would like to explore, please contact me using the details enclosed with this letter.

We would also welcome the opportunity to have a wider conversation with you about our vision for the future of audit with a focus on the increasing opportunities provided by technology.

Yours sincerely

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Appendix – responses to questions

Chapter 1 – Definition of an audit and its users

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

The Companies Act 2006 states that an auditor "must make a report to the company's members" [1], whilst ISA (UK) 200[2] states that an audit is for "intended users" without giving further definition or specifying their needs. Therefore, it would be helpful if company law defined more precisely who should benefit from the audit and clarify its purpose accordingly. Such a change could contribute to the narrowing of the expectation gap that is discussed in our responses to the questions in Chapter 2.

Recent changes to the UK Corporate Governance Code (and associated changes to statutory requirements) have emphasised the responsibilities of the board to a broader range of stakeholders, not just shareholders. This reflects wider concerns that businesses need to take a stronger societal role in respect to the public interest. In our view, it would be consistent with these developments for an audit to be conducted for the benefit of this wider group of stakeholders, including but not limited to shareholders.

EY hopes that many users will respond to the Call for Views and articulate what value they derive from an audit (or indeed what value they might derive if audit evolves). We anticipate that different users will appreciate the audit in different ways, depending on their relationship with the company. However, we expect that there is a common thread to these perspectives which relate to the benefit of having a defined and codified package of information about a company which is independently assured. The more relevant and decision-useful reporting by companies becomes, the more valuable audits become.

As discussed further in our response to Question 42, we recognise that there will be significant challenges (e.g., auditor liability) if the beneficiaries of an audit are widened beyond shareholders. These issues will need to be addressed.

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

As set out in EY's cover letter, we are strongly of the view that it is critical that the actual content of corporate reporting (including the financial statements and the standards under which they are prepared) needs to evolve to become more relevant, decision-useful and valuable to a wider group of stakeholders. We welcome the FRC's Future of Corporate Reporting project and hope it leads to significant changes in reporting for UK companies. These changes, if implemented successfully, will

[1] Companies Act 2006, s 495: A company's auditor must make a report to the company's members on all annual accounts of the company of which copies are, during his tenure of office:

(a) in the case of a private company, to be sent out to members under section 423;
(b) in the case of a public company, to be laid before the company in general meeting under section 437.

[2] ISA (UK)200, paragraph 3: The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

create an opportunity for the audit to provide confidence in broader aspects of corporate reporting, in addition to the financial statements (e.g. key metrics that demonstrate long-term value creation for stakeholders).

The phrase "degree of confidence of intended users in the entity" can be interpreted in many ways. Notwithstanding the potential for enhanced value described above. EY thinks it is important to recognise the limitations of what an audit can provide. For example, a clean audit opinion can never be a guarantee of an entity's future viability, that a company has not suffered fraudulent activity or, in the case of financial services, that a company has not miscalculated regulatory capital or risk-weighted assets.

EY also notes that management or audit committees currently have the ability to extend the assurance provided by the external auditor beyond that which is required by law and regulation. For example, they could require the auditor to perform attestation procedures over an entity's control over cyber risk, or additional procedures on fraud detection. In our experience this is uncommon (see response to Question 36).

However, one way of enhancing the degree of confidence in an entity is for there to be attestation over the entity's internal control (and potentially not just internal financial control). Please see our response to Question 12 for further details. We also see potential for assurance in other areas to build confidence in an entity, for example in areas such as culture, risk management and the impact of climate change, but we believe assurance in these areas might be better delivered outside of the statutory audit.

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?**

   See response to Question 1 – EY believes that greater clarity on the purpose and intended users of an audit would be beneficial. Any resulting changes to UK law should be informed by the output of the FRC's Future of Corporate reporting project (there should be a strong connection between meeting the needs of intended users of an audit and corporate reporting) and this Call for Views. We expect such changes to be directionally consistent with recent changes to the UK Corporate Governance Code and related regulations which emphasise stakeholder engagement.

Chapter 2 – The expectation gap

4. **Do respondents consider there is an expectation gap?**

   Yes, for a long time there has been a gap between what an audit is required to deliver and what various stakeholders expect from it. This has been demonstrated most recently in research conducted by the ACCA[3], and is apparent from recent media coverage of the audit profession. There is also a gap between the reasonable assurance that an auditor is statutorily required to provide over an annual report and accounts, and the perception from some users that an audit provides ***absolute*** assurance and that they are free from any misstatement due to fraud or error.

[3] "Closing the expectation gap in audit", published in May 2019 by the ACCA

5. **If so, how would respondents characterise that gap?**

See response to Question 4. We have also, in responses to other questions, identified a gap between what users want from corporate reporting and what law, regulation and accounting standards provide – this is distinct from the expectation gap in respect of the audit.

EY's view is that the audit expectation gap is most notable in the following areas: going concern/viability, fraud detection/prevention and anti-money laundering, capital maintenance requirements, compliance with laws and regulations, key performance indicators and other non-GAAP measures and cyber risks. For example, in their survey, the ACCA recorded that approximately 50% of UK respondents believe that auditing standards are designed to prevent corporate failure, and approximately 50% of UK respondents expect auditors to either detect and report fraud, or detect and report any fraud that impacts the financial statements[3].

We draw your attention to a speech given by Jeannette M. Franzel at the 2016 International Institute on Audit Regulation. This includes a helpful analysis of the expectations gap which may assist in devising a strategy to address each constituent of the overall gap.

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?**

EY acknowledges that audit quality could be delivered more consistently to existing standards. However, we do not agree that there is a significant delivery gap between current standards and what auditors do. We think the debate on this issue has been hindered by the fact that successful audit outcomes are often not visible. We believe there is an exaggerated focus on "audit failures" and no visibility of "audit successes". In our experience, which we would expect to be consistent across the profession, robust challenge and objective scrutiny by the auditor of management's decisions and disclosures in company reporting lead to significant changes to management's original position on all audits leading to more appropriate and transparent reporting. This activity is not visible to users of audit reporting (except for some limited information in extended key audit matter reporting).

Currently, the only reported measures of audit quality are either media coverage of the auditor's role in a corporate failure, or the results of the FRC's inspections of a sample of a firm's audits. If the audit is re-defined, more balanced measures of audit quality need to be established.

Chapter 3 – Audit and wider assurance

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

As discussed in response to specific questions below, EY believes the statutory audit can and should be expanded to provide assurance over more relevant corporate reporting. Even with an expanded scope of audit we would still anticipate that a board might commission additional assurance beyond the audit, as they can do now. We also see merit in a board articulating, in their external reporting, how they look at assurance holistically, the various sources of assurance they utilise and how external assurance (including the audit) fits in this holistic picture.

Specifically, with respect to paragraphs 36, 37 and 38 of the Call for Views document, we agree that a range of skills are required to deliver a quality audit other than traditional audit and accounting. Audit firms currently access those skills from the other service lines within their broader practice.

We emphasise that many risks will arise, and opportunities will be lost, if an auditor is forced to buy these skills in from outside the audit firm (for example if full or operational separation is imposed on the audit profession):

- An audit firm will not be able to guarantee the timely supply of specialist resources.
- There could be unforeseen independence issues – the non-audit part of the firm will not want to be ruled out of other services. This also applies to outside firms with specialist knowledge who may want to retain/pitch for more lucrative services than merely providing a small task for another firm's audit.
- There are likely to be significant issues where entities have material operations in country's which do not mandate a split between audit and non-audit businesses – i.e. such a split will be very difficult to implement on a UK only basis.
- If a joint audit is undertaken, the challenger firm may not have ready access to all requisite non-audit skills.
- Issues related to attractiveness of the audit profession to potential recruits.
- A pure audit business is less likely to have the resources to keep pace with technological advancement and invest in enhancing or innovating the audit product.
- A broader assurance offering leads to more innovation in the audit, which helps to attract and retain more/better talent, which leads to higher quality auditing.
- There is a greater chance of closing the audit expectation gap if the wider assurance offering (with relevant/necessary liability protection) forms part of the statutory audit.

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?

As set out in paragraph 21 of the Call for Views, an audit under ISAs (UK) currently requires the auditor to obtain reasonable assurance (rather than absolute assurance) about whether the financial statements are free from material misstatement. EY expects all audits conducted under these standards to be designed to provide this level of assurance irrespective of the business sector or business risks. We do not advocate revising standards to incorporate different levels of assurance on the same content for different companies as this would, in our view, lead to more confusion on the part of users and could increase the expectation gap.

In our response to Question 7, we have noted that the complex nature of an audit report creates confusion as to the level of assurance being provided for a given company on different elements of the corporate report.

Consideration could be given to disaggregating the audit report and including the relevant "audit report" under each section of the annual report and accounts which could make the level of assurance provided on different content elements clearer. Alternatively, some form of "key" could be used to mark-up the content of a corporate report and indicate, for each key item, the relevant level of assurance provided. We acknowledge these ideas would have technical implementation challenges under current auditing standards but believe they are worthy of consideration.

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

EY's view is that boundaries between internal and external auditors are reasonably clear – although current disclosure requirements in relation to the respective roles of internal and external audit could be revisited to include a more explicit requirement to set out their respective scope more clearly, including clarity on the extent to which the audit committee seeks assurance more broadly on the content of any corporate reporting (see the response above to Question 7 on disclosure of sources of assurance utilised by the board).

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

For a statutory audit, the auditor is required to understand a company's financial reporting processes and controls and then elect whether to test those controls. In performing these procedures, UK auditing standards prohibit the external auditor from "sub-contracting" any of this work to internal audit ("direct assistance"). In EY's view, this prohibition on using internal audit creates an appropriate separation between internal and external audit, avoids confusion and ensures the external audit is suitably independent and objective.

However, there are circumstances where an external auditor should be able to use and rely on evidence obtained by internal auditors in the execution of their own scope of work (as agreed with the board). This could include, for example, understanding legal, regulatory and other compliance issues a company faces and the robustness of process and controls in such areas.

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?

Integrity, objectivity and independence (as set out in Ethical Standards) remain fundamental to audit quality. However, independence rules have become overly complex and difficult to understand and monitor. EY believes that independence rules should be simplified so they are better understood and more practical (and where possible, globally harmonised). We also recognise that the perceptions of an audit firm's independence are at least as important as a firm's view of their actual independence.

In our view, the key restrictions on innovation in the industry are:

i. the unlimited liability auditors operate under and the tough regulatory and sanctions regime, which we believe limits a firm's willingness to innovate and provides a significant barrier to new entrants and potential disrupters; and

ii. the necessary adherence to auditing standards and the potential for regulators to take time to accept the incremental assurance provided by innovative ways of auditing (e.g. through technology) and the commensurate reduction in more traditional forms of testing. This may restrict innovation or the benefits to be gained from increased use of technology.

iii. more generally, as the pace of innovation, technology development and disruption increases, auditing standards need to be kept under more regular review to ensure they are not holding back innovation.

As such, independence per se is not the reason for a lack of speed and adoption of innovation.

Chapter 4 – The scope and purpose of the audit

Risk and internal control

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?

Although the UK Corporate Governance Code currently requires a statement by the board regarding its assessment of risks and the results of its review of the effectiveness of internal control systems, EY believes that there would be merit in considering an additional approach aligned with that adopted in the US (i.e., the CEO/CFO to certify all disclosures in the annual report and accounts and the effectiveness of internal control over financial reporting). As in the US, there should be meaningful ramifications for inappropriate certifications. In the 15 years since SOX was introduced in the US there is a general agreement that its implementation has increased audit quality, strengthened the corporate governance requirements for listed companies, particularly with respect to audit committees, enhanced auditor independence by prohibiting external auditors from providing certain non-audit services to audit clients and increased investor confidence[4].

It is worth noting that the UK Corporate Governance Code obligations are in respect of risk management and the broader system of internal control, not just internal control over financial reporting, so consideration could be given to broader management certification covering risk management and the whole system of internal control – consistent with the UK Code obligations.

We recognise that directors may want external assurance to support the certification referred to above but the decision on whether to mandate external attestation of such statements should be based on stakeholder demand/feedback. We believe external attestation of any form of UK SOX reporting should only be mandated if there is clear user/stakeholder demand.

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

See our response to Question 12 above.

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?

We can see some merit in the auditor reporting externally more of the information they provided to audit committees on internal financial control.

[4] "The Sarbanes Oxley Act at 15: What has changed?", EY, June 2017

However, there is a risk of expanding the expectation gap further – i.e. stakeholders see the auditor as being responsible for reporting on all internal controls – which would be misleading under current auditing standards. Currently, auditors only undertake testing of the design and operating effectiveness of controls over financial reporting selectively – i.e., where it is most efficient and effective to do so. Including the results of the selective testing in the audit opinion could be of limited value to a user as it may not be representative of the control environment in the organisation as a whole. Ultimately, we believe the more important question is whether we should adopt a form of "UK SOX" requirement with an associated responsibility for the auditor. Please see our response to Question 32 and 12.

Going concern

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

We support the proposed revisions to ISA(UK) 570 – *Going Concern*, which have been introduced to address concerns relating to the extent of audit work on going concern. EY believes that it would be beneficial to align the disclosure requirements of going concern and viability more effectively. This would require companies to discuss and disclose specific details in relation to risks, assumptions and sensitivity testing in relation to the going concern basis of preparation. This would not prevent corporate failure, but could contribute to avoiding "surprise" failures. Current viability disclosures are important and should remain in use, but they should provide greater transparency and specificity (see response to Question 18).

We recognise the suggestions above would require revisions to accounting and auditing standards.

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"?

See response to Question 15. We believe the revisions to ISA (UK) 570 should adequately address this issue.

Viability

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

Current viability reporting by companies has diverged from the original intention when the UK Corporate Governance Code was revised, in that not many companies include in their statement any concrete information about the board's view of the long-term prospects of the company – i.e., the sustainability of the business model in the long term (beyond the formal viability assessment period) and associated risks or threats. This issue is addressed in a recent report from the FRC's Lab.[5] EY believes it would be helpful if the Code requirement is updated to make this a separate and distinct requirement of the statement in relation to the selected viability period.

18. Should such a statement be subject to assurance?

[5] "Risk and Viability Reporting", FRC Lab Project Report, November 2017

Any additional statement in relation to the long-term prospects and sustainability of the business model is likely to be subjective and therefore it would be difficult to envisage how such statements could be externally assured. Where projections are made many years into the future the level of subjectivity in management projections or statements increases and the value of any related assurance inevitably decreases.

We believe some form of assurance could be provided on the specific statements made in relation to the selected viability period and the model the board has used to support its statement. If disclosure requirements were enhanced to require more specificity on the key assumptions used by management, the sensitivity testing undertaken (with quantification) and the results of this testing, then assurance could be provided on this disclosure in a similar manner to the assurance procedures undertaken on working capital models for a public transaction. This assurance would not be on the viability statement per se, but on the transparency and accuracy of the associated disclosures.

19. Who might be capable of giving such assurance?

Whilst any audit firm should have the necessary skills to perform such work (assuming the retention of a multi-disciplinary model), we foresee risks if this work is conducted by a firm separate from the auditor. The external auditor should develop a holistic view of risks and financial models used by the company, and consider the inter-connectivity with impairment models etc – this makes the auditor best placed to perform this work. Though we believe disaggregating the provision of assurance would risk impairing the quality of the audit product, we acknowledge that this is a way to allow new entrants to the market. This trade-off between assurance quality and market choice is ultimately a decision for policymakers and regulators to make.

Unaudited information

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

As we acknowledge in our opening letter, we want the audit to be focused on the measures that matter to stakeholders and we also acknowledge that forward looking information is often of great interest to stakeholders. Therefore, we are keen to explore ways in which greater assurance could be provided on more of this type of disclosure (for example see our comments above on assurance in relation to viability).

It is important to note, as stated in our response to Question 2, that there are some things an audit can never be, and this includes a provider of guarantees over the future performance or viability of companies. Also, an auditor cannot provide an audit opinion on more qualitative disclosures such as a company's risk appetite, strategy, business model and risks (these cannot be considered in the context of being "true and fair"). However, under existing standards some auditors already perform audits on forward-looking information e.g., models supporting impairment assumptions, going concern and fair value models. We emphasise that if the external auditors' responsibilities were increased in more areas involving forward-looking information, there is a risk that this would exacerbate the existing issue of a misunderstanding of the respective roles of the board and auditor – ultimately the board is primarily accountable for any forward-looking information included in the corporate report.

There may be other disclosures relating to forward-looking information that users would see value in assuring, many non-financial KPIs also reflect forward-looking information and could be subject to assurance (see Question 21), however there need to be frameworks and standards against which such projections can be tested e.g., there are detailed requirements in IFRS for the preparation of projections supporting impairment assessments.

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?

As stated in our response to Question 5, EY regards this as a key factor in the expectation gap and would expect stakeholders to see greater value in audit if there is more assurance in this area. We believe that stakeholders should decide whether they want assurance over KPIs, key industry information and other non-financial information: an auditor can provide a level of assurance over these disclosures if this is seen as valuable, and there is transparency in corporate reports on what level of assurance has been provided over such metrics. We agree with the challenges set out in paragraphs 65 to 68 of the Call for Views regarding the increasing relevance and prominence of non-GAAP metrics relative to the financial statements. It is essential that the audit profession provides assurance over measures that matter to stakeholders, so we support any move to provide assurance over these metrics. This would require the development of new standards as envisaged in the IAASB's Extended External Reporting Assurance Consultation paper[6].

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

As referenced above, this should ultimately be a matter for shareholders and other stakeholders to decide. However, EY believes there would be value in providing assurance over the reporting of metrics that demonstrate long-term value creation for stakeholders (see the Embankment Project for Inclusive Capitalism Report[7]). See also our response to Question 18 in relation to assurance on viability and Question 2 in relation to climate change.

Chapter 5 – Audit product and audit quality

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

Yes, EY agrees that these are two separate issues.

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?

EY believes our audit teams are appropriately focused on matters requiring the exercise of considered judgement. Our experience is that the inspections focus on the audit process and documentation, which we recognise are important, and we acknowledge that inspections have primarily been focused on higher risk areas of the audit.

[6] "Extended External Reporting (EER) Assurance", IAASB Consultation Paper, February 2019
[7] "Embankment Project for Inclusive Capital Report", 2018

However, we encourage an inspection regime that is more focused on the culture of audit quality in firms, and audit quality outcomes rather than just auditing standard execution and related documentation. The FRC believes this is an important measure of audit quality and has recently started to assess the culture of audit firms[8].

In order to build trust with users of financial reporting, we believe it would be beneficial to communicate inspection findings in the context of whether the audit met its purpose, rather than solely specific findings on where the execution of auditing standards, or the documentation thereof, were inadequate.

Additionally, we recommend that regulators regularly consult with users as to whether the audit product is meeting their needs. This should be coupled with more explicit engagement obligations on investors in the Stewardship code which is due to be revised shortly. This would help maximise the relevance of the audit and encourage meaningful communication between relevant stakeholders.

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

Our view is that it is important to separate the form of opinion issued on the financial statements from the amount of information provided about how the auditor has reached its conclusion. We believe it is more practical to increase disclosures about how an opinion has been reached and the auditors' considerations in relation to their conclusions, than it is to introduce multiple forms of conclusion that are as likely to increase confusion as they are to provide clarity.

Furthermore, audit reporting and communication should meet the needs of users who should be engaged to find out what they would value, rather than the profession and regulators deciding on their behalf. The expanded audit report has not generated the level of interest from investors/stakeholders EY had hoped for, and so careful consideration needs to be given to the addition of more disclosures by the auditor. Graduated findings could provide more meaningful information to investors/stakeholders and may encourage greater communication with the auditor. Any such additional disclosure is likely to mirror information currently provided to the audit committee by the external audit, but we recognise that there will be challenges with confidentiality and management sensitivity.

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

See response to Question 25.

27. What would prevent such disclosures becoming boiler plated?

Once user interest and demand has been established, auditing standards should be updated to capture detailed requirements for consequential increased reporting, with a view to minimising the risk of boiler plate disclosure. For example, a key audit matter disclosure is not boiler plate for the most part, because it is a company issue and auditor specific.

[8] "Audit Culture Thematic Review", Financial Report Council, May 2018

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

    As stated in response to Question 7, audit firms have been able to innovate the audit in the current audit environment, often through working together with the non-audit side of the firm; for example, the development of analytical tools designed to increase assurance but reduce human audit effort. However, EY acknowledges that there has been, in some cases, insufficient user input to accounting, disclosure and auditing standards. We support any development to increase the extent of user input to the development of audit generally, and specifically how innovation in audit could enhance user value.

Chapter 6 – Legal responsibilities

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?**

    EY's view is that an auditor cannot "audit" the extent to which a company has complied with all legal and regulatory matters. The number of laws, rules and regulations companies must follow (particularly large, complex multinationals), is very extensive and it would be impractical and not cost effective for the auditor to have to verify compliance across all requirements. However, we believe that directors should be required to disclose more on their monitoring of compliance with laws and regulations for which they are ultimately responsible. We believe it is appropriate that ISA (UK) 250 continues to focus on "…compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements".

    However, it may be appropriate for assurance to be sought over the compliance framework adopted by boards, although we consider this to be outside of the external audit.

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?**

    We agree with the comments in the Call for Views that this topic of distributable reserves is unhelpfully complicated and would benefit from a simplified definition in Company Law and associated guidance. If the rules and definitions were simplified and a more explicit disclosure requirement added to require the disclosure of distributable and non-distributable reserves, this disclosure could be subject to specific audit requirements.

    It should be noted however that this would be complicated for international groups. The payment of dividends by listed parent companies is facilitated by the passing up of dividends from subsidiary companies to the parent company. The assessment of whether these dividends paid at the subsidiary level are paid "legally" needs to be assessed against the legal requirements in each country. The assessment and disclosure of parent company distributable reserves would only provide a part of the overall picture required for an assessment of the reserves available for distribution in a group. However, we note that for some companies with a long history, validating historical records of distributable reserves may prove to be significantly challenging.

We also support the recommendations set out in the FRC Lab report on dividend disclosures[9] which set out what aspects of dividend policies (and the related constraints or risks to the fulfilment of that policy) are of most interest to investors. We note that the most relevant constraint is often not distributable reserves but funding, for example.

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

See response to Question 30.

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?

Currently the practical benchmark used by auditors in assessing this requirement is whether the auditor has been able to obtain the accounting records required to complete the necessary procedures under auditing standards. This may not be the benchmark that is of most value to users of the financial statements. EY believes the relevant statutory requirements should be updated, in terms of both the clarity of definition of "adequate" and the objective of accounting record keeping. This would clarify what value such reporting by the auditor can add over and above expanded auditor reporting. We note though that any new mandated internal controls regime (e.g. a 'UK SOX') may supersede this requirement which predates today's focus on systems, processes and controls.

Chapter 7 – the communication of audit findings

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 agree with the observations in Chapter 7 that there is currently limited interaction between investors/stakeholders and the audit committee and external auditor. Ultimately, it is for shareholders and other users to decide how valuable such interaction could be, but we would welcome more dialogue with investors and are actively engaged in outreach.

We would be open to the idea of an "annual assurance meeting" e.g., involving internal and external audit, the audit committee and shareholders. We envisage these being similar to investor "capital markets days" where everyone is "on the record".

However, potential confidentiality issues would need to be addressed. For example, there is currently a conflict between the specificity some investors/stakeholders want on an auditors' views on company specific issues the confidentiality obligations the auditor must fulfil (as set out in audit engagement letters) and requirements in relation to price sensitive information.

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?

[9] "Disclosure of Dividends – Policy and Practice" – FRC Lab, October 2017

The extended audit report and audit committee chair's report already include a significant amount of the communications that occur between auditor and committee. In EY's experience, these disclosures have not generated much interest from investors and other users. We would be open to the provision of more information (subject to the confidentiality issue raised above) if it is demand-led and likely to lead to more engagement – for example the annual assurance meeting discussed in Question 33.

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 relation to changes to key audit matters, from year-to-year, there should be such an obligation and it is EY's policy to require this explanation in our reports. More generally, any future additions or changes to the audit report need to be tested with stakeholders to ensure those changes are relevant, useful and likely to lead to increased engagement.

Chapter 8 – Fraud

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?

EY does not believe that users' expectations align with the requirements set out in law and auditing standards. This is a key contributor to the expectations gap as users commonly believe that the auditors' obligations extend further than those requirements.

The expectation gap in this area could be partly addressed by:

- Establishing and issuing a standard framework for boards of what a fraud prevention and detection system should include, requiring the auditor to benchmark a company's processes against that framework (including how the organisation monitors and tests compliance with the framework) and report on their findings.

- Changing auditing standards to more explicitly require the review and testing of specific transactions based on a fraud risk assessment (but continuing to recognise that the auditors' responsibility remains to identify and assess the risks of material misstatement, whether due to fraud or error).

Boards currently have the option to choose what level of assurance they require, either a minimum level defined under standards, or additional assurance targeted at specific fraud risks or issues requested by the board. If the ideas above are not adopted, audit committees should be transparent in their external reporting as to what additional assurance they have commissioned, in order for stakeholders to perform meaningful analysis and benchmarking against other entities.

It should be recognised, however, that there is a significant risk that increased variability in the extent of an auditor's work in this area could lead to more confusion and therefore a greater expectation gap. In addressing this it will be important to remind users of reports that the directors are ultimately responsible for the prevention and detection of fraud.

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

    We believe there has been an increased focus by external auditors on fraud risk but, ultimately, a focus on the risk of fraud that the auditor would consider material to the financial statements.

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

    It is not clear to us what additional value such a test would bring. Please see our response to Question 36 for our suggestions to address the expectations gap in this area.

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

    See our response to Question 36.

Chapter 9 – Auditor liability

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

    The profession's willingness to embrace change is constrained by auditing standards (see our response to Question 11) and, to some extent, by the threat of litigation. Any changes in the purpose and intended users of an audit (for example beyond investors to other users) could increase this threat of litigation which would impact the willingness of the profession to embrace change.

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

    Again, as stated in our response to Question 11, unlimited liability is an impediment to innovation and market entrants. There is also a question about the attractiveness of the profession for those already in the market. The risk of audit failure and unlimited liability deters some people from staying in the profession and becoming audit partners. EY also understands that challenger firms are put-off from bidding to work for high-risk clients because of the consequences of audit failure (i.e., fines, sanctions and litigation).

    Limiting liability may bring in new entrants to the market, disrupt traditional behaviours and process, promote competition and attract the best people for the job. These factors are likely to improve audit quality.

    We note however that reputational damage and fines/sanctions for audit failures occur long before any potential legal liabilities, and this factor would remain even if liability was explicitly limited.

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?**

EY expects that any widening of auditor liability to all stakeholders who reasonably rely on their audit work (without any associated limitation of liability framework) would create an open-ended, unmanageable exposure which would threaten the commercial viability of such work for the large audit firms and would discourage challengers and disruptors even further and potentially significantly raise costs.

We note the comment in paragraph 120 of the Call for Views that it may be important to distinguish between parties to whom auditors might be responsible, and those to whom they may be liable for any failure. Conceptually this is one approach to widening the value and purpose of an audit without having a detrimental impact on the sustainability and attractiveness of the audit profession however, from a legal perspective, we understand there is no practical difference between responsibility and liability.

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?**

See response to Question 41. In our view the most important implications of limiting liability would be the encouragement of new entrants to the audit market and facilitating the evolution of audit to address the needs of a wider group of users.

We also note that limitation of liability agreements (LLA) could help address this issue as they could introduce both a cap and terms dealing with the proportionate allocation of damage. The use of an LLA may not only redress potential unfairness but also provide more incentive and reassurance to challenger firms to participate in the market. However, it is currently a matter for any individual company as to whether it is prepared to enter into an LLA. We note that since their introduction in 2008 there has been little take-up in the market, and therefore a wholesale adoption is currently unlikely. It is therefore likely that some reform or clarification, as to whether contractual provisions addressing proportionality are permissible within the restrictions on auditor liability set out in the Companies Act, will be needed.

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?**

The cost of external professional indemnity insurance became prohibitively expensive some time ago and therefore EY moved to a captive insurance model with a captive insurer that operates on a global basis. Therefore, as a member firm within the EY global organisation of separate member firms, we retain an exposure to the financial impact of an increased level of claims.

Chapter 10 – Other issues

Technology

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?**

EY uses technology extensively when performing audits and we strongly believe that its use provides better quality assurance. For example, an audit firm's ability to now audit a full data population supporting an account balance and focus testing on exceptions to risk driven filters, provides better quality assurance than a traditional sampling approach. Additionally, automation of certain audit processes, such as the preparation of engagement letters and machine reading of contractual information, frees up the time of experienced audit personnel to focus on areas of key judgement and estimation.

Going forward there is an opportunity arising from the use of artificial intelligence and "big data" which will allow an auditor to access information beyond that provided by an entity to better challenge management positions and provide greater comparability against the market. For example, using such techniques to gather data on office rental transactions in a certain jurisdiction would enable an auditor to provide greater challenge to a real estate company's valuation of its assets and its future cashflows.

However, auditing standards make it difficult to differentiate this increased quality of assurance in audit reporting. For example, audit firms develop tools to test full populations of data rather than rely on random audit sampling, but auditing standards do not currently facilitate maximising the efficiency from this.

Greater use of technology in auditing (and auditing standards that encouraged this greater use) should also encourage new entrants to the market, which we would welcome. However, it should be noted that if firms are subject to an operational or structural split, access to the skills and know-how to develop the further use of technology in audits might be compromised.

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?**

EY would approach this question from a different perspective. The first question to address is what broader areas of corporate reporting would stakeholders value assurance (beyond assurance currently provided). Then we would consider how technology could allow us to provide such assurance more efficiently or effectively. We are exploring the increased use of technology in different areas of the audit, harnessing the scale of our global firm and our multi-disciplinary model. This allows us to innovate are approach to auditing. Many of the new areas where we are employing technology in our audits are adaptations of innovation created elsewhere in our firm. For example, our forensics business uses AI to identify adverse behavioural patterns.

Technology is also changing how companies operate and manage risks, for example using tools such as block chain and artificial intelligence, which create additional risks over data integrity. This has the potential to challenge trust in business when such risks are not managed appropriately and this could become a key focus for assurance providers.

We would be happy to provide the secretariat with a working session to both demonstrate how we use technology currently and share development areas.

Proportionality

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

In EY's view, the more important issue is superfluous disclosures required in an annual report and accounts, rather than superfluous audit procedures. We recommend streamlining reporting to what really matters which will help to drive a reduction in audit procedures. We hope the FRC's Future of Corporate reporting project will help to facilitate this.

As the adoption of technology increases, a refocusing of auditing standards around the use of technology would both accelerate adoption and reduce the risk of duplication of effort in redundant manual audit procedures.

48. Given that a zero-failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

EY's view is that shareholders and broader stakeholders are best placed to respond to this question.

49. Does today's audit provide value for money?

Ultimately it is for investors and other stakeholders to decide if an audit provides value for money. Company management are not necessarily best placed to answer this question objectively. EY's dialogue with investors indicates that they derive a high degree of comfort from the audit process, even if they do not invest time in understanding the details. Cost does not appear to be a key issue with investors from our engagement with them, and frequently they will comment that they are happy to pay more for stronger assurance.

However, if stakeholders do not believe that the audit is covering specific risk factors which are important to them, boards and audit committees are able to request the auditor to perform additional procedures targeted at those risks. The increased engagement between stakeholders and boards would also inform the audit committee of any such concerns. In our experience, it is rare that an auditor is asked to do more than the minimum required under auditing standards.

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?

We believe the most important aspect to considering the cost / benefit equation of the audit is for investors and other stakeholders to proactively engage in the debate and make their views known. Boards are more likely to accept an increased cost of audit if they can see that it is clearly meeting all of the needs and expectations of their investors and other stakeholders, as well as providing assurance to the board.

However, in order to continue to maintain the attractiveness of the profession and both deliver and improve audit quality, it will be necessary to share the costs with the market of the investment in tendering, switching, compliance, technology, people and training. A multi-disciplinary model currently allows the non-audit side of a business to support the ongoing quality of the audit during periods of significant investment in these areas. Economic separation of the audit business risks the resilience of the business model to cope with these investment demands, and ultimately risks audit quality.

Shareholders

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?

As external auditors EY receives limited direct enquiries from investors on our audit reports, and we do not have any evidence to indicate the extent to which these reports are read, or the extent to which AI is used to analyse our reports.

We note that there is an intention to review and update the Stewardship Code in the near future. We hope that this review leads to an enhanced obligation on investors to proactively engage with audit committees and external auditors, which should increase the level of dialogue on reporting by external auditors.

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

As stated in EY's response to Question 34, we believe that more interaction with shareholders outside of the AGM, prior to and after the audit, would be desirable if confidentiality issues can be resolved. We leave it to the shareholders to comment on the practicality of this idea.

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?

This could be addressed through the "annual assurance meeting" described in paragraph 96 of the Call for Views. It is probably impractical to suggest more than one interaction a year with shareholders on the audit, but this one meeting could cover the findings from the audit just completed and also be used to gather shareholder input to the planning for the next audit cycle on topics such as materiality, scope, risks and specific accounting areas of concern.

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

Shareholders are best placed to respond to this question.

Culture

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

The assessment of culture through an extended assurance service already exists. For example, EY helps companies to measure their culture (e.g., identifying misalignments between corporate values and personal behaviours, and the associated risks to the long-term success of a business). If mandatory reporting on culture is to be introduced, it should first be determined whether attestation would be performed by reference to a company's reported self-assessment of culture, or whether it would be the auditor performing the culture assessment and presenting a report on the findings. Thought should also be given as to whether the reporting should be part of a statutory audit or become an extended assurance service.

For an auditor to be able to report on the culture of an entity in a meaningful way that would be comparable across companies, it would be necessary to develop a framework and methodology that would drive consistency in the way culture is assessed and reported on (e.g., reporting actual and target indicators of key cultural dimensions such as inclusion and wellbeing, ethics and integrity, and performance and accountability). More detail in the UK Corporate Governance Code and Disclosure and Transparency Rules on the reporting of culture would also help to facilitate more/better reporting on, and attesting of, culture.

We believe that the best outcomes could be achieved by combining audit attestation of the completeness of disclosure and accuracy of culture KPIs reported on by the entity in line with a framework, and with an extended assurance service that compares the reported culture against negative culture indicators to highlight potential risks.

We have noted in our response to Question 24 that the FRC is now expecting audit firms to monitor and assess their culture to ensure there is sufficient evidence for a focus on audit quality. In addition, the FRC performed a thematic review to assess how the audit firms were performing in this regard. We see this as consistent with a similar expectation being set for companies to discuss and assess aspects of their culture they view as critical to the delivery of their business strategy.

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

The enhanced disclosures in relation to key audit matters (including the specifics of the auditors' response to these matters) has already provided more information about how an auditor has exercised appropriate scepticism. The discussion that would arise at the 'annual assurance meeting' described above might also allow the auditor to expand upon how this scepticism has been applied.

57. Should the basis of individual auditors' remuneration be made available to shareholders?

The basis of an individual audit partner's remuneration (as opposed to the amount) could be made available to shareholders if this would help restore confidence and trust in the profession. This could include the specifics of how audit quality influences the remuneration of audit partners.

Cost

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

We consider it more appropriate for companies, shareholders and other users of the audit to respond to this question. However, there is increasing pressure on the cost base of the audit industry which will need ultimately to be shared with the market in order to maintain and enhance audit quality (see Question 60).

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

There is already a requirement for fees paid to the auditor to be disclosed and analysed by various categories of service. If more information is desired on the actual statutory audit fee this can be provided, but it would be helpful to understand from investors what further detail they would value.

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

There has been a significant increase in audit innovation since mandatory tendering was introduced, but the associated costs are being absorbed by the profession rather than being recovered in higher audit fees. Further costs will be incurred if audit firms are operationally split.

The following factors have driven increases in the cost of an audit: tendering, audit switching, compliance, investment in technology, the increasing complexity of the business models of companies being audited and the consequential impact on the range of specialist skills and experience required, in addition to training costs associated with these factors. See our response to Question 50 for our view on the in-built cyclical protection in multi-disciplinary firms – audit fees would have to be increased further in the absence of this natural protection.

It is also critical to the audit profession and the corporate reporting eco-system that the profession remains attractive to talented young professionals. However, there is a threat from changes in the aspirations of some "millennials" e.g., concerns about the reputational issues associated with big business. This needs to be taken into consideration when firms are seeking to recruit and retain the best talent to help sustain audit quality. The recent heightened regulatory environment has increased the market demand for qualified accountants. In addition, market demand is also increasing for this talent in non-audit roles in both the profession and industry.

One of the current pressures on audit costs is that (from a company perspective) they form part of the costs of finance and assurance that a CFO is responsible for and are therefore subject to the same cost reduction pressures. Whilst this would not be permissible under current accounting standards, it might be preferable for audit costs to be moved out of this budget by removing the cost from the income statement. The audit cost could be designated as an equity item, or charged against dividend payments, since the audit is conducted on their behalf.

One of the fundamental responsibilities of the audit committee (as set out in Provision 25 of the 2018 UK Corporate Governance Code) is to review the effectiveness of the external audit process which should include consideration of whether audit remuneration is sufficient to ensure a high-quality audit[10]. Our experience is mixed in terms of the extent to which audit committees have intervened in the discussion of the audit fee between the external auditor and management, and we believe this responsibility of the committee should be an area subject to regulatory inspection by the new regulator which will replace the FRC.

[10] "IOSCO Report on Good Practices for Audit Committees in Supporting Audit Quality", The International Organisation for Securities Commissions, January 2019