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Dear Sir/Madam

Independent Review into the Quality and Effectiveness of Audits – Call for Views

1 Introduction

I am pleased to make a partial response to the Brydon review Call for Views. I am not responding to all 60 questions in the Call for Views but focusing on the question of what behavioural changes might improve audit outcomes.
I am also a signatory to another Response from Natasha Landell- Mills and other Investors. I did not get the views in this Response finalised in time for it to be considered for inclusion in that other Response.

This Response reflects my views on how some behavioural changes by shareholders, audit committees, auditors and the regulator could have an immediate effect upon audit quality by reducing the number of "audit scandals". For me, the number of "audit scandals" is the best measure of audit quality. Without such "scandals", the public outcry about audit quality would diminish noticeably, if not disappear entirely. An audit failure or scandal can occur only after a management or governance failure at the company being audited. An audit failure is a failure to spot or report on such a management or governance failure. At the heart of my recommendations for all parties to an audit to focus on market signals of incipient company failure, is that it would increase the likelihood of avoiding not just an audit failure but limiting the scale of the company failure too. Directors and auditors would soon

realise how exposed they might be if they are trying to explain "why the market has got it wrong" and prefer to get the company into talks with lenders and/or major shareholders about how to deal with the issues that the market signals are highlighting.
Equally importantly, shareholders, audit committees, auditors and the regulator could act upon my suggestions now without waiting for changes in legislation or further developments arising from the Kingman, BEIS Select Committee, CMA or Brydon reviews.

Also at the heart of my thinking here is that unless we can achieve changes in behaviour from many of the participants in the financial reporting process (shareholders, directors, auditors, regulators) we are unlikely to see a step change in audit quality. To this end, I urge the Brydon Review to analyse all of its proposed recommendations for what behavioural changes (and by whom) each recommendation is expected to produce. For example, some of the CMA recommendations would, if implemented, add cost and complexity which may or may not change audit quality. Changing behaviours are more likely to change outcomes than changes in structures.

2 Other Enquiries

The week before Easter saw the publication of both the BEIS Select Committee's Future of Audit inquiry's Final Report and the CMA's Final Report from its Review of the UK statutory audit market. These valuable reports must be considered alongside or seen as complementary to Sir John Kingman's Independent Review of the FRC in December 2018 and Sir Donald Brydon's review of the quality and effectiveness of audit, also launched just before Easter.

This activity reflects a valid response to the number of perceived audit failures preceding high profile company collapses (Carillion, BHS, Patisserie Valerie and many more)
Pleasingly, the CMA Report's recommendations include some relating to audit committees as well as those for changes to the structure of audit firms and audit appointments. This is an acknowledgment of an oft ignored truth that before every "audit failure" there has been a management or governance failure in the company being audited. It is my contention that more focus on companies and audit committees could do more to improve the quality and effectiveness of audits and the number of "scandals" than any amount of institutional reform. We need to see different behaviours from audit

committees, auditors and indeed investors, if we want to see different outcomes. And there is one area of focus that could achieve just the sort of change required.

3 Market signals always precede company collapses

There are **always** warning signs in the market ahead of any listed company collapse that then becomes an accounting/auditing "scandal".
These are usually in the form of a share price collapse and/or large amounts of short selling and/or sustained negative blogs or analyst reports or blogs which are effectively saying to the company "we don't believe you". These (almost) never get discussed in company annual reports (e.g. in the audit committee report) or auditors' reports. I question if they ever get properly discussed at Board or audit committee meetings (beyond being dismissed by the executives as "not understanding us")? Certainly, that is my experience as a turnaround CFO and NED.

4 Recommended solution to change behaviours and improve Audit Quality

Requiring such market risk signals to be addressed in company and auditor reports would create behavioural changes that should have a very significant positive effect on audit quality. Having to treat the share price collapse (or short selling or negative analyst reports/blogs) as a market signal of doubts as to the future sustainability of the business model would benefit audit quality in the following ways:

- shareholders would know that the issues had been addressed (at present we don't' even get to know that the Audit committee or auditors are even aware of these matters);
- audit committees and boards (and auditors) would know that their explanations of why the market risk signals were misplaced or based on incorrect understandings would be subject to scrutiny should anything subsequently go wrong;
- shareholders could easily engage by asking companies and auditors to address the specific short selling/share price collapses or analyst blogs that they (the shareholders) are aware of;
- in many cases, the proper examination (as opposed to curt dismissal) of these risk signals would lead to earlier engagement with the underlying risk factors in the company that are being signaled and therefore to discussions with shareholders and lenders early enough to make changes that could avoid the Armageddon scenarios seen at Carillion,

Patisserie Valerie et al. This is probably the biggest benefit of all. The market warning signs would stop being ignored or swept under the carpet until it was too late;

- where short selling could be shown to have been unjustified, the company's explaining of this would also be beneficial to the market.

And all this could begin tomorrow, without any requirement for legislation or regulatory change. Shareholders could start asking for it. Auditors could demand it be done as part of their audits. Audit Committee Chairs could start worrying about their reputations now if they don't address such market risk signals. And the soon to be reformed Regulator (FRC) could signal that it will be beginning its enquiries into collapses by asking companies and auditors why such signals had apparently been ignored and asking major shareholders what they had done to ask the company to address those signals.

It is also clear that there is sufficient AI type of software now available to Boards and auditors to ensure that they become aware of all sorts of contrary market signals that might exist. There is no excuse for not knowing what others are saying about the company. My Response here is to argue that there is no excuse for audit committees and auditors who fail to focus on such signals and adequately explain their response to those signals.

I suggest that such behavioural changes would do more to improve audit quality than any amount of tinkering with the structure of the audit firms or mandating joint audits – especially so when reinforced by the coming regulatory heat that audit committees will begin to feel from the reformed Regulator.

Eric Tracey
9 June 2019