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For the attention of the Brydon Review Secretariat

7 June 2019

Dear Sir Donald

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT – CALL FOR EVIDENCE

I am writing to set out Deloitte LLP's response to your consultation on the quality and effectiveness of audit.

This is a critical time for the audit profession in the UK and we welcome the current debate. You have adopted an open, enquiring stance to ask fundamental questions about audit, to deconstruct current perceptions and to identify the real needs of users. Taken together with the findings of the Competition and Market Authority's statutory audit services market study and Sir John Kingman's independent review of the Financial Reporting Council, your review will help to ensure that audit meets the ongoing requirements of stakeholders and is fit for the future. It will define the audit environment in the UK for decades to come and profoundly influence the positions taken by regulators and legislators around the world.

We support far-reaching discussions about what a broad range of stakeholders need from audit and the wider financial reporting and corporate governance ecosystem. We are keen to contribute to the debate constructively.

We believe that in carrying out the review the current confines of an audit and contents of the annual report should be set aside. If the review just seeks to refine and adapt the status quo it may not fully address the most important issues. This requires involvement in the debate from the widest range of users of corporate information to understand what truly matters and how the audit product should adapt to the changing business landscape and changing needs.

We highlight below a number of themes that we believe are critical.

1. Define the role of audit within the wider financial reporting and corporate governance ecosystem

Audit does not exist in isolation, but rather provides a link between companies that prepare financial reports and other metrics and the users who rely on them. In defining the role of audit, therefore, it is critical to also define the responsibilities of preparers and the needs of users. We welcome the questions that explore this dynamic in more detail and note that:

- Audit serves a range of users including, but not limited to, existing shareholders in companies. Expectations and needs vary depending on the type of user, and are likely to develop to cover matters that go beyond financial results.

- A clear framework is required that sets out the responsibilities of companies' managers and directors, and potentially requires them to assess and opine on how they have fulfilled these responsibilities (including an assessment of the internal controls environment for large public interest entities, as proposed in Sir John Kingman's review). Such a framework would also provide robust direction to the audit.

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- Changes should be adopted on a proportionate basis, as the degree of public interest and complexity can vary significantly for different types of entity.

- Many investors rarely read financial statements or use them in their decision-making, yet the volume of reporting increases.

Within this context, the profession needs to define more clearly the role of audit in the future.

2. *Address the expectation gap and promote the evolution of the audit product*

In the past the audit profession has been too complacent in blaming concerns with audit on the expectation gap (i.e. the difference between what auditors do and what users of financial statements and the broader public think they do or should do). We acknowledge that there have been deficiencies in audits that should not have occurred, and we work diligently to address any shortcomings. There are also areas, driven by the evolution of the business environment and changes in stakeholder expectations, where we believe there is a need to enhance and/or expand the scope of the audit product:

- In particular, the assessment of viability, risks, business strategy and clarification on fraud detection and reporting, are fundamental requirements that apply to the broadest set of users. Auditors should have clear responsibilities for providing assurance on companies' reports of these requirements.

- The financial reporting ecosystem should evolve to provide a holistic and forward-looking view of the health and resilience of companies. Users' demands for assurance over a broader set of measures, such as social responsibility, carbon usage and anti-money laundering will increase. Standards setters need to align with changing expectations and requirements, and the level of assurance in extended areas should be tailored to specific user needs – there is unlikely to be a "one size fits all" product.

3. *Improve clarity and transparency in the audit process and outputs*

In recent years, the length of companies' reports and accounts have grown and accounting standards have become ever more complex. Companies and their auditors should do more to ensure that the information they convey in their public reporting is clear, succinct and intelligible to a wide range of stakeholders. There should be greater transparency with regard to the challenge and rigour that the audit process has brought to key judgements – some progress has been made with extended audit reports, but more is required.

Further thinking on these issues and a wide range of other factors that will influence the future of audit are covered in our answers to your sixty consultation questions, set out in the attached appendix.

As you consider changes, it is important to consider the UK environment in an international context. We hope that reforms will be designed in such a way as to retain the overall competitiveness of the economy and capital markets. It is also important to acknowledge that the 'comply or explain' corporate governance model has served the UK well, though we recognise it may need to evolve.

I would welcome the opportunity to discuss any of our thinking further with you, if you feel it would be helpful.

Yours sincerely

Stephen Griggs
Deputy UK CEO
Managing Partner Audit & Assurance and Public Policy

Independent Review into the Quality and Effectiveness of Audit - Deloitte's response to the Call for Views: Appendix

CHAPTER 1 – DEFINITIONS OF AUDIT AND ITS USERS

Q1: For whose benefit should audit be conducted? How is it of value to users?

1.1 Audit originated to address the principal-agent issue, primarily to give independent assurance to shareholders over management's reports about a company's performance. However, the stakeholders of an audit are broader than just investors of individual companies and include employees, pension fund holders and the broader society on which the company's behaviour has an impact. At the highest level, an audit provides an objective snapshot of certain aspects of a company's health and helps to engender trust in the company and the market in which it operates. It leads to a lower cost of capital, creates a more stable market environment and promotes better understanding around business performance.

1.2 Audits should therefore be conducted to serve multiple types of users, each of which may have differing requirements over the level of trust and the specific measures (including non-financial measures) on which they seek assurance.

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

2.1 The audit product should go beyond an opinion on the financial statements. Increasingly, a company's performance and health are seen in broader terms than are disclosed in the financial statements. Where this information has a significant impact on the confidence of stakeholders, there may be a need for an audit opinion on management's reporting of it. Requirements are likely to evolve over time (for example, a company's corporate responsibility performance may be perceived to be much more important now than it was twenty years ago) and vary by industry, so requirements for audit should remain flexible.

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?

3.1 There is no doubt that a better understanding of what an audit is and is not would be helpful, though the challenge is around outreach and stakeholder communication, rather than requiring a change to the law. We would welcome a clear framework that guides directors on their responsibilities and links to the needs of the users of audits.

3.2 At least as important, though, is the need for greater transparency of preparers' reports.

3.3. In addition, companies and their auditors should do more to ensure that the information they convey in their public reporting is clear, succinct and intelligible. Transparency around the challenge and rigour that the audit process has brought to key judgements has improved in recent years, but could and should be developed further.

CHAPTER 2 – THE "EXPECTATION GAP"

Q4: Do respondents consider there is an expectation gap?

4.1 Yes. Paragraph 24 of the Call for Views acknowledges that expectations of audit are not matched by the corresponding statutory and regulatory framework that define what an audit is.

4.2 In particular, there is a gap around the extent to which external stakeholders believe that the audit provides assurance over the assessment of viability, business strategy and risks, operational key performance indicators (KPIs), as well as over fraud and controls reporting.

4.3 We believe there is also a general misconception that an audit provides absolute assurance, whereas in reality it only provides reasonable assurance on those areas covered by auditing standards.

Q5: If so, how would respondents characterise that gap?

5.1 The description in paragraph 24 of the Call for Views covers key elements in the difference between the expectations of audit and the corresponding statutory and regulatory framework.

5.2 In addition, we emphasise the following characteristics of an audit that are often misunderstood:

- An audit is an informed opinion based on historic performance. It is not a guarantee, and nor does it provide certainty over future performance.
- It assesses the extent to which accounting standards have been followed by the company, using a defined set of auditing standards. To the extent that these standards do not match the expectations of wider stakeholders, it is reasonable to say that the framework of accounting and auditing standards needs revision, but it is not fair to say that individual auditors or audit firms have performed deficiently.
- A company's directors, rather than its auditors, are ultimately responsible for the company's performance and the preparation of its accounts, including prevention and detection of fraud and the effective operation of internal controls.

Users assume that some or all of the narrative accompanying the financial statements has been subjected to the same level of challenge as the financial statements. The auditor's duties under current law and standards are significantly narrower.

5.3 We believe these characteristics go some way to explain the "audit quality gap" described in paragraph 25 of the Call for Views.

Q6. 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?

6.1 The perception of audit quality is hampered by misunderstandings of what an audit is and what stakeholders think it should be. We do recognise, though, that audit quality is not always as high as it should be. The profession – including Deloitte – needs to address poor quality as a matter of the highest priority.

6.2 The "quality gap" needs to be seen in perspective. As measured by the FRC audit quality assessment teams, for example, audit quality is actually higher than it was a decade ago. At Deloitte, we take quality very seriously. We have a programme of continuous improvement and make very significant investments in audit quality.

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

Q7: What should be the role of audit within wider assurance?

7.1 The concept of the single audit product needs to evolve into a broader audit and assurance landscape with multiple products and providers, giving a holistic view of a company's health ("Modular Assurance") and addressing different stakeholder needs. Audit has an integral place within this wider ecosystem, which should provide users with assurance over many aspects of a company's health including, but not limited to, matters disclosed in the financial statements, business model resilience, risk management, fraud, ethics and culture, and environmental impact. Some of these health indicators will naturally sit within the extended scope of an audit, underpinning the financial statements opinion and driving auditor risk assessment.

7.2 Deeper and broader assurance may be required in certain circumstances, driven by stakeholder needs, the nature of the business, and where it is in the public interest to do so. This assurance may be provided by a variety of specialists and should promote increased competition and new entrants to the market.

7.3 The audit and assurance ecosystem should provide a consistent framework and improved transparency to help all stakeholders understand the level of assurance obtained by an entity on key areas of its health, and to enable a stakeholder-led model around assurance needs.

Q8: 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?

8.1. Yes, we believe it can and the variability of assurance should be considered both in terms of nature and level of assurance.

8.2 Different business sectors have their own key data which is critical for different stakeholder groups – for example like-for-like growth in retail, order book in construction, reserves in energy companies or risk-weighted assets in the financial services industry. There is a legitimate demand for different reporting and assurance across business sectors to serve different stakeholder needs.

8.3 In this broader assurance landscape, each assurance area could be tailored to the industry or business landscape and associated risks, and driven by the assurance needs of a particular stakeholder group. However, clarity on the scope of work within a defined framework and consistent reporting of findings are critical to this modular approach.

8.4 Increased transparency of the levels of assurance that a company has over key data (internal audit, external AUP, external audit or assurance) overlaid with information on the nature of the entity's business risks should drive legitimate variation in stakeholder demand for more independent or deeper assurance.

Q9. Are the existing boundaries between internal and external audit clear?

9.1 Yes, to companies, regulators and internal and external auditors, but sometimes not to other stakeholders.

9.2 Internal audit ("IA") is a tool for management and those charged with governance to gain comfort around risks. When IA first emerged it was largely around financial transaction risk – e.g. segregation of duties in invoice approval; overtime authorisation in payroll; bank reconciliations in treasury. Over time, it has evolved to be a more business risk focussed response as part of the lines of defence a company establishes to manage risk. In some cases IA spends little time looking at lower risk financial transactions and more time on other areas e.g. compliance in financial services; product diligence in fast moving consumer goods. The board sets the risk appetite of the company and deploys IA as part of their response to monitor the way in which risks are being managed. In some cases IA also has an advisory role – as to how risk management works and could be improved – rather than being a pure assurance role.

9.3 External audit differs as it is independent (it exists to report to the shareholders); focuses on the assertion that the financial statements are true and fair; and looks at business risks to the extent that they impact on financial reporting, rather than starting with the broader risk universe. The same would be true of other external assurance with regards to other subject matters e.g. sustainability assurance on a sustainability report would focus on business risks to the extent that they impact on sustainability, rather than all risks, many of which may not impact sustainability.

9.4 Other stakeholders (i.e. those outside the audited entity other than the external auditors and some regulators) often do not understand what internal audit actually is and what it does and does not do. Typically, corporate governance and audit committee reports contain a broad statement of the existence (or otherwise) of internal audit. Fewer companies provide details of how internal audit is staffed, qualified, or of the areas looked at in the year; this is by contrast to external audit where there is a reasonably lengthy explanation within the audit report of what it is and does and, for public interest entities, a detailed discussion of the key audit matters considered. We believe that understanding would be improved by asking audit committees to include a summary of what internal audit is asked to do and which areas it has focussed on.

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

10.1 We believe that the existing auditing and ethical standards strike the right balance. External auditors can rely on the work of IA where they believe the IA function is suitably skilled, resourced, objective, and their work (commissioned by management) covers areas in which external audit are interested – primarily in relation to risks around the capture of financial transactions. External auditors wishing to place reliance on IA's findings must obtain evidence as to these factors, review portions of IA's work and, on a risk-based approach, may re-perform a sample. This is appropriate – in the same way that auditors can rely on controls performed by management once they are satisfied that those controls are designed appropriately and operate effectively; IA is (at its simplest) a monitoring control established by management.

10.2 Even where no reliance is placed on any of the work performed by IA, their work is considered to help inform the external auditor's risk assessment.

10.3 We are aware of some calls for increased reliance, which are normally justified on cost grounds (both the cost of actual external audit hours, and the time of management in dealing with differing but overlapping demands of two sets of auditors). Indeed, international standards, and those of the PCAOB, permit direct assistance whereby the external auditor can instruct internal auditors directly and rely on their work. However, this was banned by the FRC in recent years, and the ban was strongly supported by investors and external auditors alike. This is because the objectivity of IA is less than that of external audit (even if only on grounds of perception – as ultimately IA are accountable to management and those charged with governance, rather than directly to the shareholders), and IA personnel are not as independent (e.g. they may well be allowed to own shares in an organisation, and are of course paid by it). For that reason, full unfettered reliance of IA by the external auditor is not appropriate.

Q11. 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?

11.1 No, we do not believe this to be the case. It is clear from the views of investors to repeated consultations by the FRC and others that they value an independent, objective view from the auditor, and would not wish to see that compromised.

11.2 The current control requirements require that the majority of the board of an audit firm hold an audit qualification and are members of a UK accountancy body, and likewise that the majority of the voting rights are held by such people. This means that both the board and the firm itself are controlled by people who are required both to understand audit quality and independence, and to commit to following the FRC's Ethical Standard, the relevant professional body's code of ethics and the rules of that body. The rules of the professional bodies typically also require non-members who are owners and/or board members to become 'audit affiliates' and commit to following the relevant bye-laws and ethical requirements and be subject to disciplinary sanctions if they do not. The effect of this is that decisions cannot be taken that would harm audit quality or independence and objectivity.

11.3 The current audit firm control model is also designed to avoid conflicts of interest between those who provide capital to the audit firm and the entities audited by that firm. With a relaxation of the rules, there could be perceived conflicts where a provider of capital to an audit firm also owns all or some of an audit client. A model which involves raising funds through debt or equity that is tradeable on a market makes it significantly harder to prove the lack of conflict as the audit firm would find it hard to know who its shareholders and lenders were at any one time (a shift during the conduct of an audit could result in a perceived conflict of interest whereby a shareholder turns out to own, say, 5% of an audited entity and 5% of its external auditor or other assurance provider).

11.4 It is also worth noting that the FRC did explore this in respect of smaller listed and quoted companies – whether the quality benefits of increased auditor advice and support would outweigh the actual or perceived threats to quality of reporting from the lower degree of independence. Generally this argument was only advanced by preparers, and not by audit firms or users of annual reports.

CHAPTER 4 – THE SCOPE AND PURPOSE OF AN AUDIT

Q12: 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?

12.1 We believe improvements are required to the overall financial reporting ecosystem. In our view those improvements should start with the directors' responsibilities for risk management and internal control. A requirement of premium listing is to have a Financial Position and Prospects Procedures ("FPPP") report which supports statements the directors make in the prospectus about having suitable controls in place. There is currently no requirement for that process to be repeated on an on-going basis.

12.2 In our submission to the CMA we stated that we would welcome a form of proportionate UK Sarbanes Oxley style requirements to enhance the overall financial reporting ecosystem, thus increasing audit quality. In line with this recommendation, we would expect the directors to make an explicit statement in respect of risk management and internal controls on an annual basis. This should follow-on for listed companies from the initial requirement for an FPPP report at listing and ensure adequate controls are maintained throughout the business lifecycle.

12.3 Given the significance of any such statement by the directors, it should be subject to audit. As there is a risk of diverging practice in the auditor providing assurance over such a statement under the current auditing standards, we consider that a clear framework should be established to ensure quality and consistency in approach. There should equally be suitable regulatory sanctions established to penalise directors for making false/misleading statements, as there are in the US currently.

12.4 Such a statement should be carefully defined, as to its scope and the period to which it relates. It could be based on an 'as of' date like Sarbanes Oxley, or might refer to the entire period under review. Covering the entire period under review is likely to give more insight into the controls culture at an organisation as the current 'as of' approach allows companies to remediate deficiencies each year and always achieve a 'clean' opinion.

12.5 We recommend that in developing the assurance framework to accompany such a statement, thought should be given to the potential benefit to users of graduated findings. Whilst a control can 'pass' or 'fail', there is clearly a wide range of permissible quality and the current factual statement made by directors and auditors under Sarbanes Oxley does not differentiate between a 'good control environment' and a 'marginal control environment'. With reference to a suitable peer group the findings might call out the relative quality of the control environment (i.e. market leading, good, satisfactory, poor, very poor). We would support graduated findings in this area.

12.6 This will help foster an environment in which poorly controlled companies are called out amongst their peers and those that do not appropriately respond may struggle not only to obtain investment but to identify an auditor willing to perform the work.

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

13.1 As outlined in our response to Question 12, we would be supportive of increased responsibilities for both directors and the auditor in this area. We believe this will help improve the overall financial reporting ecosystem and thus audit quality.

13.2 If directors are required to provide a statement in respect of their internal controls then there will need to be an appropriate framework under which they can make that statement (like the US COSO framework for Sarbanes Oxley). This would necessitate specific standards for auditors to follow to audit and report on an entity's system of internal control with reference to such framework.

13.3 Absent any change to the directors' responsibilities to report publicly on internal controls, we would be supportive of increased guidance for auditors with regards their responsibilities for assessing the effectiveness of an entity's system of internal control.

13.4 In particular, as outlined in our response below to Question 14, we would support increased disclosure requirements in this area in enhanced audit reports.

Q14: 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?

14.1 We believe that auditors should be required to report publicly their views on the general internal controls environment. We have already suggested enhanced reporting in this area for audit teams that goes beyond the requirements of ISA (UK) 701.

14.2 We consider that since the introduction of enhanced audit reports disclosures on Key Audit Matters and significant judgements, this has improved significantly. We believe the same would happen over time for internal controls, if the auditor was required to publicly report its views. This would likely be a more gradual way to improve the financial reporting ecosystem over time, compared to a requirement for directors' to more explicitly report on risk management and internal controls.

14.3 For December 2019 year ends onwards, we expect Deloitte audit teams to describe how our controls strategy was incorporated into our audit. This discussion is designed to be broad; whereas we may mention controls directly relating to key audit matters, the focus should be on presenting information not already discussed in the key audit matters section of our report.

14.4 We plan for teams to include specific details in our enhanced audit reports regarding:

- the components, IT systems and account balances where controls were relied upon;
- areas where we sought to rely on controls but were unable to, including mitigating work performed; and
- reasons where we did not plan to rely on controls.

14.5 We would welcome enhancements to the ISAs (UK) to mandate this sort of reporting.

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

15.1 We think it could be improved. There are three questions to consider here, which we set out below.

15.2 Firstly, is the current corporate reporting framework operating as designed, with the vast majority of audited entities and audit firms applying the law and accounting standards appropriately? This is the framework which requires the going concern basis to be adopted unless an entity's management (a) intends to cease trading or enter liquidation within twelve months or (b) have no realistic alternative to cease trading or enter liquidation within twelve months, requiring disclosure of any material uncertainties which give rise to significant doubt as to the entity's ability to continue as a going concern.

15.3 We believe that the current framework is operating as designed, although there are examples where a material uncertainty was not disclosed that should, based on the evidence available at the time, have been. This is a failure by management and those charged with governance – and is unlikely to be improved by moving the bar. Whilst there have been some high profile failures, these are comparatively rare.

15.4 Secondly, is the current audit framework operating as designed, with the vast majority of audit reports correctly calling out if there is a material uncertainty (or qualifying if there is an uncertainty which directors refuse to disclose)? Again, we believe this to be the case – with again, a few high profile failures.

15.5 In our recent response to the FRC on its implementation of the 2016 Audit Reforms we argued that whilst the test in both accounting and auditing standards – that the audited entity is solvent now and likely to be for twelve months, with any material uncertainties to be disclosed – is the right one, there is a big challenge in that directors are not legally obliged to have controls over the inputs to the forecasts, and the forecasting process itself, that they use. Auditors, as a result, whilst forming their own view, often find themselves "auditing in quality" into management's own assessment process. We think that, for at least the more significant audited entities, directors should be required to put such controls in place to support their assessment, and then auditors be required to test those controls, calling out any failures.

15.6 The harder, third question, is whether this going concern test meets the interests of stakeholders, even if it were operated perfectly. Inevitably, the use of hindsight is an issue – it is often argued that because entities become insolvent with a clean audit report and no disclosure of an uncertainty, the regime has failed. Whilst this may sometimes be the case, it will not always be so – events may have occurred that could not reasonably have been foreseen at all, or were only foreseen as remote, by management, those charged with governance or the auditors.

15.7 We suggest that some improvements could be made to the current reporting model, which could then be subjected to audit by the auditor:

15.7.1 One enhancement to the required disclosures could be a disclosure by the directors of their historical forecasting accuracy. This would drive them to improve the forecasting process and inform users as to how reliable management's estimates might be.

15.7.2 Another would be to require disclosure of going concern risks prior to mitigation, and then the mitigation put in place by management and those charged with governance. By disclosing these sorts of risks pre-mitigation, users of financial statements could be more informed about the quality of directors' judgements and the risks. This would require a change of attitude by everyone in the financial reporting supply chain – preparers would need to be willing to disclose these matters, auditors would then be able to qualify if they were not disclosed, and users would need to take mature decisions based on the information.

15.7.3 In addition, management could be required to implement controls over assessment of the adoption of the going concern basis of accounting and the existence or otherwise of material uncertainties, and the auditor could report on the effectiveness of these controls. This may give some comfort that, provided the directors continue to operate the controls as designed, future shocks and uncertainties would be identified and disclosed.

15.8 Finally, we note that a deeper level of comfort is delivered when a working capital statement is included in a prospectus or class 1 circular which is normally subject to scrutiny by reporting accountants. The phrasing of the test differs slightly between the Listing Rules for an IPO, a class 1 transaction and in the AIM Rules, but each implies a similar level of comfort. To explore this, we consider the test in the Prospectus Directive Regulation which requires a "Statement by the issuer that, in its opinion, the working capital is sufficient for the issuer's present requirements or, if not, how it proposes to provide the additional working capital needed".

15.9 The practical effects of this are explored in Recommendations issued by the European Securities and Markets Authority[1]. For example:

15.9.1 ESMA do not allow there to be any assumptions, sensitivities, risk factors or caveats. Paragraph 121 of the ESMA Recommendations is clear that the statement cannot be unqualified if there is a need for any refinancing, negotiation of or new credit terms/facilities, decrease in discretionary capital expenditure, revised strategy or acquisition program or asset sales.

15.9.2 The test in a working capital statement requires that bank facilities be committed for at least twelve months from the date of the statement. Requiring this standard for going concern would require many companies to put in place funding for a longer period (for example, renewing overdraft facilities for eighteen months rather than twelve), which will have an economic cost as banks will charge more.

15.9.3 Likewise, if even a modest cost-cutting exercise or asset sale is required, this would lead to a qualification. Investors currently would expect this not to be disclosed as a material going concern uncertainty as long as it was only a remote prospect that these plans would fail. In the working capital statement model, the entity would either need to have already secured facilities to cover the shortfall that even a remote prospect of failure came to pass, or else accept a qualification.

15.10 The effect of such a test, which would either increase the number of going concern uncertainties disclosed, or require significant new financing, would necessarily cost more. It would be for investors to decide if these costs outweigh the risks that they would address.

Q16: 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"?

16.1 We believe the existing framework requires sufficient detail of such matters where they are materiality uncertainties that give rise to such doubts.

16.2 The broader question is whether such events or conditions should be disclosed when they are not material because there is a mitigating action in place. We explore this in paragraph 15.6 above.

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

17.1 Yes, a new statement would be a useful thing, clarifying the directors' views on the future of the entity's business model and associated risks over the longer term.

17.2 Neither the UK Corporate Governance Code nor the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting indicate that the viability statement is about the sustainability of the entity's business model. They do link the viability statement to the current position and the principal risks, and principal risks are defined as those which might threaten the company's business model, future performance, solvency or liquidity and

[1] See paragraphs 107-126 of the *ESMA update of the CESR recommendations: The consistent implementation of Commission Regulation (EC) No 809/2004 implementing the Prospectus Directive* available at https://www.esma.europa.eu/sites/default/files/library/2015/11/11_81.pdf

reputation. To support this, para 4 of Appendix B states the following: "The statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios".

17.3 The main criticisms of the current viability statement largely relate to whether the company's future prospects can be reasonably assessed beyond the 3-5 year period most companies have selected for the viability statement outlook period – for example by considering longer term risks to the business model such as climate risk.

17.4 A minority of companies comment on the sustainability of the entity's business model in the viability statement. A more usual approach is to see it as about availability of financing in the mid-term. Some companies do split this out – a statement of 3-5 years based on the entity's medium-term financial strategy and related forecasts, coupled with an outlook statement of longer term sustainability of the business model – for example, so as to consider risks whose financial effect may be further out but which need to be taken into account now, such as climate change.

17.5 Ultimately, we believe that there should be a statement based on funding over the medium-term, and then a statement that the board believes that the company's strategy and business model supports the development of sustainable value over the long term. This statement should include sufficient detail to explain why this is the case, which could involve aspects such as vision for the market in the longer term, its approach to current principal and emerging risks and its sustainability (e.g. ability for a company to be agile and innovative). The assessment should consider a wide range of macro risks in addition to financial and operational matters, including commercial factors, technology and environmental factors. This statement would make a more explicit connection between the principal risk disclosures and viability, with more challenge to risk disclosures which do not adequately address the sustainability of the business model. This linkage would lead to a really compelling discussion of the prospects and viability of the business.

17.6 It might also be beneficial for users if preparers were required to discuss alternative business models considered and rejected in favour of the applied business model. This might better inform users on the risk appetite of the directors. There might then be less perceived 'shock and radical change' when new executives join and alter the strategy.

17.7 Such a statement would be subject to the existing safe harbour for directors, recognising that as anyone looks further into the future, they lose degrees of certainty – for example, in its existing Guidance, the FRC states that "*Reasonable expectation does not mean certainty. It does mean that the assessment can be justified. The longer the period considered, the more the degree of certainty can be expected to reduce.*" What is important is that the directors make such statements, whether covering the short term (going concern), medium term (viability) and long term (sustainability) that they do so having taken reasonable steps. In that context it might be beneficial to users if the directors were required to outline the steps they have taken in making these statements.

Q18: Should such a statement be subject to assurance?

18.1 We support the provision of enhanced assurance over viability, risk and strategy disclosures.

18.2 Ultimately it is not practical to expect an auditor to provide assurance on, or otherwise "underwrite", the future sustainability of the business model itself. However, with careful scoping an auditor could provide a level of assurance regarding the directors' due diligence / controls / forecasts over making the statement. The auditor would need a form of 'safe harbour' akin to that of the directors – recognising again that even if their work is done to a high standard, there can be no certainty that they will identify all failures of management, nor that they will be guaranteeing the long-term viability of the business.

Q19: Who might be capable of giving such assurance?

19.1 To give meaningful, carefully scoped, assurance in this area, the assurance provider needs a detailed understanding of the financial reporting practices of the entity and its future prospects, together with processes to prepare forecasts.

19.2 At the moment, the auditor is ideally placed to provide such assurance as it already has this knowledge – maybe not to the same depth as management, but deeper than any other external party, and there are many natural crossovers with the knowledge and expertise needed to audit the financial statements. The auditor may need to call on specialists (whether within their firm or not) to assist, but the core disciplines of looking at controls over financial forecasts are traditional audit skills.

19.3 Such a service could be provided by another service provider, including another audit firm, but the time (and therefore cost) required to provide that assurance would likely be significantly higher than if the auditor was used, reflecting the breadth of the areas which would need to be looked at, including understanding of risks, testing of controls and processes and the reliability of external data sources.

Q20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?

20.1 Yes, there is a strong case for a more forward-looking audit that provides an assessment of the forward looking judgements that the company has within its business model. We believe that this expansion of audit scope is required to meet the evolving needs of stakeholders and the business landscape. There are a number of benefits and risks associated with this:

20.2 Benefits:

20.2.1 Forward-looking judgements underpin many management estimates and disclosures and provide the foundation for many aspects of business resilience. By extending the scope of an audit to include more forward-looking assessments, there will be increased challenge to these judgements and estimates as reported by the entity. Independent challenge should in turn lead to greater transparency around key judgements, better disclosure around sensitivities underpinning judgments and give the user of the accounts a greater level of understanding around the variability of future outcomes.

20.2.2 The past is not necessarily an indicator of future performance. The audit has to become more forward-looking to remain relevant in helping stakeholders make informed decisions.

20.3 Risks:

20.3.1 Ultimately, the risk is that the expectation gap is amplified.

20.3.2 There is a significant risk that a more forward-looking audit would be seen as underwriting the future performance of the entity. As such there would be a higher risk that the audit is seen as a guarantee for stakeholders in circumstances where the auditor is unable to determine any future unexpected actions by the entity. This could act as a barrier to market entry and stifle competition, unless there is absolute clarity in law and public perception about what those enhanced responsibilities entail.

20.3.3 The ability to make accurate predictions diminishes the further out into the future one goes. Board changes over time impact key strategic decisions, and technological trends are fast paced and can have significant impact on the competitive landscape. However, enhanced disclosures around risks and opportunities against a longer time horizon will allow users to understand the inherent uncertainties and make their own informed decisions.

Q21: 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?

21.1 Given the relatively limited assurance currently provided by an auditor's report on information in the front-half of an annual report, specific audit or assurance over that information would enhance its usefulness to users of the financial statements. This is particularly important as some of the information in the front half is regarded by stakeholders as the most relevant and useful information.

21.2 Whether such assurance would be sufficient and/or beneficial to users of the financial statements will depend on the significance of that information to users and their decision-making. This is likely to vary by groups of users, but there is likely to be some key information (such as KPIs) that applies more widely.

21.3 We can see a scenario where differing types of assurance might be provided depending on the significance of the information to users.

21.4 There is also a broader point that it might not just be enough to provide assurance over the numerical data (i.e. KPI metrics), but to provide a wider remit of assurance and independent challenge that the right metrics are being reported in the first place. This could be done through benchmarking against peers and ensuring that the metrics provided best align with the business model and the needs of users, rather than being metrics chosen by the directors to best portray performance.

21.5 We believe there is also a wider debate to be had around what other information companies currently produce that users rely on (i.e. investor day presentations, analyst meeting slides, RNS announcements, capital market presentations) that might benefit from or warrant some level of assurance. Currently, with the backwards-looking nature of an annual report, analysts take most information to build their models and issue their buy/sell notes from RNS announcements, trading statements and investor day presentations. This information is currently subject to no external assurance and there can be a long time lag between in-year statements made by the company and an annual audit opinion being issued. More continuous assurance reporting would likely be of benefit to users.

Q22. If so, what information might usefully be subject to audit or another form of assurance and why?

22.1 The range of other information presented by companies in their corporate reporting has expanded significantly in recent years, mostly driven by changes in legislation. Equally, the range of 'users' considered to have use for such information has expanded, particularly with the focus being on broader public interest.

22.2 As this review progresses we would recommend seeking input from a range of users to understand what importance they place on information and for what purpose. This might necessitate a debate around the quality versus quantity of information produced by companies and whether there is benefit in streamlining some current reporting requirements. This discussion should also challenge whether reporting historical financial information is still relevant.

22.3 Given the current landscape, we would recommend differentiating between "the fundamentals" of a company which are likely to be relevant to the widest set of users and "further information", which is likely to be relevant in serving niche demands amongst sub-sets of users.

22.4 The fundamentals should cover reporting on the quality of the internal control environment, the future viability of the business and the accuracy of its reporting financials (including associated key performance indicators). Given the significance of these factors to users (particularly highlighted by the recent corporate failures), these should be subject to audit.

22.5 The further information (e.g. carbon emissions, gender and cultural diversity, payment practices etc.) could be subject to a lower level of assurance (but at an increased level to that received today) depending on user sentiment. This might include something similar to that seen in sustainability reporting currently.

22.6 It is worth considering as part of this assessment whether there is any other information published by companies outside of its annual report on which reliance is placed and assurance would be valuable, as highlighted in our response to Question 21.

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

Q23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

23.1 Yes, we believe it should. The review's consideration should be to consider the value and quality of the product first:

- 23.1.1 What assurance, in an ideal world, would users want?
- 23.1.2 What is the right audit (or assurance) product that could realistically be achievable – considering the degree of certainty that could be achieved, cost of achieving it and benefit of doing so?
- 23.1.3 What is needed for auditors to be able to deliver that product effectively?

23.2 Once the value and quality of the product has been determined, the effectiveness of the process to achieve that value and quality should be addressed:

- 23.2.1 What does good look like?; and
- 23.2.2 How can regulation support and challenge whether auditors have met that task.

23.3 These latter two questions should be dealt with as part of the implementation of the Kingman Review by BEIS and ARGA.

Q24. 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?

24.1 No, although firms have to invest significant amounts of time and effort to mitigate the danger of this.

24.2 It is true that auditors do spend time checking that they have completed all of the steps in the audit file – checking that they have complied with standards and the law, and crucially (as this is a requirement of ISA (UK) 230 *Audit Documentation* and other subject specific ISAs (UK)) that they have documented their exercise of professional judgement and are satisfied with judgemental areas such as management estimates.

24.3 The real challenge around the areas of judgement is that showing how that judgement has been exercised is harder than writing up basic testing; and any regulatory challenge is both easier for judgement areas and there is less obvious "pass/fail".

24.4 In our response to the Kingman Inquiry, we noted that a shift of regulatory approach by the FRC or its successor may be helpful. For example, the PCAOB tends to raise fewer points, but those they do raise are more challenging and tend to focus more on the key judgments.

Q25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

25.1 We do not believe this is an "either/or" question.

25.2 We strongly believe that the binary unqualified/qualified "true and fair" opinion should be retained. Investors value a line where the auditor clearly says "this is unacceptable and we disagree" or "we just cannot get the evidence".

25.3 We also strongly believe that graduated findings should be introduced for each of the key audit matters ("KAM") discussed in the enhanced audit report. In our comment letter to the FRC, we called for observations or findings for each KAM to be mandatory – currently the standard says "where appropriate".

25.4 We believe that findings in areas which involve estimation should indicate whether that estimate is at one end, the other or in the middle of an acceptable range – an indication of prudence or otherwise, recognising that prudence can also arise from holding back profit to meet next year's target.

25.5 Guidance will be needed on how to do this in a way that achieves consistency and comparability across companies – bright lines between "aggressive/mildly aggressive/neutral/mildly prudent/very prudent" may be hard, and the impact vary depending on the materiality of the estimate. We believe a visual representation, together with an 'overall view', will be required to balance the focus between individual KAMs and how the overall audit conclusion was drawn.

25.6 Some KAMs are not estimates, and may involve findings that do not clearly sit within a range. For example, a judgement may have been taken as to whether an entity is or is not controlled and therefore should or should not be consolidated as a subsidiary. This judgement is not a sliding scale, but auditors could give a flavour of whether the judgement is just about acceptable or strongly supported by the evidence available, and of the factors on which they have based this conclusion.

Q26. Could further narrative be disclosed alongside the opinion to provide more informative insights?

26.1 Yes, in the reports on public interest entities and other listed entities. There is, however, a tension acknowledged in some of the comments from users already received by the FRC in their review of the 2016 Audit Reforms and in the Call for Views between those who would value more information and those who do not have time to read the audit report. We believe that there should be an executive summary signposting the most important conclusions and issues, allowing those who want to read more to dip into the full audit report behind it.

26.2 We have some further suggestions where findings and insights in other areas could be more expansive and help users, again focussing on the reports for public interest entities and other listed entities.

26.2 If there is no requirement for companies to assess their controls environments (ICFR), we have suggested to the FRC that standards should require auditors to explain in areas of KAMs whether they:

26.2.1 expected to find a control and were able to rely on it;

26.2.2 found a control that was designed appropriately but not operated effectively;

26.2.3 found a control that was not designed appropriately;

26.2.4 did not find a control they had have expected to find; or

26.2.5 did not look for a control because they had not planned a controls approach.

26.3 If there is a Sarbanes Oxley type reporting on ICFR, then the presumption would be that controls were in place. Any qualification of the ICFR opinion should then clarify whether any failure is one of design ("the control would not achieve what it set out to achieve, even if operated perfectly" or "the control is missing"), implementation ("the control looks fine on paper but has not been put into operation on the ground") or operation ("the control is designed appropriately and has been put into place, but management did not operate it as designed").

26.4 In our answers to other questions in this Call for Views, we have explained that auditors could usefully explain more about the way in which they approached other areas of testing – for example, which key factors fed into their going concern assessment and which laws and regulations were considered for non-compliance.

26.5 Auditors could also explain what performance materiality ("PM") is and why it has been set at a particular level. Investors often consider PM as a code for poor control or history of error. Whilst these may be factors, auditors do use a lower PM for other reasons (first year audit; major change; complex structure with lots of small components and few large ones).

26.6 Some have argued that auditors could report adjusted and non-adjusted errors. Whilst this may appear appealing, because it is a measure of bias and quality of underlying management accounting processes, we believe there could be unintended consequences. Firstly, it is harder to deal with errors in judgemental areas, as there is a distinction between a difference of views and an actual error. In our view, graduated findings address this risk – estimates that are all just about acceptable but at the same end of the range will give information on bias that is more useful. Secondly, on adjusted errors it is hard in many cases to determine whether the auditor found an error that management were unaware of or whether management had already identified the error and were correcting it anyway. This is particularly true when management goes through several drafts of the financial statements during the close process – the process is not one where management clearly say "here is the finished article" and then wait for the auditor to find errors. Management's process of refining the financial statements runs in parallel. We believe more useful information on the quality of management's processes is given by control findings (see 26.2 above) and, ideally, an opinion on controls (see 12 above).

Q27. What would prevent such disclosures becoming boiler plated?

27.1 We believe that it is sufficient that the application material in the standard calls for the avoidance of boilerplate and stresses that the audit report should be tailored to the facts and circumstances of the specific entity. Disclosures may, in due course, become more bland and standard, but this may be because of the effect of being audited. For example, if auditors keep calling out estimates as being at one end of an acceptable range, it is likely that next year, management will want to (or the audit committee will make them) move back towards the middle. This will be a more graduated version of the perceived problem of "auditors doing a bad job because there are so few qualifications" – which masks the significant number of battles auditors currently have over threatened qualifications where management eventually back down.

27.2 Enhanced narrative around the disclosures that have changed as a result of the audit process may address this perception.

Q28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

28.1 We do not believe that audit is entirely producer-led, nor that this has inhibited innovation.

28.2 Arguably the IAASB has been auditor-led, although this has changed over recent years, and the work of the Monitoring Group to reconstitute the IAASB will end up with a body dominated by lay voices. In the UK, standard setting has been lay-led for some time. The FRC has the power (and does use it) to add requirements to international standards; the FRC Board has nobody who is a recent auditor, and the Audit and Assurance Committee has few actual auditors. Part of the problem in standard-setting is that investor views are scarce – often the FRC receives few views from investor bodies and only a handful from actual investors. In our response to the Kingman review we stressed the importance of user voices in future standard-setting.

28.3 Often the challenges around standard-setting are that the process considers "the art of the possible" and that this is not always done in a holistic way ("make directors do X, then auditors can check X"). The challenge is that societal expectations of audit differ from those set out in company law and/or securities law and therefore the mandate given to standard setters. This is one of the reasons why this Call for Views is so welcome – users, preparers and auditors can think more broadly "what would an ideal reporting and audit regime look like?" rather than starting from "how would I change the current regime?".

28.4 Producer-led audit has not stifled the level of innovation that auditors are bringing into the audit process. As set out in our response to the CMA and elsewhere in this response, auditors have invested significantly in analytics. This is a response to the increased use of big data and automation by preparers of financial statements, and time freed up is redeployed to work on judgemental areas.

CHAPTER 6 – LEGAL RESPONSIBILITIES

Q29. 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?

29.1 In general, auditors are currently required to consider whether corporate reporting complies with relevant laws and regulations. Any requirement to audit compliance beyond existing corporate reporting (or areas directly associated with the financial statements, i.e. books and records) would require further guidance for auditors and would potentially require access to an extended range of specialists to provide the necessary input.

29.2 We would support mandatory reporting of distributable reserves and capital payments in the financial statements. This would therefore subject it to audit.

29.3 In this case, it would not be appropriate to distinguish between matters, which might affect the financial statements, and other matters, as the two things are interlinked.

29.4 In other cases, where the laws and regulations extend beyond the financial statements to broader areas of governance and compliance, it might be appropriate to distinguish between matters which may materially affect the financial statements and other matters.

Q30. 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?

30.1 Yes, in part. There are three distinct issues, though, which need to be separated:

30.1.1 Is there an actual inconsistency between company law and accounting standards, and if so, how should it be addressed – and if there is a perceived difference but no actual difference, how should this be put beyond doubt?

30.1.2 Once it is clear what companies and directors should be doing, what role should auditors play?

30.1.3 Would the public expectations be addressed by such a regime, or is more fundamental change needed?

Actual or perceived differences between company law and accounting standards

30.2 The existing capital maintenance regime is based on a context of "realised profits". There has been significant debate over recent years as to whether or not this leads to harm. As a simple example, consider the challenge that "mark to market" profits should not be used to pay distributions as their inclusion is not prudent. Imagine that there are three companies, each set up with £100 in cash which is subscribed for share capital. In each of the following situations, the current rules on distributable profits would support a dividend of £50:

> Company A buys a building, which rises in value to £150, which it then sells for cash and reinvests in another building. It has made a cash profit of £50. It cannot readily pay a dividend without borrowing until it sells the new building – which may take some months.

Company B buys shares in a listed company, which rise in value to £150, which it then sells for cash and reinvests in other shares. It too has made a cash profit of £50, but can pay a dividend quickly as it can sell some of the new shares immediately.

Company C buys shares in a listed company, which rise in value to £150, and keeps holding them. It has not made a cash profit – as it has not sold anything – but can clearly pay a dividend as quickly as company B as it can sell some of the existing shares immediately.

30.2.4 A view that only "realised profits" which have been received in cash are distributable would mean that company A, which cannot readily realise cash, is entitled to pay a dividend, whereas company C, which can readily realise cash, is not. This would also draw an artificial distinction between company B and company C, which are in substance in the same place.

30.3 The FRC and BEIS have both been clear that they do not see an actual conflict between company law and accounting standards. Nevertheless, some investors hold the view that there is. Both the FRC and investors have sought views from leading counsel; these views conflict with each other. We believe that, if a realised profits test continues to feature in company law, the issue needs to be properly addressed by BEIS – by consultation and then clarification of the law to come up with an actual statement of what there is that cannot then be the subject of conflicting interpretations by lawyers.

What role should auditors play?

30.4 Some stakeholders criticise auditors for allowing distributions to be paid based on accounting standards, which those stakeholders argue conflicts with the law. Again, it is first and foremost the duty of directors to determine the profits available for distribution. Most of the criticism of auditors has been that they have accepted the views of the FRC and BEIS as to the legal requirements on directors, which some commentators believe are wrong. In our view, if change is required the requirements on companies and directors should be amended as required and then auditing standards reviewed to reflect these. Our suggestion in 30.3 would address the concern that auditors are being asked to prefer one leading counsel's opinion over another by putting the issue beyond doubt in the Companies Act.

30.5 In addition, we suggest that the role that auditors could play if the law or accounting standards required disclosure of distributable profits in our response to 31 below. Other roles for the auditor could involve a duty on directors to implement controls over the calculation of distributable profits and the auditor to opine on those controls. This would be a natural consequence of requiring both disclosure (see 31 below) and an opinion on IFCR (see 12 above).

What alternatives might better meet public expectations?

30.6 Wider public concern is largely based on situations where dividends are paid by a business which subsequently fails, or has paid such dividends for a number of years whilst providing what is perceived to be a failing service to the public. Such concerns are unlikely to be addressed by changing the requirements of accounting standards and/or ICAEW/ICAS guidance.

30.7 For this reason, we believe that a shift to a solvency basis would be better – because ultimately that is what capital maintenance is about. Such a regime would require that directors only pay a dividend if they had a reasonable belief that the company would, after paying a dividend or buying back shares, be able to pay its debts as they fall due for at least twelve months. This would cement the existing common law solvency duty on directors into the Companies Act, would be consistent with the existing solvency statement regime for private company capital reductions, would remove procedural complexity and reliance on complex accounting judgements, and focus on the risk to creditors. Such risks are also relevant to investors who are investing for the long term as a short term solvency issue would harm the value of their investments. We recognise, however, that current EU law does require the UK to have a distributable profit mechanism for those companies that are PLCs.

30.8 We believe that this shift would address many, but not all, of society's broader concerns too. Sophisticated investors may understand the range of views as to what is or is not realised under the joint ICAEW/ICAS technical release, and have views as to whether this is appropriate. However, the lay person is more likely to want to answer "why did this company pay a dividend and then enter administration?" which would be addressed by a solvency test. Other questions, like "why should a dividend be paid when there is a pension deficit?" are best addressed by pension regulation.

Q31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

31.1 Yes. We support increased transparency in this area. Clear disclosure of the company's strategy and policy on dividends would be helpful to users.

31.2 Disclosure of a specific figure is appealing in terms of simplicity, but producing such a figure may be hard in situations where there is a complex financial history – for example, a group which has been the subject of a buy-outs, IPO or demerger. Such companies may have reserves which arose more than six years ago, beyond the period for which accounting records must be held and the memory of those still employed by the company. In such situations, companies may need to explain that the status of some reserves is less clear, but this could be addressed by additional disclosure around dividend policy – for example, if the current dividend policy only relies on current year profits, then the status of some opening reserves may not be relevant. As at present, any uncertain reserves should not be relied on for the purpose of paying a dividend.

31.3 Some commentators have argued for disclosure of reserves throughout the group. This could be misleading, because in the case of the reserves of many overseas companies there are no rules restricting dividends to realised profits, and there may be other factors in play (e.g. exchange controls, tax consequences of moving dividends up a group, investment demands in subsidiaries etc.). Disclosing a figure for reserves available for distribution throughout the group may also give a misleading picture as to what may realistically be available for distribution taking account of other priorities for allocating capital across the group. We believe that this issue would be best addressed instead by a narrative statement explaining the extent to which group reserves may or may not be passed up to the parent together with the entity's current plans to do so (or not) and the potential impact if they did so.

Q32. 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?

32.1 Currently a group audit opinion only covers the books and records of the parent company, not all companies in the group. For subsidiaries:

32.1.1 UK entities would be covered by their own respective audit opinions, so far as they are required to be audited (i.e. not dormant or covered by parent company guarantee).

32.1.2 Non-UK entities would only be subject to any requirements for audit in their respective jurisdictions. In the case of some countries (i.e. the US), there is no requirement to file local statutory accounts or to have them audited. In many countries where an audit is required, a specific opinion on adequacy of accounting records is not required – if the records are good enough to support the audited financial statements, that is enough – even if this required significant extra work by the company and/or the auditors.

32.3 As a result of this current structure the extent of the opinion given by the auditor in respect of the books and records of a public interest group are limited. We do not therefore consider that the existing statutory requirement is effective in setting the bar high enough at the right level across Groups.

32.4 If the requirements were extended to report more broadly then they would need to be aligned to the materiality and scope of an audit, meaning that only reasonable assurance could be provided that any inadequacy in the books and records would not materially impact the financial statements.

32.5 If the requirement was to extend beyond the normal scope and remit of a group audit then further guidance would be required to establish 'adequacy' in the context of entity-specific circumstances. For example, we are aware of some debate as to the other requirement of 'adequate' accounting records – being sufficient to determine with reasonable accuracy at any time the financial position of the company.

32.6 At the time the Companies Act 2006 came into force, the FRC did not provide any guidance as to what 'adequate' accounting records would look like. The ICAEW has issued guidance, which recognises that there is not a 'one size fits all' answer – updates in real time may be necessary for a bank, and regular updates may be needed if the company is at risk of insolvency and cash is tight, whereas far less regular entries would be needed in a business with a long operating cycle that is comparatively solvent. The FRC declined to issue an auditing standard setting out the work which an auditor should do.

32.7 If change is needed in this area, we believe that the FRC (or ARGA) should consult on guidance as to what 'adequate' means (following due process and considering the public interest) and the consequence for the auditors' work.

32.8 Whilst the duty to maintain adequate accounting records is an outcome, rather than the duty we have suggested for management to maintain internal control over financial reporting, these ultimately address the same end. Change here may therefore not be needed if our suggestions of an internal controls reporting requirement (similar to Sarbanes Oxley in the US) is introduced in the UK.

CHAPTER 7 – THE COMMUNICATION OF AUDIT FINDINGS

Q33. 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?

33.1 We support transparency, clear communication and openness.

33.2 There is no reason that the AGM cannot be used for this type of communication between shareholders / other stakeholders – this would be preferable as it would enable directors to answer those questions that they are most suited to answer, and for attendees to ask the same question of executive management, the audit committee and the auditor. We think this could be transformative for the understanding of the approach to the audit and perspectives of the auditor.

33.3 However there are some important enablers to this:

33.3.1 Questions should be tabled in advance to enable the auditor to prepare and potentially to get input from specialists or component auditors or even ask them to attend in the case of more complex questions on specialist areas.

33.3.2 The liability regime requires reform so that the principle of the auditor having responsibility to the shareholders as a body is not undermined (or there could be significant liability / insurance / cost implications). This could be compromised by the auditor having liability to individual shareholders who are in attendance and rely on something said in the meeting or to third parties such as suppliers or customers.

33.4 If a wider range of stakeholders are invited, it would be important to be clear as to whether the auditor (or other assurance provider(s)) should be expected to address the subject matter in question, or not – being clear that (for example) matters which might be reflected in the annual report should be debated, whereas unconnected matters should not.

Q34. 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?

34.1 As we set out in our response to Question 14, we are supportive of providing more insight into our views on the internal controls environment to users of the financial statements. We are recommending this for our audit teams in their enhanced audit reports from December 2019 onwards.

34.2 Often communication with an Audit Committee is an iterative process throughout the year and, where necessary, seeks to facilitate a change in management's position. The current key audit matter reporting seeks to present a final summary to users of a key matter, the audit work done and the conclusion reached.

34.3 We are supportive of the use of graduated findings and there are some examples in the market where we have already provided our view on the level of prudence or aggression being used in a particular area of accounting (see Ferguson plc, Dixons Carphone plc and Saga plc as examples). We do believe this would provide useful information to users of the accounts so long as there was a meaningful way to interpret and benchmark the results.

34.4 Alongside any proposed changes to the nature and extent of the reporting of communications between the auditor and the audit committee, we would recommend increased reporting requirements on audit committees to report more thoroughly and transparently on the nature and extent of their activities during the year to discharge their responsibilities. This should then be subject to regulatory review and monitoring. This would also give an ability to benchmark between industries and peers, which in turn should drive positive behaviours amongst audit committees.

Q35. 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?

35.1 Currently, our approach is to report on the removal or addition of KAMs since the last enhanced audit report. Any update on key audit matters that remain consistent year-on-year would normally be provided in the summary of that key audit matter.

35.2 We would be supportive of this reporting being made mandatory and this is an area where users would likely benefit from graduated findings with prior year comparatives.

35.3 We are supportive of other general enhancements to the items reported on in the enhanced audit report, such as controls (see our response to Question 14). However, care should be taken to maintain the quality and clarity of the information reported, over quantity.

CHAPTER 8 – FRAUD

Q36. 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?

36.1 We consider there to be an 'expectation gap' currently with regards to users' expectations of auditors' role in fraud detection and the requirements of UK law/auditing standards. Part of this expectation gap is driven by a lack of clarity about what constitutes a fraud and specifically which types of fraud the audit should be required to identify. This current ambiguity is highlighted in your Call for Views.

36.2 The current requirement for auditors is to obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. Whilst it is in fact the responsibility of the company and its directors to prevent and detect all fraud.

36.3 Public sentiment would appear to be that the auditors' responsibilities extend beyond that current remit both in terms of the size/nature of the fraud and the level of assurance being greater than 'reasonable assurance'.

36.4 If auditors are given greater responsibility then it will be important to define what constitutes fraud more broadly and specifically a 'material fraud'. It will also be important to determine what level of assurance we are expected to provide, either that no 'material fraud' exists or that any that exist and have been detected have been appropriately disclosed. This will likely necessitate enhanced responsibilities and reporting by directors in this area. It will also be important to clarify the distinction between the broader concept of materiality as would apply in the audit and what would constitute 'material fraud', in order to avoid the 'material fraud' threshold becoming the default in the context of audit testing.

36.5 A requirement to audit the control environment, with reference to a suitable framework (UK-Sarbanes Oxley), should itself improve corporate processes to prevent and detect fraud and likewise the auditors' ability to detect it. This could incorporate a specific requirement to audit and report on the controls the directors have established to prevent and detect fraud.

36.6 We would therefore be supportive of an enhanced responsibility for auditors as long as it was accompanied by clear guidelines and broader requirements to enhance accountability for directors on internal control.

Q37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

37.1 We believe that auditors are clear on their responsibilities in respect of detecting material misstatement in the accounts, whether through fraud or error.

37.2 Whilst broader areas of potentially immaterial fraud are considered by auditors and factored into their procedures, including the misappropriation of assets, the main focus is generally on material results manipulation and significant management bias. We consider that there is a disconnect between the mindset of an auditor in detecting fraud under the current auditing standards and the general public's perception of what the audit is designed to consider. There has also been a significant change over recent years in the means of committing fraud and the complexity of business models with the result that standards and training for auditors have likely not kept pace with the current fraud environment.

37.3 In line with our response to Question 36, we would be supportive of the auditors' responsibilities being extended around fraud detection so long as the relevant steps were taken to increase accountability for directors and this was implemented as part of a broader requirement to assess and report on internal controls (similar to Sarbanes Oxley requirements in the US).

Q38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

38.1 We believe current standards do this, requiring an auditor to plan and perform their audit to obtain reasonable assurance that the financial statements are free from material error, including error caused by fraud. The challenge remains that frauds typically occur because:

38.1.1 An entity is poorly controlled, or controls as designed are not operated effectively. A Sarbanes Oxley style opinion on controls would help here, coupled with an explicit legal duty on directors to put in place controls to prevent and detect fraud. For example, it may be appropriate to mirror the approach in the Bribery Act which requires directors to put in place reasonable steps to prevent and detect bribery and corruption.

38.1.2 There is significant collusion. If third parties are also involved, it is often next to impossible to find evidence (absent the forensic investigation steps listed in 38.2) within the organisation or outside it which would contradict what the auditor is told and therefore probe by way of further investigation.

38.2 As outlined in our response to Question 36, a further challenge is the lack of a common definition and understanding of what constitutes fraud and specifically which types of fraud the audit should be required to identify. This would need clarification before an effective 'reasonable person' test could be devised.

38.3 Auditors are already required to plan their audit so as to stand a reasonable chance of detecting material fraud, and poor execution of these procedures does not mean the bar is in the wrong place. The bar can be moved up, but will never be a guarantee against fraud. The perception problem is often that hindsight suggests a risk was obvious that would not have been evident at the time; the test should be what a reasonable auditor should have considered as a risk based on evidence available at the time they planned their audit, rather than through the lens of an after-the-event forensic investigation.

38.4 Increased use of data analytics presents an opportunity for audit to at least stand a greater chance of identifying individually immaterial frauds, but consideration also needs to be given to ensuring a proportionate response against this backdrop and the cost/benefit question. Auditors could stand ready to do a lot more work – for example, the sort of forensic interrogation of file servers, emails and instant messaging systems that we do when we are called in to investigate a fraud – but these are very time consuming for auditors (and for management), and would cost a lot and delay results announcements.

Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

39.1 The auditor is well placed to evaluate and report on an entity's systems and controls around fraud. However, in order to do so, management should have much clearer responsibilities (beyond current company law, which is too broad) to put such systems and controls in place and there needs to be appropriate sanctions and penalties to enforce those requirements. The audit then needs to assess the statements made by management, or actions/controls of management within a defined framework. Without clarity of framework and management responsibility there is a risk that the expectation gap is widened further.

CHAPTER 9 – AUDITOR LIABILITY

Q40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

40.1 Many stakeholders expected that when the FRC first moved from a pass/fail audit report to one with KAMs (adding more colour) that the auditor's appetite would change; we are not aware of any auditor who decided to move out of the listed company audit market due to this change. We believe that the profession is willing to embrace other change irrespective of liability caps or the lack thereof – indeed, we do not currently apply different quality procedures for those audits where we can cap compared to those where we cannot.

40.2 There are three specific areas that need to be considered, however:

40.2.1 We explore the question of to whom the auditor should be liable in our response to Question 42.

40.2.2 In each of the areas where we propose change, such as viability, fraud and internal controls, we note that the law should first require directors to do something and then the auditor to audit it. Accordingly, directors should be liable for their failures, not just the auditor for their failure to detect it. Where both have failed - directors fail to do something, and the auditor does not detect that failure -such liability should be proportionate. Whilst this is the current position applied by the Courts where the company is still standing and/or the directors can pay, if the company has become insolvent or the directors do not have sufficient assets (or the limits of their respective insurance policies have been reached), the auditor is liable for the full amount, even if the Courts decide that the auditor is only 20% to blame.

40.2.3 Moving towards assurance on forward-looking information should be accompanied by a similar safe-harbour to that in place for directors – if an auditor issues an opinion on a forward-looking subject matter in good faith, having carried out their work in accordance with standards, they should not be liable if, with hindsight, an assumption turns out to have been wrong.

Q41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

41.1 Auditors try and do a good job in the public interest; if they do not, they will be removed by audit committees and/or shareholders. For that reason we do not believe a cap on auditors' liability would improve quality or effectiveness. Conversely, we do not believe that (as is sometimes argued) auditors would do a worse job were there caps on their liability; the impact of regulatory sanctions (including withdrawal of an individual or firm's ability to audit) and the reputational damage from being removed by an audit committee for being insufficiently challenging would still be a deterrent to poor work.

41.2 The only potential indirect impact would be if the current position were to be a barrier to entry for new players, and the entry of new players into the market might lead to quality improvements.

Q42. 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?

42.1 Yes, when considered with our answers to Question 1. The primary question is "who is an annual report principally for?" – with directors and the company itself being liable to those people – this recognises that the primary responsibility for a poor annual report should rest with those who prepared it. It is not unreasonable for the auditor to then address their report to those people and to be liable to them.

42.2 However, to the extent that the annual report is relied on by others, for whom it is not necessarily designed, then it needs to be acknowledged that:

42.2.1 directors will not necessarily have considered the needs of such other users in the preparation of the report;

42.2.2 auditors will not, therefore, have had to consider whether such needs have been met; and accordingly;

42.2.3 directors and auditors are not necessarily liable if a user takes a decision in respect of such a need based on the annual report and/or auditors' report thereon.

This would also apply to a specific user whose needs may not be the same as those of their class of user as a whole.

42.3 Accordingly, the degree of liability to any class of users should be linked to the question of whether the annual report (or relevant element of it) was designed for their needs.

42.4 We do believe one reform of auditor liability would reflect a fairer allocation of responsibility – making proportionate liability a feature of the law. Whilst, at present, the Courts will impose proportionate liability (e.g. the directors are 80% liable for failing to do something; the auditor 20% liable for failing to detect the directors' failure), this is reliant on all of the parties being able to pay. If (say) the company has become insolvent, the Directors' and Officers' (D&O) insurance cover exhausted, then the auditor could end up paying all of the liability. Introducing a statutory proportionality regime would provide a fairer position, whilst not capping liability.

Q43. How might the quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

43.1 We have set out above our views as to whether quality would improve if the approach to liability altered. In particular:

43.1.1 In Question 42 we consider whether auditors (and directors) should be liable to other classes of users of the annual report. If they are, then this will be because elements of the annual report will have been designed to address their needs, and therefore the auditor will have planned their report to respond to those needs.

43.1.2 In Questions 40 and 41, we explain that changing the auditors' liability regime to cap liability would be unlikely of itself to improve quality, but that a form of safe-harbour may be needed for a reasonable auditor if the audit (and the annual report) is to become more forward-looking.

43.2 Ultimately, audit quality will be improved (both in terms of the existing product and any changes to that product) if those involved in the financial reporting supply chain – preparers as well as auditors – pro-actively seek to get it right first time, supported by standards, guidance and tools to achieve this, rather than by looking over their shoulders with an eye to the consequences if it goes wrong.

Q44. 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?

44.1 In common with other firms we do not publically disclose details of our PII cover, including the levels of excess or the premiums. We consider, however, that the level of cover we have in place is appropriate and reflective of the level of risks associated with our business.

44.2 Whilst we do not believe existing market participants would cease to compete on quality grounds if the PII landscape were to change, increased regulatory fines and the significant sums that have been awarded recently against auditors might mean some smaller audit businesses or potential new entrants simply will not take the risk, especially in the context of complex public interest entities. If this results in clients having less choice then this may reduce the perception of competition on quality grounds, even if it does not make a difference to actual competition.

CHAPTER 10 – OTHER ISSUES

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

45.1 General ledger analytics is now being used in most audits to inform risk assessment and to do journal entry testing.

45.2 Within some industries, analytics has evolved to be a 100% test of transactions or of the operation of a control, for example tracing revenue through to cash in high volume low value businesses. The use of analytics more widely is limited in part by the ability to extract client data easily (not all accounting systems make it easy to extract data in a way that enables meaningful analytics to be performed) – although firms do build bespoke analytics for the largest audits. As client systems are upgraded to enable easier data extraction, the range of analytics is growing – across types of balances and classes of transaction, industries and scale.

45.3 Artificial Intelligence such as contract reading software, is being piloted in limited use cases. Whilst there is not broad scale deployment at the current time, early use cases are focused on enhancing risk assessment across large complex populations to support human judgements.

45.4 We are also using some automation and robotics to support the back-office operation of an audit, as well as collaboration sites to share information with clients.

45.5 There is still considerable room for further development and deployment in the use of analytics and other types of new technology (e.g. blockchain – both as an audit tool and the tools to audit blockchain systems themselves).

45.6 Nevertheless, there has been some (justifiable) nervousness from regulators as to the level of assurance analytics provide to deliver actual assurance, whether as a substantive test ("recalculate the depreciation charge for all of the company's machinery") or test of operating effectiveness of internal controls ("check that each invoice bears two different approvers' sign-offs as evidence of segregation of duties"), as opposed to their use in risk assessment ("give me a list of all particularly large invoices to investigate further"). Use to provide actual assurance often requires testing of controls over data used in analytics, and in some cases the ability to test that is currently limited. For example, consider a test of loan losses in a mortgage lending business, part of which requires a comparison of apparently impaired loans where people have stopped paying instalments with the value of the collateral held. The actual test to check that the impairment calculation has taken appropriate account of the collateral value is relatively simple, and can be done on a 100% basis, but requires comfort that the valuation of the collateral has been done appropriately and has then been recorded correctly in the loan system – e.g. controls over the transfer of valuations from a surveyor's report to the electronic loan record.

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

46.1 Analytics has certainly enabled increased assurance in high volume, low value businesses and businesses where general IT controls are not effective and therefore very large sample sizes are required.

46.2 It has helped focus risk assessment activities and therefore identify and test transactions and balances which are of higher risk, leading to more focus. We are still at a relatively early stage of being able to use analytics to provide comprehensive 100% assurance. This does not just require further investment from auditors but for the FRC (or its successor) to be comfortable with this change.

46.3 Assurance over a broader range of issues is still dependent on the ability to readily extract data. Consider a test over compliance with laws and regulations in a lending business. Some of the data is in a standardised form and analytics could provide a useful tool (for example to recompute an affordability calculation in a loan decision) but cannot address all the risks (for example to check that a property valuation has been entered into the system in the first place, which may require a check to a manual/scanned record, or at the least require testing of controls over data quality). As an entity's systems mature, analytics over broader issues will become possible.

46.4 In addition, the emergence of new technology within a client environment demands a new assurance framework to address matters such as accuracy and confidence levels of output and ethics and bias, which Artificial Intelligence models may amplify.

Q47. Are there aspects of current audit procedures or output that are no longer necessary or desirable?

47.1 No, at least not in the context of a larger entity. We believe that the current procedures, executed proportionately, are each part of a cohesive whole to express an opinion on the truth and fairness of the financial statements. What is needed is to reconsider whether:

47.1.1 The scope of reporting by companies needs to change. One of the issues raised in the Call for Views is whether all of the notes to the financial statements should be audited. If that information is not used by users, then the issue is not unnecessary audit procedures but that the information is required in the first place.

47.1.2 An alternative product is needed for SMEs. In practice, financial statements nine months after the year end may not be that useful for suppliers, customers, employees and owners (particularly if owners are the directors) – and so the audit of such financial statements may not be that beneficial either. An alternative approach might be more comfort over management accounting processes.

Q48. 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?

48.1 Any assessment of the risk of failure needs to distinguish carefully between:

48.1.1 The risk of corporate failure, which is the risk that a business fails due to an unsustainable business model, poor decision-taking by management or external shock. For example, not every going concern risk can be anticipated by even the best management.

48.1.2 The risk of failure of corporate reporting – the risk that a business fails (or that reporting is materially wrong). For example, the risk that management's assessment of which going concern risks is wrong.

48.1.3 The risk of failure of audit or assurance – the risk that the auditor fails to detect that there is a failure of corporate reporting and gives the entity a clean opinion.

48.2 The interplay between these is crucial. It will not be a failure of audit if an entity fails for conditions that could not reasonably have been anticipated by management, having been duly diligent in their enquiries, and therefore not reported on, even if with the benefit of hindsight those conditions were present at the time the annual report were issued. Likewise, it is possible that a company may fail for a reason that could have been anticipated by management, without this constituting an audit failure. For example, some entities have suffered a significant financial impact because of a reputational issue or scandal that has engulfed their senior leadership entirely unconnected to their role in leading the entity – arguably management should have known that they were, say, a criminal, but the auditor may not have been able to know about an issue in their private life.

Q49. Does today's audit provide value for money?

49.1 Yes, we believe it does. As the CMA argued in its final report (paragraphs 2.113 – 2.117), an effective corporate governance regime (including audit) generates a range of positive outcomes including: a more efficient allocation of capital, improving productivity and growth; a better functioning financial system due to increased public disclosure by banks and insurers; higher levels of trust between business and society and a lower cost of capital.

49.2 Those who benefit from audit extend well beyond those who work in the City or manage companies, and include anyone with a vested interest in the health of the UK economy, including employees, customers, suppliers and pensioners.

49.3 In addition, the audit sector in the UK is also one of the most important sources of business education for school leavers and graduates. The business model of audit firms is such that it trains many more people than it needs in senior positions. As a result, chartered accountants that have been trained by audit firms are found in positions of responsibility across UK industry and commerce.

49.4 This is not to say that audits could not be improved or that they necessarily provide optimal value for money. With sensible reforms there is scope to improve the benefits that auditors provide.

49.5 In our discussions with companies and investors, we do not encounter a widespread suggestion that audits are too expensive. On the contrary, many believe that it would be perfectly acceptable – and indeed preferable, given the potential impact on quality – for audit prices to rise.

Q50. 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?

50.1 We believe that changes stemming from this review and other related reviews that lead to a material improvement in audit quality and help stakeholders develop a more rounded and more accurate view of the company – and therefore improve the levels of trust – are likely to generate value for money.

50.2 Quantifying the financial value of a change is very challenging. We note the CMA's reference, in paragraph 2.116 of its final report, to research previously carried out by the Competition Commission, which found that a one basis point decrease in the cost of capital would represent an increase in the overall market capitalisation of the FTSE 350 of around £3.8 billion, though we are unable to verify this independently.

Q51. 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?

51.1 This is a question for shareholders. We believe that institutional shareholders do read the full annual report on at least the largest companies, but that not all shareholders read the full annual report on every company. This is one of the reasons why, in our response to Question 26, we suggest that the reports on public interest entities and listed entities should start with an executive summary to signpost the key issues.

Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

52.1 We already hold discussions with a wide range of investment managers outside the AGM, although typically on a firmwide basis (for example to discuss our views on the future of audit, our plans to invest in quality or on broad developments in reporting and governance) rather than on an entity-specific basis.

52.2 We would be open to considering further interaction. It may be useful to carry out such interaction through an intermediary such as the Investment Association.

52.3 If auditors were to discuss individual audited entities, the auditor would need to take care not to disclose inside information to a limited group of market participants. This is one reason why the AGM is a good option, as it is open to all shareholders, large and small, and often these days is streamed online or by conference call to anyone else who wants to attend.

Q53. 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?

53.1 We believe shareholders (and potentially other stakeholders) could and should raise issues (either in the AGM or outside it). In view of the limited attendance at AGMs of all but the largest companies, it will be hard for a representative group of shareholders representing a consensus view to provide a useful check of planning matters at another forum. We believe that it may be possible to use technology to assist in this area – for example, to crowdsource concerns from shareholders and present the significant themes to the auditor (and to the audit committee). It might also be possible to gather views at the AGM that feed into the scope of an audit for the upcoming year.

53.2. The audit committee's role in this area should also be considered – currently they stand in the place of the shareholders and agree the audit plan; interaction with a mechanism for stakeholder input will need careful thought.

Q54. What assurance do shareholders currently obtain other than from audit reports?

54.1 This is a question for shareholders.

Q55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

55.1 Whilst the auditor may have observations around tone from the top and the control environment in place around ethical practice, any report on culture is at risk of being subjective and an incomplete view being based solely upon areas linked to regulation or financial reporting.

55.2 The auditor could report observations on certain aspects of entity culture and could validate factual statements that the company makes around their culture (for example existence of employee engagement programmes or existence of controls around laws and compliance). However, this will not represent an overarching view on company culture.

55.3 Any assessment of culture needs to be made within a consistent framework and against some defined indicators of cultural controls to avoid the risk of subjectivity. Outputs to be comparable, clearly understood and to avoid a boilerplate or generic statement.

55.4 There are risks around any cultural assessment. The observer effect means that it is likely that the behaviour of the entity's management will change because they know they are being observed and commented on by the auditor, therefore a point in time view on culture may not be reflective of the company 'norm'.

Q56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

56.1 We believe our earlier suggestions on auditor reporting, accompanied by more narrative as to the challenge applied for KAMs, addresses this need. One issue which could be explored is whether the auditor could explain the extent to which third party evidence has been obtained and, if it would be expected to be available, why it was not.

Q57. Should the basis of individual auditors' remuneration be made available to shareholders?

57.1 Firms in the UK already publish average profit per equity partner, CEO remuneration and INE remuneration, as well as the basis for determining equity partner reward. We are open to the views of others, but believe this gives sufficient transparency to external stakeholders.

Q58. Do respondents view audit costs as generally too high, about right or insufficient?

58.1 In our experience, investors and company boards do not view current audit fees as being too high. Indeed, many believe audit fees should be higher, given the importance of audit and the need for high quality. The changes that are likely to arise from the range of reviews currently underway will almost certainly require the amount of work involved in audits – and therefore audit costs – to increase. This is healthy and may also make audits more attractive for challenger firms to compete.

Q59. Would users of financial statements wish more detail on the make-up of audit fees?

59.1 There may be a case for giving shareholders more information on the number of hours spent on the audit. However this information would need to be viewed in context – raw numbers alone would be insufficient to give a full picture on whether appropriate effort is being expended on the audit. For example, a reduction of hours could be because of a change of scope, use of new technology or incorporating learnings from previous years. That being said, we have not experienced significant demand from shareholders to provide further detail than at present. We believe that some calls for this may be to detect changes in hours and therefore in approach; this would be better served by mandating auditors to explain changes in scope and approach in the audit report.

Q60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

60.1 No. Audit profitability – and therefore audit pricing – needs to be higher to:

- Fund continued and increasing investment in the audit product and related technology, making it more relevant and higher quality.
- Encourage challenger firms to invest in their FTSE350 audit capability and bid for them.
- Ensure that audit continues to be an attractive destination career for the very best. While firms still manage to recruit large numbers of graduates and school leavers, they find it increasingly difficult to retain the experienced staff members who might otherwise stay and become partners in the future.