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Dear Sir Donald,

Independent Review into the Quality and Effectiveness of Audit

Grant Thornton UK LLP ('Grant Thornton') welcomes the opportunity to comment on the Independent Review into the Quality and Effectiveness of Audit ('the Review'). Our detailed response is set out in the attached appendix. We have commented on most areas of the Review and have deliberately only focused on those specific questions where we have a point to make, as the questions are directed to a broad range of users, providers and stakeholders in the statutory audit market.

The attention that the UK audit profession is currently facing has been driven by issues of declining **trust and integrity and this must now be addressed and reversed.** To achieve this, Grant Thornton UK considers that reform must have improving audit quality as its fundamental aim and that **audit independence is at the heart of this agenda.**

Competition will not fully remedy the issue and the work of your Review combined with that of Sir John Kingman's review of the Financial Reporting council ('FRC') will be critical to rebuilding trust and restoring the international reputation of UK audit and consequently increasing the attractiveness of the UK for global investment, by creating a world class framework for trust and integrity.

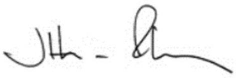
We strongly believe that the audit product needs to be updated and refreshed to provide better value and assurance to a wider group of stakeholders, all of whom have a financial interest in the success or failure of the organisation being audited (including employees, pension holders, suppliers, customers, investors and local communities). This should include:

- Clarifying who the audit is intended for and what assurances are required and then ensuring that subsequent reforms are user-driven;
- Ensuring that all parties play their role in supporting improved quality of reporting, governance and stewardship;
- Being bold with suggested reforms to audit scope around fraud, viability and non-financial reporting and finding effective solutions to the potential challenges to the status quo, such as the issue of auditor liability;
- Thinking creatively about ways to address the binary nature of audit reporting and deal with the complexities of modern accounting; and
- Opening the audit profession to the full possibilities of technological advancement.

Finally, the Review has a major part to play in the sustainability of audit as a profession and the opportunity to design a first-class audit product that will contribute towards attracting and retaining talent to the profession.

If you have any questions on our response, or wish us to amplify our comments, please do not hesitate to contact me.

Yours faithfully



Jonathan Riley
Head of Quality & Reputation
For Grant Thornton UK LLP

Independent Review into The Quality and Effectiveness of Audit

Grant Thornton UK LLP Response

Summary

The stakeholders of an audit are more than the investors of a company and it is clear that their trust in the UK's audit profession is in considerable need of improvement. We are supportive of acknowledging that the needs of a broader group of stakeholders should drive wider corporate reporting responsibilities and that auditors have a key role to play in providing reasonable assurance to these stakeholders that the audited financial information provided to them is complete and accurate in all material respects.

We recognise both an expectation and delivery gap regarding statutory audit but consider it is time that the debate is now moved on, to identify and address the underlying factors behind the current loss of trust in UK audit.

The financial reporting ecosystem is broad and requires both diligence and collaboration among many constituents: management, audit committees, regulators and shareholders. Enhancing the trust that society has in our largest businesses must focus on improvements and accountability across the whole ecosystem.

Introducing greater transparency of audit reporting, addressing the current 'binary' (pass or fail) nature of the audit and auditors engaging more publicly with stakeholders at Annual General Meetings of the companies subject to audit would be important innovations to the audit that we support.

In addition, broadening the scope of an audit, through those areas already suggested by the Review (fraud, viability and non-financial reporting) and making it more forward-looking would transform the audit product, addressing many of the criticisms of UK audit that have led to the demand for this Review. But such reforms will not be easy, as history has shown that the pace of change in UK audit reform is slow. The bolder the nature of the reforms, the more likely will be challenges to them, in such areas as auditor liability and the creation of greater unintended expectation gaps. We consider that the drivers for change are strong and that the Review should seek to find a way through these potential challenges and be bold over its aspirations for a UK audit product that is truly 'world-class'.

We are mindful of the fact that the UK is not the first country that has experienced financial reporting failures and criticisms of the auditing profession's role in detecting those failures in advance. In particular, the US financial markets have historically experienced similar challenges. Their response, driven largely through the US Sarbanes-Oxley Act of 2002 (US-SOX), contains much from which we can learn. In particular, while the initial implementation of US-SOX had challenges, the end result was vast improvements in the quality of both financial reporting and audits that made the US capital markets and the auditing profession stronger – the very goals we seek for the UK market. Accordingly, we support the development of proposals for a UK Sarbanes-Oxley-style approach to controls assurance for Public Interest Entities, as this will promote improved governance and accountability but we recognise that it will be important to tailor the elements of such an approach to the needs of the UK market.

Finally, we agree that the Review's focus should be on large listed Public Interest Entity (PIE) companies, as this is where we observe the current lack of trust in UK audit and we are supportive of the calls to re-examine the definition of PIE that other reviews have raised. Many of the areas of reform will be beneficial to the whole of the UK audit market but many will not be appropriate to the needs of the mid-market, where the nature of ownership dictates a different level of audit scope (eg whether or not to apply a type of Sarbanes-Oxley approach) and engagement. We suggest that the Review is careful to examine this issue and provides clear views of the application of its findings beyond Public Interest Entities.

Chapter 1 – Definitions of audit and its users

There are many users of the financial statements. In the case of the audits of Public Interest Entities (PIEs) and larger companies, potential stakeholders are wider than management and shareholders and reflect the public interest nature of the entity, encompassing a range of stakeholders such as pension holders, employees, customers, suppliers and local communities, for example.

In the present environment there is a greater expectation that the annual report and consequently the external audit should satisfy a broader range of stakeholder interests than legislation requires. Differing groups of stakeholders also have varying interest in different information from these reports.

Establishing greater clarity of the stakeholders of an audit and the assurances they need is the first step in designing a more effective audit product.

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

At present there would appear to be no clear definition or consensus as to for whose benefit the financial statements are prepared and for whose benefit an audit should be conducted, as there are inconsistencies between IFRS, auditing standards and the Companies Act.

For example, we note that company law does not define for whose benefit the audit is undertaken.

The Conceptual Framework for Financial Reporting issued by the IASB states that,

'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to <u>existing and potential investors, lenders and other creditors</u> in making decisions relating to providing resources to the entity.'

From the perspective of International Standards on Auditing (UK) (ISAs), ISA 200 Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK) states that,

'The purpose of an audit is to enhance the degree of confidence of <u>intended users</u> in the financial statements.'

And in terms of the audit report, in the UK, for entities incorporated under the Companies Act, the auditor is required to report to the <u>company's members</u> because the audit is undertaken on their behalf. Such auditor's reports are, therefore, typically addressed to either the members or the shareholders of the company.

The value of audit is in its independent and professional promotion of trust in the economy, which is particularly the case where ownership of companies subject to audit is separate from their management. Auditors are highly trained and experienced to reflect the significance and complexity of the companies' activities and the importance to a range of stakeholders of ensuring that the state of their business is reported accurately through their financial statements.

In our view there are many users of the financial statements, and not simply its current members or shareholders. In the case of the audits of PIEs and larger private companies, potential stakeholders are wider than management and shareholders and reflect the public interest nature of the entity, encompassing a range of stakeholders such as pension holders, employees, customers, suppliers and local communities. Other reviews of UK audit have called for the definition of PIE to be re-examined to include larger and more complex privately held companies. We are supportive of this recommendation and consider that their range of stakeholders is also relevant for the findings of this Review to apply to.

Further, legislation has recently been strengthened to reflect directors' duties in relation to promoting the success of the business and having regard to a range of stakeholders such as employees, customers, community and environment.

Not all stakeholders will have an interest in identical information. The annual report may not be the best vehicle for communicating this information. Even where investors are seen to be the primary stakeholder, there has historically been little engagement from investors in the audit process. We would urge caution in respect of any formal extension of the auditor's legal duty of care to a wider range of stakeholders, but recognise that auditors should be mindful of the fact that others may have an interest in the audited financial statements even where the audit report is not addressed specifically to them. How to engage effectively with these stakeholders is another matter that we will comment upon later in this submission.

In respect of the role of corporate reporting, there is a need to establish what information different stakeholders require, where that should be located (for example, in the annual report or on a company website) and the level of trust and assurance that stakeholders expect of that information. We are aware that there is a tension between keeping the length of the annual report at a manageable level but at the same time there is an increasing demand to provide more and more financial and non-financial information to satisfy the needs of a wide range of stakeholders. A broad review of corporate reporting should consider what the annual report of the future may look like and how it will be accessible to stakeholders.

As discussed later in this submission, there is potential for the scope of an external audit to be widened. In order for the auditor to report meaningfully and objectively on such a range of non-financial measures some form of recognised standards or benchmarks would need to be introduced against which those measures could be assessed and graded by the auditor. In addition, if the audit scope were to be widened, then liability should be appropriately applied to auditors and those responsible for preparing the information, as well as recognising that additional work will be required to prepare and audit this information.

Finally, it is worth noting that changes to the scope of an audit, intended to enhance the confidence of users, may result in a further widening of the expectation gap, as discussed below.

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

The external audit has a role to play in giving users confidence in the financial statements. It is not designed to give any wider confidence in the entity that is being audited. It is possible however that the external audit could be seen as one aspect of a package of assurance for public interest entities. Other aspects of this package could include reviews of internal controls and assurance reports on different elements of the entity. This would provide an enhanced degree of confidence in the entity to users.

Enhancing the confidence of users in the entity involves wider stakeholders playing their role, including management, directors, audit committees and shareholders. We consider that the role of others in providing confidence to users of an entity has been underplayed.

Chapter 2 – The Expectation Gap

The expectation gap has been described as what the public and other stakeholders expect an audit to do and what an audit is actually required by legislation and proper practice to do. In addition, the greater the presence of items of account requiring significant judgement and estimation by management, the more important it is that a user of the financial statements understands the limitations of an auditor being able to report with certainty. Currently, even with Extended Audit Reports, the binary (pass or fail) nature of audit reporting contributes to this disconnect and we think that this is an important area of consideration for the Review team.

Q4. Do respondents consider there is an expectation gap? Q5: If so, how would respondents characterise that gap?

We recognise the existence of an expectation gap between what the public and other stakeholders expect an audit to do and what an audit is required to do. The expectation gap exists in two forms: the level of assurance users think the audit is designed to provide, and what that level of assurance extends to.

Expected level of assurance – By definition an audit is designed to provide "reasonable assurance" that financial statements are complete and accurate in all material respects. An audit is not a "guarantee" of completeness and accuracy, primarily because the procedures necessary to provide a guarantee would be prohibitively expensive to companies.

Extension of auditor assurance – The financial statement audit opinion is just that, an opinion providing reasonable assurance related to the financial statements. Some, however, believe that the opinion extends to a qualitative statement about how well a company is being run, or even whether a company's public value is reasonable. An audit is not designed to provide that type of assurance.

Clarity over the external auditor's role and responsibilities, and what financial statement users should reasonably expect from an auditor's report, will be essential, particularly with respect to establishing the role of the regulator and ensuring that they hold auditors to account and judge fairly and consistently the quality of their work.

In addition, we consider that there is also an expectation gap between what the public and other stakeholders expect directors and management to do. Company law sets out clearly the responsibilities of directors in respect of the financial statements. Every material financial statement misstatement, whether due to error or fraud, started with a corporate financial reporting system and oversight that did not prevent or detect the error, and finished with an audit that did not catch the error. Undoubtedly, even well-run financial reporting systems and well-executed audits will miss errors from time to time, but we must recognise that improvements to the quality of financial reporting require attention across the entire ecosystem.

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?

Firstly, at a macro level, it is clear that trust in audit in the UK has been damaged significantly in recent years by a number of high-profile corporate failures. However, the incidence of such high-profile corporate failure is still relatively low, and even in those cases audit quality is not necessarily a contributory factor. All factors that are contributing to corporate failure need to be addressed including corporate reporting, governance and the effectiveness of investor stewardship. We acknowledge that audit quality should be continually challenged to improve but audit quality is also part of the much wider ecosystem, where a number of stakeholders have a significant role to play including most notably directors, audit committees and shareholders.

The publication of the results of Financial Reporting Council's ('FRC') investigations in cases of corporate failure, where the external audit has been found to be of poor quality, also indicate a quality gap, although corporate failure does not automatically mean that an audit was inadequate. We consider that more could be done to learn from the root causes of these corporate failures to promote audit improvement and fully understand all of the contributory factors.

Publicity surrounding audit failure creates a poor impression of the audit profession as a whole that is in our opinion understandably contributing to this loss of trust. It will be important that the audit profession recognises and responds to the need to rebuild trust in its role.

One further component of the 'delivery gap' relates to auditor independence and the role of audit committees and engagement by investors in ensuring that selection criteria for the external auditor focusses on independence and challenge and that the relationship between the company and the auditor is delivered from a proper independent footing. We note that the CMA's study on the statutory audit market seeks to address these issues and agree that the recommendations made in this area should be implemented without delay.

Chapter 3 – Audit and Wider Assurance

A general observation is that any change to the scope of assurance that the auditor is required to give should reflect the size, complexity and nature of ownership of the business and its range of stakeholders.

One area of wider assurance that has been recommended be considered (Independent Review of the Financial Reporting Council – recommendation 51) is the case for a strengthened framework around internal controls, including a role for the auditor to report on management's assessment of internal controls. Whilst such an approach would be valuable for public interest entities, mid-market entities may find such an approach disproportionate for their needs. We note that typically in the mid-market, shareholders are also management and employees and therefore less value will be derived from widening the scope of audit to cover information that these key stakeholders will already have access to. Reform should also strive to improve quality without stifling entrepreneurialism or becoming a barrier to growth for mid-sized businesses in the UK.

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?

We do not agree that the level of assurance should vary in different circumstances. The level of assurance needed is what the market demands of an audit. The fact that the nature of one entity may be such that it is more complex to audit than another will be reflected in the amount of audit work and audit evidence that is required in order to reach an audit conclusion. If it is not possible to obtain sufficient audit evidence, then that fact will be reflected in the audit report.

Our preference would be for greater transparency within the audit report.

Whilst the Extended Audit Report has already gone some way to explaining more fully the audit work performed and key areas of judgement, our preference would be for more transparency within audit reports that explains how the audit opinion has been reached. This greater level of transparency could be applied to PIEs where there is a wider societal interest in the performance of the entity. For smaller entities, where the level of public interest is not as great, the detail of the audit work reported could be streamlined, as the owners of such smaller entities would be in a position to ensure they were more sighted on the audit work undertaken.

We also note that the recommendations arising from the Independent Review of the Financial Reporting Council include the reporting of 'graduated findings' that would give greater transparency with regards to the audit conclusions reached. This is a step in the right direction towards greater transparency. However, we are aware that companies are generally not supportive of graduated findings, even though investors are. Further work that addresses the causes of such a difference of opinion would, in our view, be helpful, should such an innovation be taken forward.

Our comments are based on the current audit scope. Should this Review recommend that there are changes to the scope of an audit, we can foresee that it could be possible that a different level of assurance would be appropriate for different elements of the enhanced scope.

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?

Independence is fundamental to the audit and audit quality. Auditors are often criticised for being too close to management, of advocating for management of the company and of performing the audit with the mindset that they are employed by management rather than the shareholders of the company. Relaxing independence requirements would only serve to provide grounds to increase these criticisms.

We do not consider independence as a barrier to either innovation or quality. Both of these can be achieved within the parameters of a fully independent auditor.

We recognise the Review's focus on technological innovation within audit. The potential for technology to fundamentally change the way in which audits are carried out will need to be embraced by audit firms and we are now seeing a greater acceptance of the potential that this has to offer. However, even where technological innovation in the audit market becomes more commonplace, there will still be a need for professional skills and adherence to technical standards to be preserved in order that management can be effectively challenged in areas where key judgement is required.

Chapter 4 – The Scope and purpose of audit

Whilst there is evidence that investors still value the traditional external audit, there is an increasing demand for the scope and purpose of audit to be widened. The external audit is just one aspect of assurance that a PIE may require.

We note that the Independent Review of the Financial Reporting Council recommends that consideration be given by BEIS to a strengthened framework around internal controls in the UK. We support this. This will place more onus on a company's board and audit committee, to focus on the internal controls around financial reporting, where they are required to report on their effectiveness. As noted below, a role for the external auditor to report on management's assessment of this effectiveness could, therefore, exist. Experience and research has shown that an independent auditor's assessment of management's assertion regarding control effectiveness increases the likelihood that material weaknesses in internal control will be identified and corrected more quickly.

Ensuring that directors effectively carry out their statutory duties under the Companies Act 2006 is also necessary with appropriate sanctions being applied when that does not happen. If the scope of an audit is to be widened, potentially increasing the exposure of the auditor to risk, then directors also need to be called to account when they are failing in their statutory duties. Broadening the scope of audit will also require management to be able to present high quality supporting evidence to those areas subject to such a wider scope.

We support more transparency in the audit report on matters such as key judgements and estimates, including the going concern assessment and the range of possible outcomes that have been considered by management, as well as their overall conclusion on the going concern assumption.

As noted above there is a need to establish what information different stakeholders require, where that information should be located and the level of trust and assurance that stakeholders expect of that information. This includes narrative information that is typically included at the 'front end' of an annual report.

Risk and internal controls

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?

As stated above we welcome Sir John Kingman's recommendation that consideration be given by BEIS to a strengthened framework around internal controls in the UK. This should include the directors providing assurances over the systems and controls in the business.

We consider that risk management and internal controls underpin the business. As such we concur that directors should be required to make a more explicit statement regarding these areas and that this should be subject to audit. Critical to the success of this is ensuring that the directors are held accountable for those statements and are subject to review and investigation where they are found not to have effectively carried out their duties in relation to making such statements.

Further, a more robust system of controls in an entity would have the additional benefit of enabling more reliance on controls as part of the external audit process. This could improve the quality of audit assurance as well as potentially improving the efficiency of the audit.

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

In addition to directors providing assurance over internal controls and risk management we would welcome the auditor being required to provide additional assurance over internal controls. The precise nature of such assurance and whether or not it is best undertaken by the external auditor should in our opinion now be considered. Whilst the application of Sarbanes-Oxley is reputed to have worked well for the US audit market, we consider it important that, should the UK adopt a controls assurance approach, it is designed for the UK market's specific needs.

Viability

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

Q18: Should such a statement be subject to assurance?

We support the case for reviewing and reforming viability statements to make them substantially more effective and that if they cannot be made more effective, serious consideration should be given to abolishing them (Independent Review of the Financial Reporting Council – Recommendation 52). Viability reporting hasn't really worked as intended so it is unclear whether requiring a statement beyond that already provided in the viability statement is likely to achieve a meaningful outcome at present. In the Grant Thornton 2018 Corporate Governance Review of corporate governance reporting in the FTSE 350, the quality of viability reporting was reviewed. It was noted that over half of the statements made gave little or no insight into the company's viability in the face of key strategic risks. Statements were often found to be boilerplate. We considered that companies should be bolder in their viability report disclosures to give investors and other stakeholders a true insight to their long-term resilience and sustainability. Bringing the viability statement within the remit of the regulator's Corporate Reporting Review function would be one way to help improve reporting. However, directors need to be encouraged to make meaningful disclosures in the first instance.

We consider that there are significant benefits to the users of financial statements from extending the scope of the external audit to give greater assurance over the viability statement. This would increase user confidence from the fact that these statements had been subject to independent consideration from the auditor and could provide more effective early warning signals of possible company failure. However, some thought will need to be given as to what level of assurance can be given on a statement, the nature of which, is forward looking. Rather than providing absolute assurance on the continued viability of an entity, the focus of the assurance might be on testing the assumptions made by management and testing the linkage between the principal risks and uncertainties facing the business and the scenarios modelled and their potential impact on viability. This is where the use of technology may have an important role. Whilst the audit cannot be expected to detect and disclose all cases of future company failure, it should be able to highlight significant risks to viability.

If the auditor is required to give any level of assurance over the viability statement, or any other forward-looking information, it will be important that the extent of the auditor's responsibilities is clearly established.

Q19: Who might be capable of giving such assurance?

The entity's auditors are likely to be best placed to perform an audit of the viability statement which would result in a separate opinion to that of the audit of the entity's financial statements. The degree of certainty in relation to a viability statement, however, may differ from that of the entity's financial statements and this should be clarified.

Unaudited information

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

A more forward-looking audit would offer better insight to stakeholders and would help to identify any potential issues earlier than the current audit does. That said, prospective assurance has an increased level of uncertainty compared to assurance over historic information, creating greater risk for auditors. If a more forward-looking audit was required, the implications for auditor liability would need very careful consideration and it is likely that auditors would need to heavily caveat their reporting.

Even though there are inherent limitations to forward-looking assurance, we consider that this area of the Review offers an opportunity for making a bold and significant reform to the UK audit product. As such, the Review should, in our opinion, seek to find effective ways to address these limitations if at all possible. If this proves insurmountable, improving the timeliness of historic assurance reporting, through, say, better use of technology to introduce a more 'real-time' basis of reporting should be considered.

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?

We recognise the demand for companies to provide increasing amounts of financial and non-financial information, but we consider this to be potentially at odds with a requirement for the regulator to promote brevity and comprehensibility in accounts and annual reports. We would therefore welcome further research into what information needs to be provided, in particular non-financial information, where it would be best placed, either within or outside the annual report and accounts and the level of assurance that users require in that information.

Some information might be best placed within the annual report and accounts and be subject to audit whilst other elements might be best placed outside of the annual report and accounts and be subject to alternative forms of assurance. However, the objective should remain to ensure that the expectations of reliable and comparable non-financial information (including elements of the remuneration report, gender pay, diversity and inclusion, non-financial KPIs and corporate governance) are underpinned by a consistent and understandable form of assurance. Such assurance would need to be provided under an appropriate framework and regulation.

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

We consider that an exercise to gain a better understanding of what the different users of the financial statements would value assurance over should inform the discussion of what information could usefully be subject to assurance. This exercise should by its nature be targeted at the users of such information.

Chapter 5 – Audit Product and Quality

We are supportive of measures to make the disclosures made by auditors more transparent and more relevant to users of the financial statements subject to clear guidelines and a framework to ensure consistency. We are mindful however of including even more detail in annual reports and the risk of boiler plate statements that do not add value to the users of these reports.

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

In broad terms there is a clear link between the quality of an audit and the effectiveness of the audit process. To be effective an audit must be successful in producing an outcome that provides value to the users of the financial statements. An audit should always be of a high-quality and should provide value to the intended users, investors and potentially wider stakeholders and therefore it would seem that these concepts should not be separated.

However more recently there is a sense that the audit process has become more focused on compliance with regulations, rather than being driven by what the users of the audited financial statements want from the audit. We therefore welcome the Review's focus on designing an audit that meets users' (in the broader sense) requirements.

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

The current binary (yes or no) form of the audit report is limited in many cases where financial statements include areas of significant judgement, with possible ranges of acceptable amounts. A more graduated disclosure of auditor conclusions would potentially permit the auditor to make more nuanced comments about such areas and would permit the user of the financial statements to get a greater context than the current opinion provides. Whilst a more graduated disclosure of auditor conclusions presents a number of challenges where there is auditor judgement and subjectivity, we would support the introduction of such disclosure with clear guidelines of how this should be arrived at and presented.

We welcome the comments of users of the financial statements as to whether they would find a more graduated disclosure beneficial.

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

In our view further transparency and insight into auditor conclusions could and should be given in the audit report. However, this should be led by users of the audited financial statements and their views on how the financial statements and the annual report and the audit process and reporting could be more useful. We are mindful that financial statements can be long, meaning additional narrative should only be required where there is a clear benefit to the users. Auditing standards and legislation have generally constrained the audit process and reporting but this should not get in the way of being able to deliver a product that users want. If necessary, standards and legislation can be amended to reflect this. We therefore look forward to seeing the responses to this call for views, collated from users of the financial statements.

Chapter 7 – The communication of audit findings

We would welcome the opportunity for the auditor to engage more with the users of the financial statements. We consider that the AGM could be an opportunity for the auditor to talk through the Extended Audit Report to stakeholders at that meeting.

In our experience investors are not consistently engaged in the financial reporting of the entity. We consider that they would benefit from greater engagement with the auditor and would welcome their suggestions of how we can work with them to create a more effective dialogue. In addition, we recognise that other stakeholders would also benefit if the audit was more accessible to their needs.

Chapter 8 – Fraud

We consider that there is an expectation gap relating to the auditor's role in the detection of fraud. Whilst we consider that, based on auditing standards, auditors do adopt an appropriate mindset in respect of fraud, fraudulent transactions can be complex and difficult to detect. We are supportive of recommendations to strengthen the independence of audit committees and introduce fixed tenures to further support an environment where auditors can challenge management and are protected against removal by the company.

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?

We recognise the existence of an expectation gap relating to fraud, between what the public and other stakeholders expect an audit to do and what an audit is required to do. Further, given the broad range of stakeholders, the expectation gap is difficult to define. Clarity over the external auditor's role and responsibilities with regard to fraud will be essential, particularly with respect to establishing the role of the regulator and ensuring that they hold auditors to account and judge the quality of their work. If auditors were to be given greater responsibility to detect fraud there would need to be an acknowledgement that issues regarding auditor liability and the cost of these additional responsibilities would also need addressing.

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

In our view, the auditing standards are already written in a way that should create the correct mindset regarding fraud detection. However, as a general observation we would note that in isolation, fraudulent transactions are often difficult to detect. For example, they can build gradually over time and as a result of small and incremental steps. Frauds can also present themselves in many different forms, some of which are easier to detect than others and particularly, fraud which is committed in areas that require judgement may be more difficult to identify.

We welcome the CMA's recommendations for strengthening the independence of audit committees, as this will create the conditions that support the auditor's role in fraud detection through improving the conditions for more effective challenge of management. In addition, we support proposals made by the BEIS Select Committee for fixed tenure of audit appointments, with protection against removal of the auditor by the company, which we consider would also improve the auditor's ability to act 'without fear or favour'.

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

Whilst in theory it is sensible for auditors to report on an entity's systems to prevent and detect fraud, formal fraud protection and detection systems are relatively rare and are more likely to exist in highly regulated entities such as banks and so this proposal may be better restricted to these entities.

Moreover, an entity's ability to prevent and detect fraud is likely to depend on other factors, for example, the culture of an organisation as set by senior management. The integrity of management and potential for collusion are key and these are not necessarily attributes that the auditor is best placed to evaluate.

Chapter 9 – Auditor liability

We consider that where changes to audit involve greater judgement by auditors under a regime of unlimited liability, the auditor is exposed to greater risk. Whilst auditors design their audits to meet the standards, not to reduce liability to some acceptable threshold, limiting auditor liability may facilitate greater transparency and detail of audit work and conclusions in the audit report.

Auditor liability in respect of joint audits should be carefully considered, as joint and several liability could be a barrier to challenger firms in joint audit engagements.

The risk associated with delivering PIE audits is already significant and we consider that changes to liability of the auditor to a wider stakeholder group could increase the risk further and potentially reduce the commercial viability of audit.

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

Currently where there is no cap on auditor liability and a degree of judgement involved in audit reporting, widening the scope of the audit product, with no change to the liability, results in the exposure of the audit firm to greater risk. For work currently outside of the statutory audit, such as fraud investigations and viability reporting for IPOs, it is possible to cap liability and auditors currently carry out such work. We would welcome exploring the use of different forms of assurance with different levels of liability if audit scope was to be broadened.

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

Auditors design their audits to meet the standards, not to reduce liability to some acceptable threshold. We do, however, recognise that limiting auditor liability could potentially facilitate auditors issuing a graduated audit report or sharing more detail about the audit work that they have performed and the conclusions they have reached.

We note that the CMA has recommended the introduction of joint audit as a means of encouraging greater competition and choice in the audit market. Behind this recommendation is their assertion that a more competitive and less concentrated audit market will, in turn lead to improvements in audit quality. However, the issue of joint and several liability could be a significant barrier to entry for challenger firms taking on joint audit appointments and should be considered by this Review, as suggested by the CMA.

In addition, we have commented above that broadening the scope of audit could introduce further liability considerations, as greater reporting responsibilities across a wider range of potentially more subjective areas will inevitably result in auditors needing to protect their businesses.

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?

In the current environment, and even without increasing auditors' liability, the risks of carrying out an audit, particularly in the PIE market, are a significant factor for challenger firms considering their involvement in the audits of large listed companies. Increasing audit liability to a broader range of stakeholders would therefore require significant consideration.

The risks and rewards of carrying out an audit under these conditions would need to be such that audit services remained commercially viable. If the level of audit fees was not increased proportionately to the increased level of exposure to risk, there would be little incentive for firms to operate in the audit market on a meaningful scale. Extending liability could also mean that an auditor is potentially liable to multiple stakeholders for the same losses, in which case arrangements would need to be such that this could not happen. In addition, the product on which the opinion is being provided needs to be fit for purpose for that stakeholder group.

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?

The cost of professional indemnity (PI) insurance is significant, particularly for challenger firms who do not have the same self-insurance arrangements as the 'Big Four'.

We note that the CMA study is exploring the possibility of joint auditors and there is a question regarding liability in these circumstances. Any consideration of PI and liability under a joint audit regime will raise additional challenges and questions to be considered.

Chapter 10 – Other issues

Technology

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?

Grant Thornton continues to make significant investment in technology, which will support transforming improvement to audit quality in the future.

As the evolution of technology is dynamic, it is difficult to differentiate between "old" and "new" technology. Auditors have been taking advantage of emerging technologies for more than two decades, but it has been the last three years where we have really seen the birth of a new digital age for audit. To date, this has not necessarily been driven by new technology as such, but more the optimisation of existing technologies to enable new and better ways to enhance our audit offering.

One big change is that auditors have become much more sophisticated in the way they collect and handle data sets from audited companies – auditors collect much more of company data than ever before and are developing more automated solutions for the capture of this data. Secondly, the data analytics routines that auditors can run are also being widely used, including machine learning routines supporting the analysis of potential fraud in a journal population. In addition, other technologies are in the emerging phase, where auditors are either running pilot projects or working to establish proof of concept.

In terms of technology enabling a higher level of assurance to be given, in certain circumstances, this is possible. For example, the use of technology allows the auditor to analyse entire populations of data and assess the impact of outliers, as opposed to running samples which results in a greater level of assurance. Companies are also developing and deploying increasingly sophisticated technology, and in many circumstances the auditor is deploying new solutions to keep pace with the complexity of the market.

The auditor is now capable of analysing a large data population through the use of technology but this does not replace the need for technical and professional skills needed to challenge estimation and judgement on complex financial reporting areas. In addition, the language of the International Standards on Auditing needs to evolve to reflect possible technological advancements.

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?

There are many different areas in which an auditor could be able to provide assurance and the successful auditors of the future will go to market with a much broader, and more customisable, form of assurance than what is covered by the traditional audit process.

As companies collect and harvest more and more data sets, this creates more opportunity for non-financial assurance. As the level of other information within annual reports increases (carbon omissions and gender pay gap figures being two high-profile examples), the auditor can deploy technology to analyse non-financial data sets much more powerfully and quickly. In addition, machine learning and artificial intelligence could in future allow the auditor to be able to use the data of the past to better predict the outcomes of the future.

Proportionality

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

As businesses evolve so too do the audit procedures within the framework of the auditing standards. The audit procedures that are carried out continue to be relevant in expressing an opinion on the historic financial information. With the continued use of technology, auditors are adapting the way in which those procedures are carried out. We are supportive of measures to consider how greater use of technology can support evolving the audit as businesses evolve.

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?

Some companies will fail irrespective of the quality of an audit. Accountability for corporate failure is wider than the external auditors and includes directors, audit committees and investors. In many cases the external audit is unlikely to predict corporate failure given the number of external variables.

However, we consider that giving greater prominence to the key risks that the business faces and the key assumptions and risks, in particular relating to going concern and the sensitivity of forecasts on which assumptions and judgements are made, would be helpful to users. Whilst the Extended Audit Report has already gone some way to highlight some of the more judgemental and complex accounting areas, this could be achieved through greater transparency in the audit report or a more meaningful statement given by the directors, either of which would ensure that users of the financial statements have a better awareness of the potential risks that could lead to corporate collapse.

Shareholders

In general, our view is that shareholders are better placed to respond to the questions in this section.

However, we would observe that shareholder engagement and stewardship is likely to vary across different types of entity and to consider all shareholders collectively as representing one single stakeholder group may be inappropriate. For example, shareholders in listed entities are very different to shareholders of entities in the mid-market which are typically owner managers. Further, in privately owned businesses auditors often have greater opportunities to interact with the shareholders as they are also part of the management team. It might therefore be appropriate only to apply any potential changes to the listed market.

We would welcome greater engagement with investors in audit and accounting issues. In our response to the BEIS Independent Review of the Financial Reporting Council Initial Consultation on the Recommendations, we have therefore expressed our support for regulator engagement at a more senior level with UK investors. Better engagement with shareholders by audit committees in relation to the auditor appointment process and ongoing review of the provision of statutory audit services is also necessary. We note that the issue of shareholder engagement with audit committees has been addressed as part of the CMA's Statutory Audit Market Study. In addition, the BEIS 'The Future of Audit' report also addresses shareholder engagement including proposals to improve engagement.

Culture

Despite greater focus on corporate culture in recent years by the Financial Reporting Council and the 2016 UK Corporate Governance Code giving culture and values a more central role, company disclosure has been disappointing. This is indicated by the Grant Thornton Corporate Governance Review 2018 which contains some analysis of reporting on culture. The review shows that in 2018 only 33% of companies provide good or detailed accounts of their company culture and values compared to 39% in the previous year.

One reason for the lack of detailed reporting could be that companies are finding culture difficult to quantify and measure. This is an area where the FRC Reporting Lab, for example, could publish examples of best practice, to try and initiate some improvement in reporting.

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

We consider that the basis of individual auditors' remuneration is a matter for the audit firm. However, we acknowledge that ensuring transparency and appropriateness of the basis of auditors' remuneration could form part of the role the regulator.

Cost

Audit professionals are highly skilled specialists with significant expertise and we consider that the pricing of audits should reflect this and reward those skills accordingly.

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

The CMA study on the statutory audit market has made recommendations in respect to ring-fencing the profits of the audit function in the larger firms, which will identify whether the profitability of the audit function is sufficient to sustain a high-quality audit industry.

We are concerned about the sustainability of the audit function, particularly in the event of changes to scope that increase the risk and also the amount of audit work required without an increase in reward.