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Dear Sir Donald,

### **Independent Review into the Quality and Effectiveness of Audit – Call for Views**

Thank you for the opportunity to contribute to your call for views for your Independent Review into the Quality and Effectiveness of Audit, which I am pleased to do here, on behalf of KPMG LLP (KPMG), the UK member firm of the KPMG International network.

### **Audit is critical**

Company audits are the rivets in our economy, binding enterprise to investment. The trust they provide underpins our capital markets. They're part of the structure on which the UK's position as a world-leading business centre is built. Trust in audits cannot be allowed to corrode further – the stakes are too high.

The debate about the future of audit is now taking place at high volume. We – the profession and those who care about its future – have been handed a once-in-a-generation opportunity. We need to look carefully, but with a sense of ambition, at what audit *should* be.

### **A delivery gap or an expectation gap?**

A number of commentators, and most recently the Business Energy and Industrial Strategy Committee (BEIS Committee), have challenged whether the erosion of trust in audit is an expectation gap or a delivery gap. In its Future of Audit inquiry, the BEIS Committee asserted audit delivery gaps in relation to quality generally, fraud detection, going concern and capital maintenance.

In our view there is both a delivery and an expectation gap. We acknowledge that there is a need to improve audit quality and its consistency, in particular in achieving the expectations of the FRC as evidenced by the results of its Audit Quality Review (AQR) inspections. We are making a significant investment in our Audit Quality Transformation Programme and enhancing the governance and performance management of our audit practice to achieve this.

But there are also areas where we believe there are differences in expectation. Some of these derive from an ongoing debate as to the role of financial reporting where some commentators argue that accounting standards, having become more prescriptive, diverge from what they argue is the capital maintenance purpose of the law in relation to financial reporting. This matter needs to be addressed once and for all. But in other areas there are valid questions as to whether audit ‘does enough’.

### **Revisiting the purpose of audit**

We at KPMG believe this is the moment to revisit the purpose of audit in the UK so that it better meets the needs of those who use it today.

With this in mind, audit could go further. Audit could be better at explaining what it does and doesn’t do. It could present with greater clarity how key judgements have been reached. It could embrace more of the opportunities presented by technology. Where there is clear demand from users, its scope could be expanded to offer assurance on other information users need, beyond simply the financial statements at the back-end of the annual report. This expanded assurance could be provided by the auditor or in many cases, by other assurance providers. Most important of all, the audit could provide greater comfort around a board’s statement on the resilience of a business – moving towards the ‘clean bill of health’ which users most desire.

Audit reports are addressed to shareholders – to ensure that those who choose to invest in a company have a view of that company’s financial position which they can trust.

But the fact is that the illumination audit provides for shareholders, spills helpfully outwards for the benefit of other users too – debtholders, customers, employers, suppliers and more. We welcome the opportunity to position audit as a valuable service to a broader group of stakeholders but with a proportionate and workable approach to liability, to ensure a fair division of responsibility and legal accountability between companies and their management/directors, investors and auditors.

### **Greater clarity of accountability and a level playing field are needed**

There is at present a glaring asymmetry in the respective interests and responsibilities of management, the board, auditors and shareholders. The role and authority of the auditor is often overstated, while the roles of the executive management and board are widely understated in the current framework.

Director and board responsibilities and accountability, while set out in Company Law, are often difficult to monitor and demonstrate as operating effectively.

As an example, there is widespread confusion around management and board responsibilities and the level of assurance that audit provides over internal controls. The Sarbanes-Oxley reforms in the US have been largely successful in improving reporting and governance in this area. We should learn the lessons from Sarbanes-Oxley and develop an enhanced model for the UK market to help make the law more operable and strengthen and clarify the position on internal controls and other areas such as fraud detection, which would also benefit from such a regime.

Equally, shareholders have an oversight responsibility under the Stewardship Code and so should be prepared to become more active participants in the audit and corporate

reporting conversation, outside AGMs. Shareholders and other key players need clearer rules around their involvement to promote better engagement and accountability.

Corporate governance and reporting needs a fair and level playing field to restore trust and become fully effective.

There is an opportunity for the new Audit, Reporting and Governance Authority to play a key role in all of these areas, becoming a new form of regulator with proactive powers to drive improvements across all of corporate governance and reporting.

### **We need a renewed focus on resilience**

There are some interventions which would be of clear value. These will require legislative change to deliver a response which is agile and aligned to the needs of capital markets.

The future of corporate reporting is one aspect of this, and the subject of a current review by the FRC. Important components of corporate reporting need to be reviewed and enhanced, notably going concern.

This is especially important in today's global economy where the volatility and velocity of change means businesses can very quickly get into difficulties or fail.

As it stands, the going concern requirements are more prescriptive for auditors than for directors. Yet in practice, it is management and the directors who are responsible for maintaining a resilient business model, not the auditors.

Corporate reporting and auditing should move beyond the going concern concept to focus on business resilience: considering the factors that would cause the business to fail and stress testing those critical assumptions which leave the business model most vulnerable.

We should explore how the resilience of the business model can be assured in a more consistent and effective way. The proposed new Audit, Reporting and Governance Authority should seek to develop a framework for resilience measures – to be identified and reported on by the company but assured through the audit – building on relevant experience such as the stress tests conducted by the banking sector.

However, these necessary clarifications alone would not fix all the problems. It's clear there's an appetite for audits which look ahead, which look at controls and which look into a company's environmental, social and governance reporting; all areas which sit outside the scope of today's audit but which are of keen interest to users.

An effective and long-lasting solution will demand collective action, from every part of the corporate ecosystem.

### **The need for action is urgent, and the various reviews must co-ordinate**

It's critical that the recommendations from each of the various reviews underway are implemented with the others in mind. But there should be no further delay. The message we're hearing from both business and wider society is clear: urgent action is needed. An integrated, holistic approach is essential and bringing the pieces together must be carefully sequenced, delivering a practical and digestible response that doesn't damage needlessly parts of the system which are working well.

We've already pushed ahead where we can. We've changed our own governance – moving towards an operational separation and giving our audit practice more independence — with the aim of reinforcing its focus on delivering high-quality audits.

We've discontinued non-audit services (other than those closely related to the audit) to the FTSE350 companies we audit, a move which the rest of the Big Four have signalled they'll follow. Stakeholders need to be able to see that the audit process is structured, conducted and marshalled in a way which is conducive to delivering a high quality audit. The duty is on us to make ourselves easier to regulate.

We're also working with the FTSE350 companies we audit to understand the appetite for graduated findings in future audit opinions. As recommended by the Independent Review of the FRC, it remains our view that graduated findings should be adopted market-wide for large companies but, as we saw in the financial crisis, comparability and consistency amongst peers is paramount.

We must also be mindful that the UK audit sector is seen as a global leader, attracting business and talent from around the world. All those considering changes must be aware that the impact will be felt internationally. There is a need to engage proactively with global regulators to ensure a joined-up response.

That global scale is a reminder of the value of our wider professional services sector. It is our biggest export and part of the very fabric of the UK economy. In our firm, we've worked alongside businesses and shareholders for 150 years. We are proud of our expertise as auditors and are determined to drive our profession forward.

In the attached appendix we address the specific questions raised in your call for views and we look forward to participating further in your Review as it proceeds.

Yours sincerely,



**Bill Michael**

*UK Chairman and Senior Partner*

## **Appendix – Detailed Responses**

### **KPMG’s Response to the Questions posed in the Call for Views by the Independent Review into the Quality and Effectiveness of Audit**

#### **Chapter 1 – Definitions of Audit and its Users**

##### **Key points:**

- Audit as currently prescribed is ‘for’ shareholders but it is clear that a wide range of other stakeholders derive benefit from it
- Where there is the demand from users, there is scope to extend the audit to enhance the degree of confidence in the entity itself beyond purely the financial statements. But this would entail significant changes to the process, cost base, skill set required and the liability regime and would therefore need to be aligned closely to users’ needs in order of value

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

Audits are the foundation of trust and confidence in our capital markets – providing a bridge between the company and its stakeholders. A robust audit provides a service that matters, both to the business community and to society more broadly.

The IFRS Framework<sup>1</sup> defines the primary users of general purpose financial statements as “existing and potential investors, lenders and other creditors making decisions about providing resources to the entity”. All such stakeholders need to have confidence in the integrity of the financial statements and that can come from the assurance that is derived from the knowledge that an effective audit has been undertaken – both through its ‘exogenous’ effect in terms of the actual audit opinion that is issued but also via a more subtle, ‘endogenous’ effect on how the awareness that there will be an audit can change the behaviour of the entities upon which the auditor is reporting. It is important that this more nuanced point is not lost in discussions.

Under company law, the auditor is accountable only to the current shareholders as a body, yet it is clear that many other stakeholders (be they customers, employees, suppliers or others) derive great benefit and value from the knowledge that a thorough audit has been undertaken, providing confidence in an entity’s financial statements. This review may consider whether there is now justification for broadening the beneficiaries of the audit opinion for the benefit of this wider group whilst retaining the auditor’s legal accountability only to the shareholders as a body.

The ‘needs’ of shareholders (and implicitly the value they derive from an audit) are clearly defined in the form of the auditor’s responsibilities in the Companies Acts and case law and in auditing standards. The challenge is whether the needs of others can be both identified and clearly articulated so that the audit is either designed to also meet them or, where the audit will not meet them, this is explicitly acknowledged. The extension of an audit’s intended beneficiaries would require a proportionate and operable consideration of the auditor’s liability, in order to ensure a fair and appropriate allocation of responsibility is maintained.

Such changes may also require appropriate revisions to both the auditing standards, and potentially the Companies Act.

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

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<sup>1</sup> Conceptual Framework for Financial Reporting, published March 2018

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Confidence in financial reporting is essential to the capital markets and ultimately contributes to a healthy economy. The purpose of financial reporting is to measure, and articulate business performance and events that have occurred, based on a specified accounting framework, in a manner which is informative to users and decision makers. Whilst financial statements are designed to help investors make well-informed decisions, general purpose financial statements have become lengthy and highly complex. For some industries it is questionable whether they remain fit for purpose with many users not willing to read through in detail. This has resulted in a situation where the audit is seen as providing ‘a clean bill of health’ on the entity under any circumstances – an implicit (and mistaken) conclusion derived from the going concern basis of preparation.

The audit, as currently defined, is designed to enhance confidence in the financial statements of the entity and so plays a key role in supporting the capital markets and the wider economy.

However, as implied by the ‘clean bill of health’ assumption, there is a clear demand for the audit to contribute to the confidence users have in the entity rather than just the financial statements, but the financial statements are inherently limited to the extent they can provide this level of confidence. As noted in the IFRS Framework, the financial statements alone cannot provide all the information that users may need to make economic decisions.

We know the market wants more – users need information on the resources of an entity, to assess both the resilience of the business and the prospects for future cash inflows, together with how effectively management has discharged their stewardship responsibilities. Shareholders and investors have told us they want an audit product (or suite of audit and assurance products) that enhances confidence across the range of statements made by a company, both in and around the annual report – not just financial but environmental, social, governance, behavioural metrics, KPIs and alternative profit measures, together with other information presented at investor meetings.

We consider there are two broad ways to achieve this: (i) by extending the reporting scope of the audit as currently designed to opine explicitly on areas which are already generally incorporated within the audit approach or are closely aligned, such as internal controls over financial reporting (ICOFR) and (ii) designing assurance options which can be delivered by an auditor or other assurance provider to meet the demands of the users in respect of metrics outside of the financial statements, that are of use and relevance to the decision making of users. Where a 3<sup>rd</sup> party assurance provider is used for such assurance options, care would need to be taken around areas closely related to the audit itself.

If the audit were coupled with an assurance opinion on an attestation by management or the board in relation to ICOFR, this could provide further meaningful comfort to users over a range of matters, not least the quality of the financial reporting governance process itself but also for example, processes around fraud prevention and business resilience. Such an enhancement, which could draw on the experience of the Sarbanes-Oxley reforms in the US, would generate additional value for users and help to reaffirm audit’s vital role within the capital markets.

An extension of the auditor’s role to include options around the provision of assurance over additional matters, outside of the financial statements, would provide users with a wider level of assurance around the entity than is currently provided from an audit of the financial statements alone. Such assurance could be offered as potential optional additions to the core audit. This would need to be industry specific given differing value drivers (and detractors) and would require broader consultation with relevant stakeholders (not least to confirm that this is something they would require and find useful). It would also be necessary to consider the liability implications to ensure a fair and proportionate allocation of responsibility.

In practical terms however, an audit can never provide users with complete assurance over the entity as a whole – it cannot provide a **guarantee** over the share price for example or that the

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business model is fit for purpose or ultimately that a business will continue – such levels of assurance would be prohibitively expensive and potentially unattainable with a clear risk to the conventionally accepted timelines for delivering timely audited financial information to the users. Ultimately, the directors should continue to be responsible for the business model of an audited entity and the way in which it is run.

### **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?**

UK law currently states that the audit is conducted for the shareholders of the company as a body; and should provide them with an opinion on whether the accounts give a true and fair view for the purpose of the exercise of their governance rights over the company. This forms part of the stewardship reporting requirements by agents (directors) to their principals (shareholders as owners).

Whilst the law as it stands may be clear in this respect, it does not set out what is *not* covered by the audit. The result is that many stakeholders want and believe the audit to deliver much more than it does. We do not believe however, that a solution is to be found simply by amending the wording of the law.

Rather, there is a need to address the unmet demands and needs of the market and this can only be done through an assessment of the purpose of audit as it exists today. If the outcome of this review is to amend or redefine the purpose of an audit; and for whom it is conducted, then the law as currently drafted will need to be revisited to clarify both of these aspects. Changes to the scope and remit of the audit (and its potential users) would require appropriate legislative amendments to reflect any such changes and ensure that the law and accounting standards were aligned.



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### **Chapter 2 – The Expectation Gap**

**Key points:**

- An expectation gap does exist
- Auditors have a responsibility to address it and to help ensure that audit lives up to expectations and/or better explain its limitations. But we cannot do this in isolation, others have responsibilities as well
- In terms of a delivery gap, we must be honest and face up to situations when audit quality occasionally falls short. We are taking steps to enhance quality but we have more to do within our own firm and as a profession

#### **Q4: Do respondents consider there is an expectation gap?**

As we comment in the covering letter, some commentators question whether the current issues arise more as a result of a delivery gap than an expectation gap. We acknowledge that there is a need to improve audit quality and its consistency, in particular in achieving the expectations of the FRC as evidenced by the results of its AQR inspections.

However, we nevertheless believe that an expectation gap has existed for many years — both in terms of the scope of the audit (see responses to Q5) and around its delivery (see responses to Q6). Seeking to close the expectation gap entirely may not be possible; it may be necessary to explore a different paradigm.

The interest in this debate and the existence of the gap itself demonstrates that audit matters to society — people care about a quality audit product and the demand is for audit to deliver more, not less but with the pace of change in technology and the resulting velocity of communication data creation there is significant risk the gap will only get larger if we don't act.

Over time, financial statements and audit reports have expanded extensively in both length and detail. This detail has included increased disclosures around the respective responsibilities of directors and auditors and on the purpose of the audit. At the same time, accounting standards have become more expansive and provide a greater level of specificity of requirements, with one result being a difference in view emerging on the interaction between company law and accounting standards (which we comment on further in response to Q30 below).

As stated in our response to Q2, the length and complexity of general purpose financial statements now means they are potentially increasingly limited in their role and so are not read by many users. Instead, the audit opinion is simply assumed to provide the 'clean bill of health' that users desire and the gap in expectations remains.

We believe the expectation gap is in part a consequence of the asymmetry that exists between the respective interests and accountabilities of preparers, auditors and users of financial information and not a root cause. Unless this asymmetry is addressed the expectation gap may never be narrowed.

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

As stated above, we believe that an asymmetry exists between the respective interests, roles and responsibilities of preparers, auditors and users of financial information. This leads to a gap in expectations and if not addressed, means there will always be a disproportionate response when any business fails. The gap itself can be broken down into a number of constituent parts:



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### i. *Respective roles and responsibilities of participants in the financial reporting ecosystem*

This is an element of the asymmetry referred to above — the role and authority of the auditor is often misinterpreted, whilst the roles of the executive management and board are understated. The ‘financial reporting ecosystem’ operates three lines of accountability:

1<sup>st</sup> line – **management** — with primary responsibility for running the business and the design and operation of controls and reporting

2<sup>nd</sup> line - **board and sub-committees** — with responsibility for oversight and challenging executive management

3<sup>rd</sup> line – **external auditor** — responsible for providing assurance on the entity’s financial reporting

It could be argued that other stakeholders (in the form of shareholders/investors for example), who are required to exercise sufficient oversight in line with stewardship requirements, form a 4th line of accountability. In practice, stakeholders who often have little to no material first-hand interest in the business take false comfort from the audit without recourse to their own oversight role or those of the other lines of accountability.

Furthermore, shareholders potentially do not always act in the long-term interests of the company – in terms of encouraging dividend or capital return policies in excess of what a company can afford or adopting different approaches based upon their own interests (long-term institutional investors vs. short sellers for example).

Each line of accountability represents a critical function that directly impacts the level of trust and confidence in the entity, its reported performance and financial position. So, whilst the auditor clearly has an important role to play in respect of the financial statements, ultimately, responsibility for the viability of the business primarily lies with the management and the board.

### ii. *Confusion over what audit does and does not cover*

- There is frequent misunderstanding amongst users as to what an audit *does* cover and what is meant by certain concepts. In particular, this misunderstanding encompasses:
  - The meaning of ‘true and fair’
  - The concept of materiality, how it is applied and what it means in practice
  - The extent of precision in audit testing
  - The meaning of going concern for financial reporting purposes – and the degree of assurance it gives on business continuity

In some cases above, there is often an expectation that the audit should be more precise than it actually is or can be. In others there is a desire that greater judgement be used, beyond the application of accounting standards.

- Furthermore, there is confusion around what an audit *does not* cover with many users expecting that the audit provides greater assurance on:
  - Business continuity
  - Fraud (other than material fraud impacting the financial statements)
  - Risks
  - Internal controls
  - Systems of governance
  - Compliance with all relevant laws and regulations

This is not an exhaustive list but provides a summary of the items which we believe have led to and sustained a gap between the expectations of at least some users and commentators and the audit as it is currently performed. In our view better explanation of these concepts would help narrow the gap and we would be supportive of measures by

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the regulator to improve public understanding (for example, in a different context, the Information Commissioner's Office 'Your Data Matters' public information campaign). This clarity cannot be achieved by audit practitioners alone.

Just as importantly, the gap can be narrowed further by looking at how the audit can meet more of users' expectations and achieve a wider societal purpose, rather than simply being 'explained away'. The discussion in the following responses around extending the scope of audit, consideration of specific topics such as going concern, internal controls, fraud and other potential areas where wider assurance can be provided, considers this.

### *iii. There is also a delivery gap*

An element of the expectation gap is also caused by a delivery or quality gap. The profession recognises the need to drive an improvement in the consistency of delivery standards and KPMG continues to invest heavily in improving audit quality standards across our audits to achieve this. We discuss the delivery expectation gap in further detail in our response to Q6.

### *iv. Independence and perceived conflicts of interest*

Whilst largely outside the scope of this review, there is also a gap in expectations caused by perceived conflicts of interest in relation to firms providing audit services. KPMG has taken steps to address these concerns through its decision to discontinue the provision of non-audit services (other than those closely related to the audit) to FTSE350 companies.

## **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?**

The audit profession and the audit regulator share an ambition of consistently high quality audits. We understand that we must, as a minimum, meet regulatory standards and we appreciate the perspective our regulator provides on our drive to improve audit quality. The majority of audits are undertaken without significant delivery or quality issues. It is important to distinguish between failures in the audit opinion, which regrettably do happen but are rare, and audit quality issues identified by regulators that, whilst important, may highlight more limited failings against compliance with all relevant auditing standards or regulatory expectations, but that may not call into question the validity of the audit opinion. In the event of such shortfalls our view is that, as well as imposing appropriate sanctions where necessary, the focus should be on understanding why these occur and how they might be eliminated or minimised to an acceptable level, through a culture of learning and improvement.

Furthermore, the bar is getting higher: our own and regulatory expectations on quality and around what is necessary to comply with standards are constantly increasing — this is understandable, and welcomed, in an environment of change, driving a desire for continuous improvement.

In order to drive improvements, auditors need a better model for both defining quality and explaining shortcomings, to enable their significance to be understood.

It is also worth considering whether audit quality in the UK is out of line with that seen internationally. Despite recent issues, the international reputation of the UK profession remains high and care needs to be taken to ensure that any discussion of audit quality in the UK does not undermine either the profession or the regulator and its ability to influence in the international arena.

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### **Chapter 3 – Audit and Wider Assurance**

#### **Key points:**

- A broad range of metrics are subject to some sort of assurance with audit at the ‘higher’ end of scrutiny
- It would make sense to incorporate some areas where ‘assurance’ is provided into the scope of audit – especially where they are quantifiable, measurable and significant to the entity’s viability (for example, risk-weighted assets for banks) but this would have both cost and liability implications that would need to be considered and addressed. There is also an argument to introduce tighter requirements on management and boards to report on certain matters and hold them to account more closely
- Although it might, on the face of it, seem attractive and logical for external audit to be able to draw on internal audit’s findings, regulatory barriers restrict this (appropriately in our view) on the basis that the external auditor needs to take ownership of their own work
- We do not believe that eligibility requirements in and of themselves restrict auditors from focussing on innovation and quality. However, independence restrictions may act as a barrier to entry for new market participants who could bring innovation to the audit

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

Assurance consists of a broad range of services, providing varying levels of comfort to users through commentary, statements or opinions on the reliability or accuracy of a reported matter. Audits of financial statements (as required under the Companies Act) sit at one extreme of this range, providing the highest level of assurance against a defined framework. At the other end of the scale is ‘softer’ assurance over less quantifiable measures such as programme implementation, system changes or compliance-related matters, typically provided privately to companies or their boards.

It is important that the core audit remains an anchor point within the range of assurance services available, but we would welcome the addition of further assurance services either within the scope of the audit itself or alongside it – to better align the audit report with the key value drivers of the business and so the needs of users. In many cases, these additional services need not be provided by the existing auditor (albeit there may be synergies through a single assurance provider) and instead could be provided by a range of assurance providers – based upon most relevant skillset and experience.

Examples of areas where assurance can be provided on quantifiable and measurable metrics include Environmental, Social and Governance (ESG) factors, behavioural aspects of culture, compliance with regulatory measures and certain industry-specific measures such as risk weighted assets in banking or oil and gas reserves for companies in the extractive industries. Assurance opinions over such areas might provide negative assurance or other forms of more limited assurance, rather than a ‘true and fair’ view audit opinion.

Extension of the existing audit to include such information, beyond the core financial statements, would of course, have cost implications for companies and shareholders and so would require their support.

However, in introducing such options, consideration would need to be given as to how the potential for any new, or increased, expectation gap might be avoided.

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### **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?**

There must be a consistent framework for assurance across all industries, but how this is implemented might differ within that framework to reflect the focus and priorities of specific industries.

It is difficult to envisage the level of assurance being different for different companies operating within the same sector, as that would undermine the consistency of the audit product. The framework governing the audit product needs to be reliable and provide benchmark standards that all auditors adhere to.

Nonetheless, insight and confidence for audit users could be enhanced through means such as graduated findings in long-form audit reports which allow users to develop a deeper understanding of specific matters affecting the financial statements and their associated risks.

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

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

The independent roles and responsibilities of internal and external audit are perfectly clear. There are regulatory requirements (in the UK, but also in other jurisdictions), restricting external auditors from utilising internal auditors' work and using internal audit in a direct assist capacity.

These restrictions reflect the independence of the different elements of the financial reporting governance framework work (see responses to *Q5 - the three lines of accountability above*).

So, whilst internal audit can certainly inform effective risk assessment by the external auditor, given the importance of the external auditor taking ownership and responsibility for the work underpinning the audit opinion, it is difficult to envisage scenarios where significant effort is being undertaken on behalf of the external auditor by internal audit.

That said, it may be worth exploring whether internal audit could publish its own conclusions. At present the internal audit function does not provide any form of public reporting (unlike the Chair of the audit committee and the external auditor). Such reporting, for example, could include commentary or an opinion on the control environment of the entity. This would be of value to the users of the annual report as, given the far wider scope of internal audit, beyond the financial controls that are relevant to the external audit, it provides a deeper perspective on the overall control environment.

### **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?**

Objectivity is the cornerstone of the audit profession and independence is critical to this – it provides the auditor with a licence to operate and enables an audit to be conducted with integrity and in an objective manner. Furthermore, it provides users of financial statements and the audit with confidence that the end product has been produced by a firm which is trustworthy and robust.

KPMG treats the requirements around auditor independence very seriously, taking great care to ensure it is, and remains, independent of the companies it audits.

These requirements have not hindered our ability to make major investments in audit innovation, such as the development of technology-led processes and the use of company-specific industry

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data and highly skilled people in the field. We provide further detail of the ways in which innovation has informed our audit approach in our response to Q28.

Eligibility requirements for external audit only permit professionally qualified independent auditors to undertake statutory audits. This restricts potential market entrants, such as software and data companies from participating in the audit market. Such companies may be able to develop and provide valuable assurance through innovative means but the independence considerations arguably impact them to a greater extent than existing audit firms. That said, the interpretation of such data as it relates to the specific situation and in informing any assurance or judgement relating to the financial statements remains a fundamental skill of the auditor requiring significant training and experience which are difficult to replicate.

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### **Chapter 4 – The Scope and Purpose of Audit**

#### **Key Points:**

- Expanding audit's scope and purpose may not be universally supported but may help to meet increasing demands from a growing number of users. However, any additional assurance requirements must be strictly defined and frameworks provided against which to measure them. And all expansion to scope will need to be mirrored in amendments to the liability regime
- We also need to assign responsibility and regulatory accountability to all participants in the reporting ecosystem – especially senior executive management
- We are supportive in principle of more public reporting of auditors' views on internal controls
- The going concern requirement of an audit has been somewhat of a 'backdoor' on regulating management. We believe the time is right to make an explicit requirement around disclosures and, within that, to review whether elements such as the materiality threshold and binary nature of the auditor's statement are appropriate
- Viability statements have not met the need they were intended to satisfy and should be reformed. We need a clear framework that focuses on business resilience – on the risks and matters that can threaten the survival of a business. The directors should be accountable for this statement and it should be subject to a meaningful level of assurance. The auditor is well-placed to provide such assurance but other assurance providers could also play a valuable role
- We also believe there is a case for elements of the audit to be more forward-looking. This would mean bringing certain measures that are currently not subject to audit into its scope such as key value drivers (or performance indicators), metrics relevant to particular industries (risk-weighted assets for banks for example) and ESG measures which could make the audit more informative, especially in terms of business resilience and sustainability

#### **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?**

In short, yes – and there is a strong case for the UK introducing a requirement similar to the US Sarbanes Oxley regime on internal controls adapted and enhanced to the specific context of the UK, whilst learning the lessons from other jurisdictions.

But there is a need to consider exactly what such a statement would comprise, and whether and the extent to which it should be subject to audit.

Our view is that it is appropriate that this matter is being reviewed again now as there has not been any significant debate on this since the 'Review of the Turnbull Guidance on Internal Control' in June 2005. Back then the consideration was whether the UK should follow the US and introduce a more explicit statement on the effectiveness of internal controls (Section 404 of the Sarbanes-Oxley Act ('SOX 404')).

At that time this was rejected as it was felt that management's assessment of internal controls covered both financial and operational risks and controls, and that the concept of 'effectiveness' would not be meaningful for public reporting purposes when considering many operational risks. Conversely SOX 404 only covered internal controls over financial reporting. In addition, at that time, there was significant negative media comment about the rule-based nature of SOX 404 and the significant cost entailed in implementing the requirements.

Since then, many studies have been undertaken on the impact of SOX 404 on investor confidence in the US capital markets and these are overwhelmingly positive. In contrast, the Turnbull

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statement does not have the same direct attestation strength that SOX has – it is weaker and does not provide users with positive assurance from the directors.

However, tightening controls over financial reporting alone will not address the public disquiet around corporate failure. There may be more benefit in focussing on the propriety of published non-financial information. The emphasis of SOX 404 on internal control over financial reporting ignores many of the operational and compliance risks and control activities that companies face that may well pose much greater risks to shareholder value. This will need to be carefully managed to avoid ‘false assurance’, with the current UK approach under Turnbull, of directors looking at a wider range of controls, beyond financial controls, being retained alongside any new more formal ICOFR requirement.

We would expect that this requirement should be linked to BEIS’ consideration of which entities should be regarded as PIEs but as a minimum should include FTSE 350 listed entities, given these are publicly owned and have significantly distributed ownership, creating a greater need for confidence in these entities within the capital markets.

Directors should be assigned responsibility and regulatory accountability for their attestation on internal controls. Assurance would provide confidence in any statement that directors will have to make. But it would entail increased cost, so this should be a matter for investors (or the regulator/legislators) to decide whether this would be outweighed by the benefits that are gained.

If an assurance requirement is put in place then the UK standard setters should be innovative in respect of the process that auditors need to follow. Lessons can be learnt from the US experience and the assurance requirements could be more principle-based and take account of advances in technology, whilst leveraging resources and training already in place.

We look forward to participating in a wider and more detailed study to ensure that an appropriate solution that meets the needs of relevant stakeholders is achieved.

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

Many people already believe that the audit opinion implicitly provides assurance over the system of internal controls; in law, it currently does not. There are occasions when a Key Audit Matter around systems is included in the long-form audit report (LFAR) but this is not always the case. We would welcome constructive engagement with standard setters to provide clarification in this area in order to address the needs and expectations of users.

If a decision is made to extend the auditors’ responsibilities in this area, they could only be extended if there was also an equivalent formal extension of managements’ responsibilities.

### **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?**

We would support including more on the effectiveness of internal controls over financial reporting in the LFAR in those areas that are covered by Key Audit Matters. This would tie in with our support for graduated findings. This broadening in public reporting should, however, be linked to an extension of the requirements for management to report on internal controls over financial reporting as discussed in Q12 above. It will be important to ensure there is sufficient transparency around the work of the auditor in this area in order to ensure users’ expectations are met.

If the auditor were required to consider management’s assessment of internal controls over financial reporting, then this would naturally result in more public reporting. We would support the



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auditor's report on this work following the same concepts that have been introduced with the LFAR over the financial statements, i.e. that the auditor's report over financial reporting includes detailed findings on internal controls.

### **Going Concern**

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

The regulatory framework seeks to draw attention to material uncertainties as to the appropriateness of the use of the going concern basis of accounting in the financial statements. This is at the very heart of the expectation gap and links to the issue that the viability statement was also seeking to address.

In our view, we consider the framework for achieving this to be inadequate. The current requirements sit primarily in auditing standards rather than specific enforceable requirements being placed upon directors or management of companies themselves. In practice, the directors and management are the ones primarily responsible for maintaining a resilient business model and assessing, mitigating and reporting the associated risks. This is especially important in today's global economy where the volatility and velocity of change means businesses can very quickly get into difficulties or fail.

There is currently very limited disclosure of which risks may affect the ultimate resilience of a business and so impact the viability and going concern assessments. If companies were required to disclose the key assumptions and financial range of reasonably possible outcomes on a given risk (including low probability, high-impact risks) that may affect going concern, then this would provide much more meaningful information to users. We recognise that this would need thoughtful implementation, with consideration of practicalities in its application to different industries but we consider that it is essential for users to understand properly the risks impacting the business.

The FRC is currently proposing a major change in auditing standards in respect of going concern with many knock-on (but indirect) effects for what companies must do. However, it is not proposing any new requirements on companies (or directors and management) themselves, which we consider essential to ensure a fair and proportional allocation of responsibility.

Historically, the response to going concern issues has always been to use auditors and auditing standards as an indirect route to requiring actions of companies themselves. We consider it is time to address this through the setting of going concern requirements for companies and their officers, including attestation around the key disclosures discussed above. We consider this to be fundamental and are making separate representations to the FRC consultation in this regard.

#### **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”?**

Yes, as discussed above, we consider enhanced financial statement disclosures on the risks, events and conditions impacting going concern to be an essential addition to the requirements and responsibilities of directors. Specific suggestions on what should be disclosed to improve transparency are included in our response to Q15 above and also in our response to Q17 below.

In respect of any such disclosures, there are some points to note which arise from definitions within auditing standards:

- If there is a material uncertainty around going concern, are the company's disclosures clear enough? Auditors pay considerable attention to these disclosures to make sure that

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the company is transparent and direct in its disclosure but the requirement on directors to make such disclosures needs to be reinforced

- In considering the above, is the threshold for material uncertainty too high? In the instance of going concern which is clearly a vital consideration, it may be appropriate to consider changing the word 'material' to something indicating a lower tolerance threshold.
- Is there a difference between a material uncertainty and events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and if so should the latter also be disclosed? We believe ISA-UK 570 (the relevant UK auditing standard governing going concern) leads to confusion on this point which should first be clarified

More fundamentally, it is necessary to decide afresh what financial statements and/or annual reports should say about going concern and why. The going concern assessment, included within the financial statements, should provide more than the current binary statement on a potential going concern problem. As well as narrative and quantitative disclosure on the risks and their impact, it may be beneficial to include graded disclosure about the level of such risks.

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

Yes. Viability statements have not met the need they were intended to satisfy and there is a need for change.

Discussion on the sustainability and resilience of the entity's business model is of clear interest and value to users and so we would support an extension of what directors are currently required to disclose (as discussed above), to incorporate a broader attestation on business model resilience and sustainability under a range of stress scenarios. This should incorporate disclosures on a resilience assessment undertaken by directors, including reverse stress tests and other measures designed to 'break the business model' together with the range of potential outcomes which would cause the entity not to be viable.

### **Q18: Should such a statement be subject to assurance?**

We believe such a statement by the directors should be subject to assurance – it is arguably already a key contributor to the expectation gap in that many users assume that the existing audit opinion covers business model resilience (the assumed 'clean bill of health').

The challenge is in determining what form such assurance should take and under what framework. Broadening the current viability statement into a statement on business model resilience could be akin to a working capital statement. Such a statement would need to be supported by a significant amount of detailed data, assumptions and projections by management which in turn would need to be validated in order to provide assurance (to a meaningful level of comfort). It is important not to underestimate the amount of work this would involve and there would be a need to consider the cost/benefit equation of such an exercise. These matters warrant further consideration and our view is that it would be helpful if this Review were to consult specifically on them.

### **Q19: Who might be capable of giving such assurance?**

A range of assurance providers, including the auditors, could feasibly provide assurance on such a statement – whilst the skillset required potentially goes beyond the remit of the core audit team, the capabilities already exist within the audit firms (and there would be clear synergies with the audit). A potential challenge exists in that it is difficult to envisage a situation where the auditor

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provides an opinion on the financial statements and a different assurance provider provides a separate opinion on business model sustainability – particularly as a negative opinion on the latter could have significant implications on the former.

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

This is a key question in the context of the role of the audit alongside that of institutional investors and other advisors. We believe there is a case for elements of the audit to be more forward-looking. In our discussions with institutional investors, some have commented that they would find this useful (although others indicated that they rely on the auditors to provide assurance on the historic position as a starting point, so that they can form a view themselves on the future prospects of the business).

The primary benefit to a more forward-looking audit would be the inclusion of value drivers (and detractors, for example in the form of future risks) within the scope of assurance provided by the auditor. The current audit is largely focused on assuring the historical financial performance and position of an entity; that is it provides a true and fair view of its financial position at a point in time and the results for the period ended at that point. This is the principal role of accounts, and often provides the base data for company valuation. However, valuations depend on a company's future prospects – either through upside growth or downside risk. It is important that these two purposes do not become confused.

Making elements of the audit more forward looking would also go some way to addressing elements of the expectation gap – there is a view amongst some users that the audit opinion currently provides assurance in relation to resilience of the business to future shocks, sustainability of the business model and associated distribution policies – all areas not covered by the current opinion but areas where further assurance could potentially be provided.

As with other aspects of the current audit (and potential amendments to the audit, considered elsewhere in these questions), in order for the auditors to provide assurance over forward-looking items, management and the board would need to take explicit responsibility for the production of such information.

Risks associated with such a change would be a potentially significant increase in audit costs – driven not only by the extension in the scope and scale of work required but also to reflect the risk premium associated with such work – future-based risks and value drivers are inherently more uncertain than historically reported financial information and so the level of work and potentially the associated liability regime would need to reflect this. At least some of the capabilities required to undertake this work already exist within many multi-disciplinary audit firms. However, this might not be the case were audit practices to be formally separated from advisory businesses in the future. We also consider this introduces risk to the conventionally accepted timelines for the production and delivery of audited results at the year end. To facilitate provision of assurance over complex forward looking measures in the same timelines as the core audit has the potential for delaying results announcements which must be balanced against the benefits obtained by investors from such reporting.

### **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?**

Bringing such information into the scope for external assurance would naturally act as a check over the reliability of such information as it ensures independent validation/verification. There will always be some element of assurance that can be provided but the extent of validation possible,

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and therefore the level of assurance that is reasonable to be achieved, will have an impact on the timeliness of reporting and varies depending on the measures themselves and would also be contingent on the industry in question.

This Review should consider the needs of the relevant users of the annual reports by industry sector and existing reporting requirements which differ between listed and unlisted companies.

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

Information that might be usefully subject to audit or assurance should correlate with the focus of the users of the annual report and measures that are relevant to their decision making. We have discussed some potential additional metrics in our responses to Q2 above. Which measures are most relevant will vary by industry sector, examples of which include, risk-weighted assets for banking entities, regulatory capital measures to the extent they are disclosed in the non-audited section of the annual reports, information around reserves for oil and gas entities, ESG reporting and any related/similar disclosures on sustainability metrics.

We also consider to the extent companies in the future start reporting cultural metrics (such as quantifiable measures of employee behaviour) that some form of assurance on such cultural metrics, to the extent they are objectively derived, is appropriate.

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### **Chapter 5 – Audit Product and Quality**

#### **Key points:**

- The value and quality of the audit product is inevitably linked to the audit process itself. Users must have confidence in both, if trust in audit is to be restored
- Auditors should provide more narrative, moving away from a binary opinion to a more graduated disclosure. KPMG pioneered ‘graduated findings’ and is very supportive of further developments to enhance the quality and depth of narrative reporting
- We do not believe that audit is entirely ‘producer-led’ as there are many initiatives aiming to bring stakeholders together, but more could be done on this
- On occasions, innovation and development has been stifled by the companies that are audited, especially in instances where they have not been mandatory

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

It is possible to consider the two aspects separately, but there is a clear dependency and linkage between product and process. A high-quality audit (from which users should derive value) is usually the end product of an effective audit process. Whilst it is possible for an auditor to arrive at an appropriate audit opinion with deficiencies in the process along the way, trust in the audit profession can only be rebuilt if users not only value the quality of the end product, but also have confidence that it has been delivered through the implementation of an effective process.

#### **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?**

There is a balance to be had. We appreciate the feedback that the regulator gives us and the perspective of this ‘second pair of eyes’ is valuable.

The timely documentation of an auditor’s thought process on a specific risk area helps the auditor ensure that the risk has been adequately understood and that the audit procedures performed fully cover the risk.

In addition, the discipline around ensuring good documentation helps to facilitate a high standard of review of the audit work by other more senior team members and the engagement quality control reviewer. However, increased emphasis on audit file completion and documentation may carry the risk that the senior team is able to spend less time focusing on the significant risk areas.

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

The core concern about audit reports, raised with us by institutional investors, is that they present a binary view of whether the accounts do, or do not, provide a true and fair view of a company’s financial results and position. This is a concern that we believe the audit profession must address.

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In our view it is increasingly important that auditors report their views on the key judgements and estimates made by companies in preparing their accounts. We have long championed more insightful auditor reporting such as graduated findings, an approach we have road-tested over the past five years. Based on feedback from institutional shareholders, this is something they value.

Graduated findings involve the auditor giving a view on management's own judgements on areas subject to particular estimation uncertainty or areas of judgement within the financial statements. They provide a year-on-year comparison of how balanced accounting estimates and judgements are. Instead of merely expressing the results of audit tests in terms of 'acceptable' or 'unacceptable', graduated findings provide shareholders with a more nuanced understanding. For example, estimates within a range might go from varying degrees of 'optimistic' to 'cautious', with a 'balanced' mid-point.

We believe the best outcome for the capital markets would be for 'graduated findings' (or an appropriate alternative) to be adopted industry-wide, with a common set of standards. This would allow comparability and maintain a level playing field between audited companies.

However, whilst welcomed, even graduated findings must be viewed with some caution. Inherently they are themselves judgements about the position taken by management (itself a judgement) reflected in the accounts. Even the range of outcomes, which the auditor uses to assess where in the range the position taken by management rests, is itself a judgement. So the auditor's view is exactly that, a perspective which may be different to that of management but is not automatically 'right'.

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

Yes. Further narrative alongside the opinion would provide more information and insight. Under the response to Q35 below we have provided some examples of matters on which the auditor could provide further commentary.

### **Q27. What would prevent such disclosures becoming boiler plated?**

Whilst there is always a risk that longer-form narrative becomes stale over time, inherently a number of the potential additions discussed in our response to Q35 (extent of reliance on controls, culture, unadjusted and adjusted audit differences, audit firms reporting on quality matters specific to the audit) are specific to that period's audit, thereby limiting the risk of disclosures becoming boiler plated.

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

We do not fully agree that audit (including standards-setting) is now producer-led. Significant work has been undertaken over the last few years with the introduction of the Monitoring Group, the Public Interest Oversight Board and the International Auditing and Assurance Standards Board (IAASB) Consultative Advisory Group, to ensure that the IAASB is developing auditing standards that meet the public interest. However, more could be done, and indeed should be seen to be done, in this area and the Monitoring Group is currently reviewing the standard setting process.

At the same time, there has been innovation and development for the benefit of users, the prime example of this is the LFAR. KPMG's graduated audit findings would be another case in point.

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Conversely, whilst there has been significant investment in innovation by the firms (especially in the area of data & analytics) that has helped to improve audit quality, the current auditing standards do not encourage innovation or the development of the audit product. It is sometimes difficult to link the audit work that can be performed using data and analytics with the requirements of the auditing standards. One key area is the nature of audit evidence as we have moved from a world of hard-copy third-party evidence to electronic audit evidence. The IAASB has been seeking views on this and the ICAEW is working with KPMG and others to consider the potential development of a common data analysis platform to be used by companies which will facilitate a more effective audit and assurance process.

In addition, for many companies, the auditor now has the ability to analyse 100% of the transactions in a specific transaction stream within an entity's financial reporting system. This means that the auditor could do more than is currently required under auditing standards, especially in the detection of fraud. Refer to Q36-39 in respect of responses on the topic of fraud.

It should be noted that innovation and development has sometimes been inhibited by the companies that are being audited. The push to have more granular audit finding in LFARs has not been embraced by a number of companies and some companies have resisted giving auditors access to download 100% of their financial transactional data. This reflects a reluctance on the part of some companies to share data on potentially sensitive matters.



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### **Chapter 6 – Legal Responsibilities**

#### **Key points:**

- Clarity is required in respect of auditors' responsibilities regarding compliance with laws and regulations in areas which do not directly impact the financial statements
- Company law and associated application guidance can be complicated in defining realised profits and hence distributable reserves

**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?**

The field of laws and regulations is very wide. Almost anything that a company does is subject to some law or regulation, from health and safety to environmental, product liability, intellectual property, market abuse, competition, to tax law and company law on distributions.

The current auditing standard (ISA-UK 250A) recognises that it is not feasible for the auditor to be an expert in all of those fields of law and so to perform whatever procedures are necessary to obtain reasonable assurance that the financial statements are not materially misstated by the omission of the financial consequences of any non-compliance. It does this by dividing laws and regulation into direct ones (i.e. those with a direct impact on the financial statements such as tax law and company law on distributions) and others, being most of them, with only an indirect impact on the financial statements. For the indirect ones the scope of the audit is in fact limited to a short list of particular procedures specified in the standard (for direct ones the audit is full scope).

That limited scope is part of the expectation gap. Should it be closed by moving to full scope for all laws and regulations? That would be practically very difficult for any auditor to achieve and it may be that this is one part of the expectation gap that can be addressed only by a public education programme. If there is demand for assurance over compliance with law and regulations in a particular area (or a small number of areas) then consideration could be given as to the level of assurance possible and how this might be achieved. However, an ARGA consultation on where the direct-vs.-indirect divide should lie would be a means of achieving some clarity and public understanding as well as clarifying and perhaps moving the dividing line to some degree.

**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?**

There is no actual inconsistency: the law requires that whatever profits are booked under accounting standards should be classified as either realised or unrealised, with only the former being distributable.

However, as the Competition and Markets Authority (CMA) notes, *"We heard from two respondents that the current audit framework, particularly the accounting standards, is failing to deliver a key purpose of audit assessing whether the company's capital is properly protected.....This particular submission on the purpose of audit has been subject to significant legal analysis in recent years. It seems unsatisfactory that what appears to be quite a fundamental question about the purpose of audit as required by the Companies Act 2006 can be subject to*

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*such debate and difference in legal opinion*<sup>2</sup>. We agree that this matter needs to be addressed once and for all by Government.

Further, there is a perceived inconsistency around which accounting profits can be reasonably treated as realised. TECH 02/17 BL (Guidance on realised and distributable profits under the Companies Act 2006) is often difficult to interpret and concerns have been expressed that it can be too accepting of some accounting profits, such as accrued income, as realised. Greater clarity and any necessary change would be achieved by reopening and revising this guidance, especially as the subject attracts wider interest now than when much of its principles were settled through consultation over ten years ago. However the law on the basis for calculating what can be distributed needs consideration — for example, would some form of pre-defined solvency basis be a fundamentally better approach in determining the level of dividends which could be paid? This would be a matter for Government again. Any such change aside, under the current regime, confidence may be increased if the new regulator were to take over the distributable profits guidance from the ICAEW and undertake the consultation on its revision.

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

If shareholders want it, yes.

However, we envisage a complication in that whilst those calling for it want a group figure, distributable profits in UK law are assessed only at the individual company level; a group figure is not legally meaningful nor easily arrived at. Therefore, it would be necessary to agree a way of deriving a figure for the maximum that could be drawn up from subsidiaries and paid out, taking into account legal, regulatory, banking covenant, liquidity and commercial restrictions. We consider this is a matter that the regulator should consult on in order to ensure that a consistent and practical measure for determining distributable profits is put in place.

### **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?**

With regards to the adequacy of accounting records, there is no explicit additional work that auditors undertake (and no requirements within auditing standards to do so).

Rather, a conclusion on accounting records is a by-product of all the work auditors undertake on a company's accounts. It would be impossible to produce a set of true and fair accounts if the accounting records were inadequate. Therefore, there should be no need for explicitly different work to form a conclusion.

We note, however, that there are two common misunderstandings concerning accounting records: firstly, the requirements do not apply to the entirety of a group and its subsidiaries but to the parent company only; and secondly, the requirements are not about controls over the systems, but only about the records that are the product of the systems.

Our view is that the existing statutory requirements are sufficient in ensuring that the audit provides the requisite level of assurance over the adequacy of accounting records given that the audit work is directly performed over the accounting records. However, in order to address the second concern (and as set out in our response to Q12), we would support a separate attestation by the board (which would be subject to audit), on the entity's system of internal controls over financial reporting (which would incorporate those controls over creation and maintenance of accounting records), and this might also be on a group basis.

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<sup>2</sup> CMA Audit Market Study Update Paper, Appendix C, paragraphs 18-21.

## **Appendix – Detailed Responses**

### **Chapter 7 – The Communication of Audit Findings**

**Key points:**

- More dialogue, engagement and transparency on audit findings would be helpful
- Dialogue and engagement on audit findings should be led by the company concerned and include the auditor and relevant stakeholders
- Whilst an annual meeting might be an appropriate forum for such dialogue and engagement, 'out-of-cycle' meetings could be useful in helping to shape the audit to serve users' needs
- We are supportive of being more transparent around the judgements behind the audit opinion and of more narrative explanation in the extended audit report. We pioneered the use of 'graduated findings' and we believe this is a foundation to build on

**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?**

As a principle, we welcome more dialogue and engagement with the users of audit reports. But it is important to be clear on who those users are. As discussed in Q1, related to defining the users of the accounts and, by extension, to whom the auditor is responsible, our statutory duty is to the shareholder body although we recognise that other stakeholders have an interest in and take comfort from the fact that financial statements have been subject to audit. However, it would be impossible to predict the needs of all users unless such stakeholders and their needs were properly defined. For the purpose of addressing this question, we believe the starting point should be that the 'users' are the shareholders.

Whilst we strongly endorse the principle of more dialogue, there are practical challenges associated with ensuring appropriate access for all shareholders given the requirements to ensure a level playing field, enshrined in the relevant regulations governing information being released to investors. Such dialogue should also not extend the auditor's liability beyond that associated with the issue of the audit opinion.

It is important to focus participation on those shareholders with valid interests and the discussion on those areas of relevance to the auditor. We consider such interaction should be led by the company and be tri-partite between the company itself, the auditor and the relevant stakeholders.

In terms of more dialogue with wider stakeholders (beyond the shareholder body), we believe this could present significant challenges given the potential list of such parties could be quite long depending on the nature of the company.

We consider that out-of-cycle meetings, potentially at the planning phase of the audit, involving shareholders, audit committee and the auditor to ensure investor views are understood and factored into the audit strategy (or to explain why the audit cannot respond to certain concerns) would be helpful.

Another option would be to publish the annual report (and hence audit report) at the same time as annual results are announced to the market and offer the opportunity for investors to question the auditor within the associated investor fora.

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### **Q34. Should more of the communication and resulting judgements that occur between the auditor and the audit committee be made transparent to users of the financial statements?**

Yes, we consider this to be appropriate and helpful in explaining the audit process and judgements to the users. More communication would be helpful in terms of bridging any expectation gap and also enabling users to make better informed judgments on the back of the audit report because they should be able to understand the limitation and scope of an audit and the rationale for conclusions.

We have taken steps in this direction through the introduction of graduated findings in our LFARs and are promoting the inclusion of graduated findings for our FTSE350 audits in 2019. This is how we have reported our findings to audit committees for many years, including commentary on internal control testing and its impact on our audit. In our submission to the CMA's statutory audit services market study's invitation to comment in 2018 we argued that requiring graduated findings to be provided in all audit reports would be an effective and proportionate way to help close the expectation gap, strengthen the quality of audit and thus increase stakeholder and public confidence in the audit profession. In order for this to be consistently applied and effective, it would need to be mandated within a regulatory framework.

We would like to see graduated findings evolve into a narrative report with greater description of the audit work, consideration of challenge and judgements made in arriving at the conclusion.

We consider disclosing a summary of audit differences (errors identified by the auditor that are either corrected or uncorrected by the company in the final financial statements) could also provide more colour in respect of the story of the audit.

### **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?**

Key audit matters are likely to remain broadly static year on year although we do have a policy of explaining changes to such matters from previous years in our LFAR wording - this further makes the case however for graduated findings, which can aid the dialogue and challenge underpinning judgements.

Other enhancements could include:

- Disclosure of unadjusted and adjusted errors (as explained in our response to the previous question) –whilst potentially challenging to implement in practice, this would assist users in their understanding of the audit process, the level of precision applied and the quality of management's process for preparing the financial statements. The number and nature of audit differences would also provide an indication of the overall quality of financial controls.
- An option to explore two different audit reports, a shorter form focussing on the outcomes of the audit and a longer-form narrative report - This reporting format already exists in some other jurisdictions. The longer-form report could add more context and colour to the audit including key judgements and challenges. There could be different time frames associated with the publication of these reports.
- Narrative explanation relating to viability and going concern - This could be further enhanced and KPMG has already taken steps in respect of the latter by including reference to the specific risks and factors we considered whilst arriving at our conclusion in respect of going concern for our 2018 year end audits. To the extent that management and the board were required to make a formal public attestation on viability and going concern, commentary and/or an opinion on this could be provided in the long-form audit report.



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- Internal controls commentary - Further to our previous responses on internal control matters, additional commentary could be usefully added to include areas where we placed reliance on internal controls and our qualitative views on that topic. As discussed previously, we support exploring the adoption of a framework similar to the US SOX404 regime.
- Fraud/anti-fraud controls and associated cultural matters - Any extension of the audit scope to explicitly consider fraud, controls to prevent fraud and measurement of behavioural metrics, being key indicators of fraud risk could be reflected through enhanced commentary in the audit opinion.
- 'Front end' KPIs and other non-GAAP metrics - To the extent that audit or assurance is extended to cover other aspects of the annual report, the audit report could include commentary on findings on these other metrics.
- The outcomes of internal and external quality reviews in respect of the specific engagement (AQR or peer reviews) and the response to these.

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### **Chapter 8 – Fraud**

#### **Key points:**

- Auditing standards should be improved to provide better definition and communication of what is material in the context of auditors' role in fraud detection and to promote a fraud-detection mindset
- While there is scope to do more around fraud-detection by external auditors, complete eradication of any risk of fraud is not achievable, especially if it is highly sophisticated and/or involves collusion
- Requiring directors to make a statement on fraud alongside internal controls under a regime similar to the US Sarbanes-Oxley rules referred to in Chapter 4 would be a useful step forward
- As with other potential extensions to the scope and purpose of audit, doing so in the case of fraud would need to be considered carefully, aligned to users' needs, require a clear framework and reflected in the liability regime

**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?**

The auditing standards' basic framework states that it is incumbent on the auditor to plan its audit so as to have a reasonable prospect of detecting material fraud. However, there is an expectation gap concerning what constitutes a material fraud and crucially, the distinction between fraud and other illegal acts (non-compliance with laws and regulations). This can lead to a divergence from users' expectations where there may have been an assumption that auditors should have detected a fraud, unrelated to the financial statements (for example, reporting of vehicle emissions by the automobile industry) or otherwise committed outside of the company's books and records. Better definition of what is material and relevant in the context of fraud would be helpful as auditors are expected to detect material fraud but that is potentially unclear to users who may apply a much lower materiality threshold to fraud and fraudulent acts over other items.

The audit of illegal acts other than fraud is the subject of Q29. As regards fraud, the expectation of users is that the auditors will find material fraud but that is not always realistic, particularly where the fraud is highly sophisticated and/or based on collusion between senior management.

Any extension in the expectations of the auditor in respect of fraud detection could have significant cost implications and would require additional, specific procedures in order to meet higher expectations.

These could include:

- i. specific fraud-related tests to a lower level of materiality;
- ii. consideration of culture-related metrics and measures; and
- iii. greater use of technology driven testing of entire data sets.

However, it is crucial that any enhancement to the auditors' responsibilities with respect to fraud must also be coupled with an internal controls attestation framework, which would include anti-fraud controls.

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Furthermore, even with an extension to the auditors' responsibilities in relation to fraud detection, we would recommend the entity's own lines of defence against fraud are given formal responsibility for reporting on fraud prevention and we outline some suggestions below:

- There is frequently confusion amongst users over the roles of internal and external audit with respect to detection of fraud. Internal audit could have a formal role in fraud detection and could report on such in the annual report.
- Further, the audit committee has an important part to play in ensuring fraud risk identification and mitigation, as well as fraud detection, are given appropriate focus within the company and this should be explicitly considered in the audit committee section of the annual report.
- Finally, there is a key role for the entity's whistle blowing function, which is very often a source of fraud detection.

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

Whilst the auditing standards have the right basic framework, they are not particularly detailed or specific in defining the auditor's response to fraud.

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

We consider that this would be difficult in practice. In order to do so, it would be necessary to clearly define what type and scale of fraud the auditor could reasonably be expected to detect. It would also need to consider limitations on the auditor's realistic ability to detect fraud – either through management collusion and/or deliberate withholding of information. Finally, the application of hindsight in the event of fraud will always make such a test difficult to apply.

However, as outlined in our answer to Q39 below, we do believe that there is a role for directors and, potentially, auditors in the context of evaluating and reporting on fraud prevention and detection systems.

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

In Q12, we assert that directors should make an explicit statement on internal controls over financial reporting and that such a statement should be subject to assurance from external audit. An entity's systems and controls to prevent and detect fraud fall within this area. On the basis that the directors and management are required to take responsibility for such a statement, then we agree that it would be possible to provide assurance over such a report as part of, or in parallel to, reporting on internal controls.

Such work would have cost implications, but this could be mitigated to an extent by defining or restricting fraud in this instance to material fraud impacting the financial statements.



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### **Chapter 9 – Auditor Liability**

**Key points:**

- Liability is a key consideration and should be factored into any and all potential changes to audit's scope and auditors' responsibilities
- A quantifiable limit on liability might reduce barriers to entry to the audit market
- Any potential changes to company law pertaining to auditor liability should be proportionate and fair

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

Only to a limited extent. For example, the recent trend towards extended audit reporting and in particular graduated findings — which goes beyond the requirements of auditing standards — is untested in terms of how an auditor may be liable for statements which are called into question, but this has not stopped audit firms from innovating and responding to this change. Having said that, any expansion of the auditor's role is likely to be perceived as extending the auditor's liability in a way which is new to the insurance market and, therefore, with potential implications for price of and/or capacity for (and ultimately availability of) cover available to audit firms.

More generally, we are very open to change providing it meets a real need and there is clarity around the reasonable and proportional limits that we would expect to apply to the auditor's responsibilities and liability. This would also need to address the current imbalance in consequences for management and directors versus auditors.

Financial exposure is of course relevant to this, but only as a component rather than being the sole factor.

We have high standards and a desire to provide a valuable service to society. A lack of clarity about the scope, purpose and limitations of our work carries a risk both to the profession and the business community.

However, there are additional risks around extending the scope of audit and dialogue or engagement with third parties. If the liability around these issues is not addressed, it may have an impact on the effectiveness of any such changes.

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

Historically, unlimited personal liability has been seen as a mechanism to ensure that individual auditors undertake the work diligently (notwithstanding the professional requirements to do so and the professionalism of individuals and firms).

However, it pre-dates the significant scrutiny (in the UK by the FRC) which exists today over auditors and which provides the 'assurance' that auditors are undertaking their work to the expected standards. In addition, the amount of insurance cover available even to the largest firms is likely to represent only a tiny percentage of the market capitalisation of the largest UK or international companies.

A change in the liability regime might (a) remove some of the barriers to entry faced by challenger firms, in support of greater choice and potentially competition, and (b) increase the resilience of

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the market. On the latter point of resilience, it will always be within the power of the regulator to remove the licence of a firm or individuals and therefore changing the liability regime would not result in moral hazard.

We consider that limiting auditor liability, and making it proportionate, would be more consistent with and complement an extension in the scope of the audit and/or the extension of the auditor's duties to a wider set of stakeholders beyond shareholders (if that is the direction of travel), in particular this would be necessary in areas where more subjective views are being asked of the auditors.

### **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?**

As we said at the outset, audits are used and valued by a wide group of stakeholders, and any reform of the current regime or extension of scope must reflect a broad range of needs. However, any regime of accountability and in particular, liability needs to be proportionate and fair, and avoid the risk that individuals or firms are discouraged from participating in the market.

With this in mind, we must:

- Define who the stakeholders of the audit are
- Ensure that the role of the auditor and its responsibilities are sufficiently clearly articulated
- Consider levels of assurance, dependent on the stakeholder
- Look for proportionate allocation of responsibility to reflect the extent to which the auditor, as opposed to other parties (in particular the directors and preparers of financial statements), might be held accountable
- Potentially cap the maximum liability

A cap on liability may be necessary to ensure resilience, although as stated above, it will always be within the power of the regulator to remove the licence of a firm or individuals – ensuring that changing the liability regime would not result in moral hazard.

The Companies Act 2006 sought to reform the liability regime relating to audit, but failed to do so in practice. This included the fact that boards felt they would be in breach of their fiduciary duties by recommending to shareholders they agree to limit the liability of shareholders.

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

See responses to Q41 and Q42 above.

### **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 amount of insurance cover available even to the largest firms is likely to represent only a tiny percentage of the market capitalisation of the largest UK or international companies.

Whilst no large audit firm has been put out of business solely as a result of a large financial claim\*, the risk exists and it is not insignificant.

It is important to note that because of the risks and unlimited liability nature of an audit, there are limits to the level of professional indemnity insurance available to audit firms in the commercial



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market, which underscores the significance of the risk for audit firms and is a barrier to entry to the market, or in the challenger firms taking on the most significant audits. The risk will become even greater to the extent that a wider group of third parties can rely on the audit report or the scope of the audit is widened, without addressing the current liability arrangements.

\*Whilst Andersen failed and was the subject of significant financial claims, arguably its demise was attributable more to client attrition following the criminal indictment made against the firm.

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### **Chapter 10 – Other Issues**

#### **Key points:**

##### **Technology**

- New technology is already being used in audits
- It enables higher levels of assurance to be given, and presents opportunities to give assurance across a broader range of issues
- The variability of data structures and systems within companies is a barrier to entry and we are working with others in the industry to drive the creation of a common data model to address this issue

##### **Proportionality**

- We agree that an ambition of a zero corporate failure regime is neither attainable nor desirable. However we believe there is scope to increase the value of audit relative to the risk of company failure
- Directors and management have an important role to play in improving corporate reporting – in particular, we believe there is scope to introduce a UK internal controls framework similar to the US's Sarbanes Oxley and potentially a stricter penalty regime for companies and directors for fraud or fraudulent reporting
- Opportunities to reduce the current scope of audit are limited although there may be a case for looking at the requirements for audits of subsidiaries in a group in some circumstances

##### **Shareholders**

- In our experience most shareholders simply want to know that a set of financial accounts has a clean opinion from the auditors and do not spend significant time examining audit reports closely
- However, we believe that more disclosure and more interaction with shareholders would be beneficial to both parties and we support greater engagement
- Such engagement should be tripartite, led by the audited company in question and in compliance with any wider relevant regulatory frameworks

##### **Culture**

- We agree culture within businesses is hugely important. While 'culture' may be difficult to measure, the behavioural outcomes that the desired culture is expected to drive may be quantifiable and there is a need for consistent, timely and accurate reporting of them
- Auditors' exercise of professional scepticism could be demonstrated through expanded narrative and the use of graduated findings in the LFAR and through more dialogue and meetings with shareholders

##### **Cost**

- We believe audit presents value for money at present
- Any potential extension of audit's scope should be considered from a risk and reward perspective by the relevant stakeholders
- We believe audit fees are set appropriately but they may need to increase as expectation and requirements of audit develop

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- We would be comfortable with disclosing more information on the make-up of audit fees if users requested this, subject to commercial considerations

### **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?**

New technology is being used in audits today in a wide number of areas. For example, technology is used to:

- Aid planning and risk assessment with a broader array of insight using technology that helps to assess corporate culture, external sentiment (for example on a company's products and brands) and dynamically assess risk in four dimensions (speed, risk likelihood, size and contagion linkage).
- Analyse, sort and filter large volumes of data and identify high-risk transactions for testing through data & analytics capabilities.
- Provide an instant automated visual mapping of process flows within an organisation's finance systems – at times, showing a 'spaghetti' of transaction flows.
- Help form audit judgements and challenge assessments made by management in subjective areas.
- Communicate with and facilitate the sharing of documents to/ from clients and with audit teams around the world.
- Use predictive analytics technology (with integrated probability assessment) to critically assess forecasts used in asset recoverability (cash return) or going concern.
- Document the results of audit work (through technology based workflows).
- Give auditors access to the latest guidance and support when completing their audit work.
- Help assess the risk of misstatement, through analysis and benchmarking of data to peer companies or industry norms.

The use of technology enables a higher level of assurance to be obtained. Our new 'KPMG Clara workflow' for audit, which is currently being deployed, has built-in machine learning and artificial intelligence functionality.

Using technology and advanced data analysis techniques, we are able to extract all financial records from a client's system and analyse these to identify those with a higher risk. For example, in the past where we may have selected 25 transactions to validate whether a control operated as expected, now we have the ability to analyse every single transaction and identify each one where the control did not operate as expected and target our audit test work over these transactions. Companies that we audit today have huge volumes of data, often billions of lines: without the use of technology to analyse, filter and sort these transactions it would be very difficult to obtain the required level of assurance over these transactions without significant manual effort. By way of illustration, last year we applied data and analytics to two trillion lines of data, 100 billion journals across 30,000 company codes.

One of the barriers for the profession in expanding the use of data and analytics is the variability of data structures and systems within companies – KPMG is currently working with the ICAEW to drive the creation of a common data model to address this issue.

As the development and application of artificial intelligence and machine learning evolves, the auditor's ability to further interrogate and analyse complex data will continue to increase. The current framework of auditing standards arguably needs to be refreshed to reflect the impact of technology on the audit process.

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### **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?**

Moving away from pure financial metrics to assessing unstructured, non-financial data is now possible using technology which has been very recently developed, providing assurance over a broader range of issues relating to such non-financial data is now possible as a result. As noted in Q45, culture, sentiment and risk assessment are already examples where technology is broadening insight (arguably assurance) in today's audit – albeit assurance (or commentary) on those topics is not bifurcated from the underlying audit opinion (nor required).

Data analytics could, even today, be used to provide operational assurance such as process efficiency (order fulfilment rates/speed of transaction processing), and compliance with a company's procedures manual (assessing debt collection timings, limits and risk). Similarly our predictive technology provides assurance over forecasts (for audit purposes) but that same capability could provide broader assurance on forecast performance: essentially 'a forecast opinion'.

Powerful analytics and the use of artificial intelligence and machine learning could potentially enable auditors to interrogate data sources beyond financial records to identify anomalous trends, erroneous transactions, fraudulent behaviours and illegal acts. As a practical example, AI could be used to read every email within an organisation to help identify inappropriate activity, unethical behaviour or breaches of relevant regulation. These capabilities have the potential to advance the audit process well beyond its existing potential.

Ultimately, the use of technology could move audit towards a continuous process which provides 'real-time' assurance over an entity's reporting. This would help to alleviate the current compression of manually intensive audit work in the weeks immediately following year end and allow audit teams to better focus on the key judgement areas in a timely manner.

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

We consider that current audit procedures remain necessary and there is limited scope for reducing the current scope of a financial statement audit. There is a suggestion of not auditing footnotes, but these should only be included in the financial statements if they are material to users — so by definition should be covered by the audit opinion, unless auditing standards were amended to explicitly exclude them.

If the audit focus is going to shift to a wider set of risks and stakeholder needs, and there is a concern about value or cost, then there may be a case to look again at the requirement for audits of single company accounts of subsidiaries in a group when consolidated accounts are available. The Companies Act provides for these accounts to be exempt of audit requirements where there is a parental or group guarantee. In practice this rarely happens (for legal and risk reasons companies decide not to take up this option).

It is not always the case that the audit of the individual accounts, relative to the group financial statements, is particularly valuable: there are a number of countries where these are not required and where markets function well, most notably the US and Canada. Such an exemption would reduce the audit burden that could be reinvested to more relevant areas. The auditor could instead focus on capital adequacy and distributions from those entities.

### **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?**

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We agree with the starting presumption that zero company failure is not attainable or desirable. Outside of cases of material fraud or fraudulent reporting, it is not and cannot be the auditor's role to prevent failure. However, the auditor does play a key role in ensuring that assumptions in relation to going concern are adequately supported and appropriate, and in relation to viability are consistent with our knowledge gained from the audit, and that there is sufficient disclosure around the risks and events that might give rise to failure. Again, redefining the audit of going concern and requiring more qualitative audit reporting (including graduated findings) will increase the value of audit relative to company failure.

Calibrating the value of audit in relation to company failure is extremely difficult given the above, rather it is much easier to look at how the value of audit could be increased relative to risk of company failure. However, with the wide divergence between what audits currently deliver and what the public might expect them to deliver, there is an important recalibration exercise into the value (or purpose) to be undertaken through this Review.

The role of the auditor to prevent and detect fraud is being questioned elsewhere, where there is a clear expectation gap. If audit was redefined to provide greater assurance over material fraud that could have both a direct and indirect effect on the financial statements and so potentially lead to a company's failure (or severe loss in shareholder value), then the value of audit would surely increase. For this to work in practice, it would need to be coupled with a UK SOX equivalent internal controls framework and a stricter penalty regime for Companies/Directors for fraud or fraudulent financial reporting.

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

As discussed in our responses to Q1 and Q2, a robust audit delivers high levels of assurance to its users, instilling confidence in an entity's financial statements and in so doing, supports the capital markets and the wider economy.

Audit fees are set at a level intended to cover the costs of delivery, including the necessary training and development of teams, together with remuneration of staff and partners. As a proportion of the audited entity's cost base, these fees are usually insignificant in absolute and relative terms.

Audit rotation and regular tendering has helped to maintain fees at competitive levels and in the context of the value provided, when considered against the risk/reward equation of satisfying even the existing audit requirements in the current regulatory and legal environment, we believe the audit represents good value for money.

### **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?**

Any extension to audit needs to be considered from a risk and reward perspective by the relevant stakeholders and take into account potential cost implications arising as a result of other proposed reforms (for example the introduction of joint audit).

For example, and as a very rough estimate, extending the scope of the audit to the full annual report and related shareholder reporting might increase fees by at least 20-30%. The impact on fees of extending the scope to include ESG audits may be greater. A UK SOX type regime could easily increase fees by a rough estimate of 40-50% (as we see with companies with dual listings with one listing in the US). A radical change in the scope of an audit to cover much greater assurance over say fraud or compliance with laws and regulations, or going concern – which could increase audit fees by several orders of magnitude — would require an assessment of the likely reaction of stakeholders to such a cost increase. Beyond pure fee increases, extensions in the



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scope of an audit could also have an impact on the timeliness of reporting, which in itself carries additional cost.

This Review might test investor appetite for such an increase. It is important that the likely financial consequence of an extension of the scope of the audit should be given due primacy in this debate – otherwise audit firms will have an additional burden/expectation placed upon them that they are unable to satisfy at an economic margin. To Q48 above, it is also important that the current costs of audit are calibrated relative to the risk of company failure.

### **Shareholders**

#### **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?**

Through our own investor engagement it is clear that even sophisticated investors sometimes struggle to understand complex financial statements or do not have a comprehensive understanding of the scope or purpose of an audit. Many investors tell us that they do not spend time reading audit reports in detail, but they do want to know that the opinion is clean. Of course, this is to an extent a matter of choice as to the amount of resource that institutional investors are prepared to devote to this important activity, but it might say as much about the current usefulness of the format of the LFARs, as it does about the level of investor appetite for information from the auditor.

Most investors described the audit as providing a level of assurance that the historical financials, on which they base their valuations and investment decisions, are sound (i.e. a reliable foundation). A number have said that the audit is backward looking, and it is for them to make judgments about future prospects and valuation.

It is likely that if the audit report provided insight that was not provided by the company and therefore enabled an investor to make a better informed decision, then audit reports would be read in more detail (if we agree that such provision of such insight is within the scope of an audit). We believe that the introduction of graduated findings within audit reports goes some way to providing investors with this insight.

We have not discussed with investors whether AI can play a role in analysing audit reports but it probably should, particularly if we consider how many companies must file audit reports with Companies House. It should be valuable for banks, regulators, etc. to spot red flags in reports such as qualifications, exemptions – (i.e. non-standard reporting). AI could also play a role in directing scarce investor and other resource to areas that matter in auditor reporting, but at the moment technology is under-utilised in this way.

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

Interaction between shareholders and auditors outside the AGM – to promote a two way dialogue — would be highly desirable and is something that KPMG is trying to promote. However, the practical considerations and cost on all parties, together with the potential for auditors to unintentionally extend their legal accountability beyond the existing shareholder body, must not be underestimated.

Historically KPMG has had good and frequent contact with investor bodies such as the Investment Association or Investor Forum, and some contact with (typically the larger) investment houses. Often this is with the corporate governance leads, but less frequently with the investment managers themselves who are closest to the companies that we audit. As we have sought to

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extend our relationships with this population it is clear that investment managers have had little or no contact with auditors and have welcomed the opportunity to meet. We would like to see greater interaction between auditor and institutional investors (as a proxy for the shareholder body) throughout the audit cycle (see response below).

One should not under estimate the amount of resource, and therefore cost, that would be required to maintain interaction between investors and auditors. As well as individual contact between firms and investment houses we would advocate an annual assurance or audit meeting between companies and the investor community that the auditor would participate in (see response below).

We would prefer that the interaction is tripartite – potentially with a representative investor body and at least including the audit committee chair, and arguably executive management. Audit committees, auditors and shareholders should have aligned interests which support that tripartite approach and the responsibility for production of the financial information rests with executive management.

### **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?**

We advocate greater interaction between the auditor, audit committee and investors (as an intermediary to the shareholder) throughout the audit cycle, rather than the present mechanism of relying on the written audit report. This could happen in various ways as set out below including input ex ante.

If investors are open to having regular contact with audit firms privately to raise concerns or provide insights on individual companies they monitor (including those that they chose to avoid or short), that could provide valuable input into the planning and risk assessment for our audits. This might include feedback on the quality or integrity of management, views on risk or viability of the company, the transparency of its financial reporting etc. We have heard frequently that investors were well aware of, or suspected, issues in many of the companies that have suffered corporate failures or significant destruction of shareholder value. Such feedback meetings could happen on an annual basis between the audit firm and investment house to cover all entities audited by the firm on an exception basis together with the ability to notify firms if new information arises. Investors have indicated that they would prefer to do this on a one-on-one basis as large gatherings or corporate meeting will likely stifle the process.

Whilst we have had support from investors for this approach we should recognise that investors secure competitive advantage from drawing such insights, so some may be more cautious in sharing their views and any such change would need to be contemplated and implemented bearing in mind the existing regulatory rules around level playing field in terms of investor access to information. It would involve considerable investment in time and process from investment houses but should be encouraged under the Stewardship Code.

We would also advocate an annual audit meeting with company management, audit committee chairs, investors and auditors. This would provide an opportunity to take questions on the outputs of the last audit and provide input to the upcoming audit in areas of reporting, ESG, governance, risk etc. We would recommend that investment managers as well as corporate governance representatives participate. We have received feedback from investors that companies appear reluctant to hold such events, and from audit committees that investors have not taken up offers of invitation to speak to audit committee chairs, focusing instead on remuneration. The auditor would be expected to be open in its communication. There may be an argument to exclude executive management from all or part of the meeting.

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We would not advocate formal approval of planning matters for each audit including scope or materiality as these should not be set in stone, but flex through the audit depending on changes in the company's circumstances. There may also be benefit in seeking investor input at an annual audit meeting for wider assurance beyond the statutory audit.

Finally, there may be benefit in allowing shareholders to pose questions of the auditor at the AGM, although our experience is that this may have limited value (relative to investor meetings) given the nature and conduct of large AGM meetings.

Feedback that we have received from investors endorses the above approach.

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

Current assurance beyond the audit report is limited. Based upon our interactions with investors, we have seen a strong appetite for greater assurance over information not included in the financial statements – including over the preliminary statement, analyst presentations, internal controls, non-GAAP reporting measures, the front half of the annual report, ESG/CSR reporting as well as additional assurance over going concern, risk etc., whilst recognising that there would be a cost implication for such additional assurance.

### **Culture**

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

It is clear from the FRC's own work and numerous other studies that culture within businesses is hugely important. The primary driver of culture is leadership tone and style which impacts the organisation as a whole. If the organisation does not get this right, the impact of a flawed culture can undermine the financial results.

Use of the word culture in the boardroom and its recognition in this context is a very recent development. Consequently 'metrics' of culture are relatively new and there are few that are commonly accepted and used consistently in boardroom or corporate reporting.

It would be possible to audit certain aspects of culture. For example, whether there are policies and procedures in place around cultivating the desired culture for the organisation to achieve its strategy.

In terms of objective and numerical measures of an organisation's culture these fall into two types which could be more or less easy to audit depending on the maturity of the organisation's governance and management of culture:

- Strategic metrics: many consultancies offer tools and processes which claim to be 'culture audits' of a whole organisation. These will become more valuable as there is consolidation and acceptance of common and consistent methodologies and standards; and
- Behaviour metrics: a dashboard of half a dozen or so key metrics of behaviour tailored for each industry sector. These might include metrics such as employee turnover, sickness and absence rates, health and safety and/or wellness metrics, whistle blowing and 'Speakup' hotlines; diversity and inclusion; complaints handling or customer response related metrics; Net Promoter Scores both internal and external; and composite metrics taken from employees engagement surveys such as the PERMA index used by the civil service.

The starting point on culture for any board is to agree what sort of culture it wants, what are greatest culture risks to the overall success of the organisation and how to measure them. This

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could potentially vary quite widely as industries are not analogous. There is a need for a consistent framework of measures, albeit with variations within this framework to reflect different organisation types.

Once the board is clear on what the most important indicators of culture are for its organisation, it needs to align them to key risks and ensure that it has appropriate metrics in place to measure outcomes.

Whilst there are professional firms that offer ‘culture audits’ as discussed above, there would need to be consistent, timely and accurate reporting of clearly defined and quantifiable culture metrics (rather than just policies and processes) for useful audits to be performed.

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

We consider that the narrative in the LFAR can be expanded to allow auditors to express qualitative views on management’s judgements including areas where auditors challenged management’s position and developed and tested alternative outcomes. The use of graduated findings in LFARs, accompanied with such a narrative, would also allow auditors to demonstrate the basis of their judgements including their qualitative views on management’s accounting judgements.

Meetings with shareholders, as discussed elsewhere in this response, could also act as a forum where the auditor can provide more context to their findings and be able to demonstrate their professional scepticism.

### **Q57. Should the basis of individual auditors’ remuneration be made available to shareholders?**

It is questionable what such disclosure would add, but we are comfortable for remuneration principles to be made public.

## **Cost**

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

We refer to our responses to Q48 to Q50 above.

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

If users requested further detail on the make-up of audit fees, we would be comfortable in disclosing the details and principles around fee arrangements, subject to commercial considerations.

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

Our audit fees are set across the portfolio of entities that we audit at a level that is intended to support the audit business, covering the costs of delivery, training and development, staff and partner remuneration. The need to maintain and improve audit quality means that the ongoing cost of investment is high and fees have not kept pace with this incremental cost in recent years. Furthermore, the impact of more regular tendering for and transitioning to new audits has not been



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reflected in prices. As expectations and requirements of audit develop, particularly leading to wider or deeper levels of assurance being required, then fees will need to increase to reflect this.