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Dear Sirs

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT (BRYDON REVIEW)

Introduction

Lloyds Banking Group welcomes the opportunity to comment on the Call for Views issued by the Brydon Review.

Lloyds Banking Group ('Lloyds') is a UK financial services provider with around 26 million customers. Our main business activities are retail and commercial banking, general insurance and long-term savings. Lloyds' shares are quoted on the London and New York stock exchanges and we are one of the largest companies in the FTSE 100 index.

As both a preparer and a significant user of accounts in its capacity as lender to many UK corporates, the Group has a significant interest in the quality and effectiveness of the audit process. In our view, the audit profession in the UK generally maintains high standards and compares favourably to other jurisdictions. However, the dominance of the Big 4 audit firms is a cause for concern; the lack of choice that this leads to is a matter requiring urgent attention. There are a number of reviews at differing stages considering matters that are relevant to the future of audit in the UK; it is important that a holistic approach is taken to considering the results of these reviews to ensure that the UK's leading position in audit and corporate governance is not compromised.

From our perspective there are two distinct issues; the form and content of corporate reporting and the scope and quality of the related audit work. Until there has been a thorough review and changes proposed to the existing corporate reporting framework, any re-definition of the scope of the related audit work is likely to be partial. Audit quality is an issue that should be capable of being addressed separately although we note that the very significant changes proposed by both the Competition & Markets Authority (CMA) and the Kingman Review are likely to place a significant strain on the availability of suitably experienced staff; accordingly, the recommendations of this review, and in particular the proposed timeframe for implementation should be made in the light of this. We also note that any enhanced requirement to audit forward looking information is likely to be very challenging for the audit firms which have to date largely focussed on reviewing historical information. This challenge will be exacerbated by the proposed separation of the firms' audit and non-audit businesses.

The Review is very wide ranging and ambitious in scope. We would suggest that greater benefit will be realised if efforts are focussed on a small number of initiatives. In this regard, we believe that the Review should initially concentrate on closing the expectation gap by a programme of education for users of audit reports, continuing to enhance the usefulness of audit reports with targeted improvements and encouraging better communication between the auditor and shareholders. Other more fundamental changes, if considered necessary, could be introduced over the medium term.

Detailed comments

We provide our detailed comments below.

<u>Purpose of an audit</u>

An audit should provide appropriate levels of assurance on a company's report and accounts. However, in determining which parties should be entitled to place reliance on this work, it is necessary to consider the purpose for which the accounts have been prepared. With the increasing sophistication of the capital markets this has changed and broadened over time, but has done so by evolution rather than by a clear and unambiguous change to corporate reporting standards. We would encourage a review of the form and content of company report and accounts, applicable to all listed companies, which could also address audit requirements and the implications for the audit firm's liability. Once this has been performed we can see some benefit in the law being amended to clarify the purpose of an audit. These actions may assist in closing the 'expectation gap' which we discuss below.

<u>Audit scope and the expectation gap</u>

Commentators have been referring to an 'expectations gap' for many years. We do not believe that this reflects an 'audit quality gap' but is a result of a misunderstanding of which matters are within, and more importantly, outside the scope of an audit.

This gap could be narrowed by explaining better the work of the auditor (either in the audit report or by other approaches) and/or by changing the scope and depth of the audit. It is worth noting that there is more than one 'expectation' of an audit and that increasing the scope of an audit would not, therefore, remove the expectation gap in its entirety. Any proposals to increase the scope of an audit should ensure that the expected benefits are commensurate with the increased costs. We do not believe that the level of audit assurance that an audit provides should vary from sector to sector or entity to entity; this would devalue the audit process and in all likelihood add to, rather than, reduce any existing confusion.

Following recent high-profile corporate failures, it is understandable that the Review wishes to revisit going concern and the viability statement. We think that the current notion of going concern is relatively well understood and a suitably tailored viability statement provides a useful summary of the risks to a company's ability to continue in operation; however, there is still scope for disclosures to be improved and further education of users as a way of closing the ‘expectations gap’. We are not convinced that requiring the directors to make a statement about the sustainability of an entity’s business model beyond that already provided would provide additional comfort to stakeholders. Preparers should be encouraged to move beyond boiler plate disclosures; in this way, they could offer the meaningful insight sought by the Kingman Review. Given the inherent uncertainties of the viability statement, we do not believe that providing audit assurance on the viability statement would be practical but it should be possible for the auditor to provide some assurance, albeit at a lower level than that provided on the financial statements.

We would not object to some extension of the audit (perhaps by the provision of negative assurance) to information (such as KPIs or non-financial metrics or the broader narrative discussion) outside the financial statements, such material being more susceptible to external review than matters such as going concern and viability. We note that under existing requirements the auditor is required to read the information included in the annual report other than the financial statements and in doing so consider whether this other information is inconsistent with the financial statements or appears to be misstated. If the auditor concludes that the other information is materially misstated, it is required to report the fact in in its audit report. Given this existing requirement, any extension may not require the auditor to do significantly more audit work but an enhanced reporting requirement may have a positive effect on narrowing the ‘expectation gap’.

As regards the proposed extension of the scope of the audit to provide assurance on distributable reserves, we believe that this has only limited merit when considered in isolation. Many factors have a bearing on the ability of companies to return capital to shareholders. In our view, it is more important that shareholders have a proper understanding of all the relevant factors, including key constraints. It is also relevant that the determination of distributable profits under UK law is complex and the requirements are arguably dated. If an auditor is to provide assurance on amounts available for distribution, we believe that for this to be a practical proposition, the law in this area would need to be simplified significantly, perhaps by moving to a solvency basis as in some overseas jurisdictions.

On other matters affecting the scope of an audit, irrespective of whether the external auditor uses the work of internal audit, it has ultimate responsibility for its opinion on the financial statements. In this regard, we believe that the external auditor should not be limited on the extent that it relies on the work of internal audit provided appropriate safeguards are put in place such as testing some of internal audit’s work.

We do not agree with the argument that there is too much focus on auditor independence to the detriment of innovation and audit quality. We see independence as a state of mind and is vital to the credibility of the audit opinion; in our experience, the audit market rewards innovation and quality. However, we have no objection to an enhanced internal controls framework. Any changes would need to be proportionate, avoiding many of the pitfalls of the US Sarbanes Oxley regime which has resulted in a significant extra cost to companies for debatable benefits and would need to be designed to minimise the risk of ‘boilerplate’ reporting.

Audit quality and reporting

In recent years, there have been significant enhancements to the audit report, including disclosure of the auditor’s materiality and key audit matters. We believe that these changes have had a positive effect, although we do not believe that these should be extended to the disclosure of discussions between the auditor and the audit committee; such disclosure may have the unintended consequence of reducing the usefulness of these discussions.

We consider that switching from a binary audit opinion to a more graduated disclosure, in the absence of an international change, would represent a potential risk to the UK's leading position in audit and would represent a significant departure from current practice where the auditor reports on the financial statements as a whole. The reporting of key audit matters in the audit report already addresses some of these aims and this disclosure could be enhanced to achieve many of the benefits of graduated disclosure. If the proposal is considered to have merit, we believe it should be pursued internationally. We are supportive of better communication between the auditor and shareholders and believe that this could be best achieved through increased interaction with the Audit Committee Chair which could be extended to include the auditor where relevant. Such engagement may also help to reduce the expectation gap.

<u>The role of audit in detecting fraud</u>
We believe that significant frauds, whilst attracting publicity, are rarely the reason for companies failing. We see any 'expectation gap' as an education issue rather than an area requiring a major change in audit approach. The primary obligation for the prevention or detection of fraud remains with senior management. One aspect that may benefit from further enhancement is consideration of fraud by senior management as personal ethics and the 'tone at the top' could impact on the reliability of corporate reporting generally.

<u>Auditor liability</u>
Whilst this is a matter better discussed with the audit firms, we would be surprised if litigation concerns restrict the audit profession's willingness to embrace change and innovation. The issue of extending the auditor's responsibilities beyond those owed to shareholders could be addressed as part of a wider review of company reporting, as discussed earlier in our response.

<u>Other matters</u>
In our experience, significant strides have been made in the use of audit technology in recent years. However, whilst the use of technology is valuable in the analysis of large volumes of data, the ultimate driver of audit quality is the professional judgement of experienced audit partners and staff.

We believe that responsibility for agreeing the audit plan should remain with the audit committee, which is accountable to the shareholders, and shareholders should not have a direct role in this area. As noted above, we would support shareholders having an extended opportunity to interact with the auditor through the auspices of the Audit Committee Chair.

Conclusion

Lloyds Banking Group depends on the existence of a high-quality audit industry. We believe that it is imperative that the audit function remains sufficiently profitable to attract and retain the high quality staff required to maintain and enhance existing standards and that any changes do not put this at risk. We also reiterate our view that before embarking on significant reform, the various different proposals need to be considered holistically and implemented together, rather than piecemeal.

Yours faithfully

Simon Henry
Chairman of the Audit Committee