IoD Inspiring business

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IoD Response to the Independent Review into the Quality and Effectiveness of Audit ('The Brydon Review')

Thank you for giving the Institute of Directors (IoD) the opportunity to respond to your independent review of the quality and effectiveness of statutory audit in the UK.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 30,000 members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum, with 70% consisting of directors from small and medium-sized enterprises (SMEs).

The IoD has long been an advocate of high standards of responsible business behaviour and good corporate governance. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings."

In addition, we strongly believe that statutory audit has a key role to play in building trust and confidence in UK business enterprises. Hence your independent review of the quality and effectiveness of audit is of great interest to our members and the wider community of board members.

Summary of our view

Recent accounting controversies at companies such as Carillion, Patisserie Valerie, London Capital & Finance and others have highlighted concerns about audit quality. However, we believe that the policy debate must go beyond devising quick fixes relating to the problems arising in these specific cases.

We should use this opportunity to undertake a fundamental rethink about the purpose and nature of audit, and the role it fulfils in our wider system of corporate governance.

All organisations produce information, statements and assertions concerning their past performance, their financial status, their future prospects, their strategic purpose and their governance framework. Reliable information on all of these issues is extremely important to a wide range of stakeholders, including but not limited to shareholders, employees, potential business partners and wider society.

The statutory audit process has a key role to play in providing those stakeholders with an informed and independent check on the credibility of this information. Are the statements and assertions being made by the company a 'true and fair' description of reality?

This impartial perspective on business information is increasingly important in the modern business system. On the one hand, we live in a world in which a high level of transparency is essential for any organisation that wishes to be trusted by society. Transparency is effectively a licence to operate for almost any enterprise, including private companies which historically may have seen themselves as closed worlds involving only a select group of insiders.

However, we also live in a world of information overload and 'fake news': from the internet, social media and a variety of other unreliable sources. **The need for company information which has been subject to informed scrutiny and challenge has never been greater.**

Unfortunately, the modern audit profession has to some extent disconnected from this wider economic purpose. This has occurred for a number of reasons. Firstly, auditors are conscious of, and nervous about, their own potentially unlimited liability in respect of the audit process. Secondly, auditors have sought to develop commercial relationships with companies beyond audit. Thirdly, auditors are concerned about the time and cost implications of promising too much from an audit, and stepping outside of their comfort zone of financially-oriented review.

The consequence is that the audit profession has self-defined the audit product in an excessively narrow way. It has sought to frame audit quality in terms of complying with increasingly complex and opaque accounting standards rather than with regard to the underlying reality. These factors have also diluted the willingness of auditors to offer a robust level of professional scepticism in respect of judgements made by company management.

We do not believe that the current audit regime is entirely broken. Historically the UK has led the world in the development of audit and many audits are completed to a high standard, albeit within the constrained parameters of the current audit concept.

However, there are no grounds for complacency. **The audit product has suffered significant reputational damage in recent years, and a significant response is demanded as a means of rebuilding trust.**

In our response, we highlight various aspects of the audit process where enhancements could be achieved. **Our main recommendation is that the scope of the future audit process should be widened so that it provides independent challenge on a wider range of issues**. The audit process should embrace environmental, social and governance (ESG) reporting, non-financial reporting and other areas that are of growing importance for maintaining stakeholder confidence and support.

We also wish to highlight the results of a recently-completed survey of IoD members concerning the future of audit (see Appendix A). Although the questions addressed in the survey are primarily concerned with the future of audit market structure and regulation (which fall outside the terms of reference of your review), we nonetheless feel that they will be of interest to you.

In particular, we draw your attention to the fact **that a majority (55%) of our survey respondents favour a complete split between audit and non-audit firms – and not merely an operational ring-fencing of audit and non-audit activities within the same firm, although members are fairly split, with 41% supporting a softer approach**. The survey also indicates a high level of support for joint audits, and opposition to a greater role for regulators in selecting audit firms.

A widening and updating of the audit concept represent a huge opportunity for the audit profession. The overwhelming majority of audit professional are well meaning and highly competent. Although a re-thinking of the existing audit concept may have implications for current audit firm business models, there is no suggestion that the need for effective and professional auditors will diminish.

If anything, the audit of the future will be a more wide-ranging, meaningful and interesting process than it has been in the past.

<u>Our response on specific issues and individual review sections:</u>

1) DEFINITIONS OF AUDIT AND ITS USERS

An external audit has been a statutory requirement for larger companies since the 1900 Companies Act. However, the lack of clear statutory objectives for audit in company law leads to ambiguity about the purpose of an audit, and who it is for.

In addition, perceived inconsistencies between audit requirements in company law and international accounting and auditing standards create further uncertainty. **These issues should be addressed by future legislation.**

In our view, the purpose of audit defined in International Auditing Standards (ISA[UK] 200) is in need of a significant update: "The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements".

This reflects an excessively narrow perspective of what should be audited, given the reliance of many stakeholders (including but not limited to shareholders) on disclosures and assertions made by companies on ESG issues, non-financial KPIs and corporate governance**. Our view is that the scope of audit should be enhanced beyond the financial statements to encompass the wider interests of a wider range of stakeholders.**

We have reservations about the extent to which an audit can provide shareholders or other stakeholders with assurance or predictions about the future viability of an enterprise. It is primarily for the board of directors to provide this kind of forward-looking assessment of company prospects.

However, **the audit process can ask some challenging questions of boards concerning key assumptions underpinning their viability statements**, and highlighting any which appear to lack credibility or an evidence base.

The external auditors should not have a direct role in judging the effectiveness with which the board and management conducts the affairs of the entity. That is a matter for others to assess (e.g. shareholders and, in certain instances, regulators), albeit taking into account information that has been scrutinised by the auditor.

We accept the caveat that audits can only ever provide 'reasonable assurance' that corporate disclosures represent a 'true and fair snapshot of the company's position. **There will always, therefore, be cases where the audit process fails to signal an impending corporate failure.** However, the number of recent sudden and surprising corporate failures suggests that the current audit process is not achieving even the 'reasonable assurance' standard in a number of cases.

2) THE 'EXPECTATIONS GAP'

We agree that there exists a significant 'expectations gap' between what users of financial statements and the public expect from an audit. To address this problem, **we need to provide the public with an updated and appropriate definition of the nature and purpose of audit, which is clearly communicated by policy makers, regulators and professional bodies.**

Such a definition should reflect the needs of our economy and society as a whole rather than preferences or interests of those with an immediate interest in the current audit process.

As a directors' association, we recognise that it is the board of directors which establishes the company's system of controls and oversight, and approves the audited entity's corporate disclosures. As directors, we accept responsibility for any shortcomings in these systems or disclosures following a corporate collapse or misreporting episode.

However, notwithstanding the board's ultimate responsibility, **the auditors cannot escape being held accountable for the robustness of their testing and challenge of disclosures made by the company.**

In our view, the audit process is currently failing to provide adequate assurance to stakeholders in a number of key areas, such as the adequacy of the entity's accounting records, capital maintenance and the avoidance of inappropriate dividend payments. The valuation of goodwill and other intangible assets is another area where auditors have failed in certain recent cases to provide sufficient challenge of the assumptions made by management and directors.

3) AUDIT AND WIDER ASSURANCE

Many large businesses, particularly those in the financial services sector, have a well-developed internal audit function. In such businesses, internal audit plays a key role in providing internal assurance regarding the design and operation of the organisation's internal controls over financial reporting, and increasingly in respect of a much wider range of key aspects of corporate functioning.

However, whilst we agree that external auditors should actively engage with internal audit as part of the audit process, **we do not think that external audit should be able to offload any of its responsibility or liability for the statutory audit process onto internal auditors**. Hence any changes to UK auditing standards concerning the assistance of internal audit in the external audit process should be approached with caution.

4) THE SCOPE AND PURPOSE OF AUDIT

We support the current process relating to the oversight of internal controls by the external auditor – as defined in the UK Corporate Governance Code. This requires that the auditor should report to the audit committee any concerns it may have regarding the effectiveness of internal control in relation to the entity's key risks or business model.

We also support the following proposed reforms to auditing standards, made by the FRC, which seek to increase the professional scepticism of auditors:

- auditors should make greater effort to more robustly challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias, and make greater use of the viability statement;

- the auditor should report on whether management's assessment is appropriate, and set out the work they have done in this respect; and

- a stand back requirement to consider all of the evidence obtained, whether corroborative or not.

However, **we feel that recent proposals by Sir John Kingman - concerning the introduction of a duty of alert for auditors to report viability or other serious concerns to a regulatory body - is inappropriate in non-regulated sectors.** Effectively, it would turn auditors into quasi-regulators, which would fundamentally affect the future nature of the auditor relationship

Part of the audit expectations gap relates to confusion over which information disclosed by companies has been subject to audit. For example, preliminary results and a wide range of non-financial and governance materials published in annual reports are not audited.

It may also come as a great surprise to members of the public that many important company metrics in particular industries - such as oil reserves for energy companies, or risk weighted assets for banks - are not subject to audit. Neither are key performance indicators that all companies are required to disclose as part of their strategic reports.

The auditor is merely required to read this unaudited information and identify whether it is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated.

Going forward, we need to recognise that Increasing weight is being placed by investors and stakeholders on qualitative information and on indicators of the long-term health of a business, encompassing issues such as corporate culture, environmental, social and governance (ESG) metrics, gender pay gap performance and supplier payment practices.

For many stakeholders, these indicators are just as important as financial performance metrics, and equally in need of independent and informed oversight from an appropriate audit process.

The audit of the future will need to bring many more of these areas within the scope of audit if the expectations gap is not to widen further.

5) AUDIT PRODUCT AND QUALITY

In our view, **many of the problems relating to audit quality derive from an absence of professional scepticism and challenge rather than failures of audit processes**. If anything, there is too much emphasis on process which may lead to an excessive focus by audit teams on "completing the audit file".

We note that audit is, at present, largely a pass or fail test. Although a modified opinion is possible, it is extremely rare. For the auditor, it is typically seen as a nuclear option, given that it may precipitate crisis at a company that is subject to one.

We are doubtful as to the viability of a more graduated approach to communicating audit conclusions outside of the company. Although this might in theory provide greater insight for stakeholders, we are not sure how they could be published in a way that avoids immediate adverse consequences for the company.

Our view is that **stakeholders want to feel confident that a challenging and sceptical conversation has taken place between the auditor and the company** which reflects their likely concerns and interests.

However, in most cases, they recognise that the details of these discussions will need to remain confidential except in those more extreme cases where the company is refusing to cooperate with the well-founded recommendations of the external auditor.

6) LEGAL RESPONSIBILITIES

We share the concerns of the BEIS Committee concerning the UK's capital maintenance regime. According to company law, the principle of capital maintenance stipulates that directors may not pay dividends other than out of a company's accumulated realised profits.

We also tend to agree that International Accounting Standards may give directors excessive leeway to pay dividends out of amounts that should not be treated as realised profits, thus degrading the shareholders' capital.

We have noted with approval the BEIS Committee's recommendation urging Government and the FRC to work together to review the capital maintenance regime and the definition of 'realised profits'. We also believe that distributable and non-distributable reserves should be required to be disclosed in the audited financial statements.

We are, however, opposed to Sir John Kingman's recommendation that specific function holders, e.g. the CEO, CFO, chair, and audit committee chair, should be held individually responsible for preparing and approving the accounts and dealing with auditors.

In our view, **these key tasks are a collective board responsibility** (supported through the advice of the audit committee). Assigning statutory duties to individual board members or senior executives is reminiscent of the Sarbanes-Oxley approach in the United States and the SMR regime in the financial sector, and would undermine the board's collective responsibility for a key aspect of governance.

7) THE COMMUNICATION OF AUDIT FINDINGS

We agree that audit processes, outcomes and quality should be made more visible to stakeholders.

In particular, we note that there is rarely any interaction between shareholders and the auditor at the AGM. Furthermore, shareholders rarely use their ultimate power over the auditor appointment and removal process to influence audit. **This is a significant shortcoming in the current behaviour of institutional investors, and they should devote more time and resources to this task**.

We think that an annual assurance meeting, in which auditors engage with shareholders and other stakeholders, is an excellent idea and well worth exploring.

Also, we agree that the audit committee could increase its transparency over the key audit and accounting judgments

8) FRAUD

The role of the company auditor with respect to fraud has never been entirely clear. There is no explicit legal requirement for the auditor to determine if fraud has occurred. Rather, accounting standards direct auditors to focus on a subtly different matter: the risk of intentional misstatement of the financial statements, arising from either fraudulent financial reporting or misappropriation of assets.

We believe that a risk-based audit process based on a sampling methodology is unlikely to be able to offer a clear assurance that fraud has not occurred. However, in the future, data analytics could be more widely applied to identify trends or anomalies and flag up areas for further investigation and study.

However**, we agree that audit committees should be mandated to discuss fraud risks with their auditor to a greater extent than at present.**

9) AUDITOR LIABILITY

We recognise that, going forward, the current liability regime will need to be redefined in respect of wider assurance services relating to a broader range of audit activities.

There is a huge opportunity for technology to enhance and widen the scope of audit. It will allow auditors to be freed from the more mechanical aspects of audit and enabled to focus on the anomalies and issues, applying due scepticism and judgment to unearth any matters of concern.

The key question for audit firms is whether they will choose to apply that scepticism in a meaningful way, or if they will conclude that it is ultimately not in their commercial interest to do so. The focus of future audit policy should be on encouraging a more constructively sceptical audit profession.

I hope you have found our comments helpful. If you require further information about our views, please do get in touch.

Kind regards,

Dr. Roger Barker
Head of Corporate Governance
Institute of Directors

Appendix A – results of the IoD survey on audit reform

This survey of IoD members took place between 24th May and 6th June 2019. The results are based on the views of 892 respondents.

Question 1:
To what extent do you agree or disagree that statutory audit process undertaken by accounting firms provides meaningful assurance that the report and accounts of large UK companies are fair and accurate?

1. Strongly agree	4%
2. Agree	25%
3. Neither agree nor disagree	27%
4. Disagree	33%
5. Strongly disagree	11%

Question 2:
How much challenge do you think auditors provide against accounting judgments made by company management?

1. Strong challenge	8%
2. Some challenge	47%
3. Little to no challenge	39%
4. No challenge	3%
5. Don't know	3%

Question 3:
Do you think that audit firms should be legally prohibited from also offering non-audit services to large UK companies, e.g. consultancy?

1. Yes - audit firms should only be allowed to undertake audits	55%
2. No - it's fine for audit firms to offer non-audit services as long as there is operational separation between their audit and non-audit activities	38%
3. No - there should be no legal restrictions on the services that audit firms can offer	3%
4. Don't know	3%

Question 4:
Should there be a cap on the number of major UK companies that a single audit firm can audit?

1. Yes	40%
2. No	45%
3. Don't know	15%

Question 5:
Should regulators demand that the audit of large UK companies be undertaken by more than one audit firm, i.e. joint audits, as a means of promoting the development of smaller audit firms?

1. Yes	46%
2. No	33%
3. Don't know	21%

Question 6:
Would the quality of external audits be improved if UK regulators played a greater role in appointing the auditors of large companies?

1. Yes	32%
2. No	47%
3. Don't know	21%