Brydon Review Secretariat
Orchard 1
1st Floor,
1 Victoria Street
London
SW1H 0ET

By email to: brydonreview@beis.gov.uk

7 June, 2019

Dear Sir Donald

Independent review into the quality and effectiveness of audit - Call for Views

PricewaterhouseCoopers LLP (We) welcome the opportunity to respond to this Call for Views as part of your independent review into the quality and effectiveness of audit (the "Review"). We also welcome BEIS's commitment to examining the audit product as part of their overall review of the audit sector. We are encouraged by your comment that there have been many reviews of audit over recent years and that the time is right for conclusions and action.

The recent media and political narrative has shown that there is confusion about and dissatisfaction with the scope, purpose and performance of audit. As a profession, we have not been sufficiently responsive to the changing needs and expectations of our stakeholders; there have also been well-documented instances where audit quality has fallen short of requirements. We are now at a watershed moment, and we recognise the need for significant change if our work as auditors is to remain relevant.

At PwC, we are committed to working hard to ensure that the quality of our audits continues to improve; we have a substantial programme of measures already underway. But although it is of critical importance, our quality programme alone will be insufficient to restore trust in audit. Reform is needed throughout the corporate reporting and audit regime, and we strongly support your work as a key contribution to that agenda. Ultimately, we hope that this Review will play a significant part in closing the trust deficit between society and UK business. We have developed ideas for potential reforms, and we look forward to hearing proposals from others. Our suggestions, which focus on public interest entities and other large companies, include:

- A requirement for directors to attest to the effectiveness of internal controls, with assurance also required for some companies.
- An explicit responsibility for the Audit Committee to determine the level and type of assurance needed by company stakeholders over the principal risks faced by the company, and to present the assurance plan to stakeholders at the beginning of each year.
- Measures to improve transparency of, and engagement with, the audit, such as external auditor presentations to shareholders at the AGM.

- Reform of the going concern reporting regime, resulting in a single, coherent piece of reporting focussed on the directors' assessment of scenarios in which the business model could break.

In addition, we support Sir John Kingman's recommendations that directors' responsibilities for the entirety of the annual report should be emphasised through increased oversight from the Audit, Reporting and Governance Authority (ARGA).

Although this letter is written by the UK member firm of the PwC network, in compiling our response, we have consulted widely with colleagues from other member firms within the PwC network, and taken account of their relevant experience wherever possible. If any of the overseas examples we cite are of particular interest to you, we would be delighted to arrange for you or your team to speak directly to individuals at other PwC member firms.

Our views on the key themes highlighted by the Review are summarised below. Our detailed responses to the Review questions are set out in Appendix 1 to this letter.

1 The audit expectation gap

In our view, there is a clear expectation gap between the legal and regulatory definitions of the scope and purpose of today's statutory audit and stakeholder expectations of what an audit should do. The concept of the expectation gap is not new and the audit profession must take some responsibility for the fact it has remained unresolved for many years. Now, following a number of high profile corporate failures, the level of associated disquiet has intensified and the need to resolve the expectation gap is critical. We observe that the expectation gap has several dimensions, including:

- Who the audit is for, and who can rely on it.
- The nature and extent of the risks the audit covers.
- The extent of corporate reporting that an audit covers.
- The extent of comfort an audit provides about the future, about the risk of fraud, and about a company's compliance with laws and regulations.

In addition, there is a general lack of understanding over whether an audit gives comfort over an entity (its behaviours, its culture, its viability) or "just" over a set of financial statements.

2 The corporate reporting ecosystem

Working to resolve the audit expectation gap is complicated by the fact that audit operates as part of a inter-connected corporate reporting "ecosystem". This ecosystem has several different members - preparers, those charged with governance, investors, other users, regulators, as well as auditors. As in any ecosystem, effective functioning of the whole depends on each member operating effectively. We fully recognise the need for auditors to embrace change, and we also observe that the effectiveness of any changes will depend on the evolution of the roles of all ecosystem members, in particular the ways in which they interact with each other.

Currently, the audit is performed for the benefit of the body of equity shareholders in a company. But we recognise that new groups of stakeholders are entering the ecosystem, and may have an interest in corporate reporting and therefore the assurance available over that reporting, including the audit. We are open to a discussion about how our audits might evolve to reflect the needs of these wider groups of stakeholders, whilst noting the need for the debate on auditor liability to progress concurrently.

3 Responsibilities for corporate reporting

The benefit of improving today's audit regime will be limited if the underlying clarity and relevance of corporate reporting subject to audit does not also improve. UK corporate reporting requirements have expanded over recent years, both in terms of volume and complexity. This can make it difficult for diverse groups of users to access information that is relevant to their needs and readily understandable. We support Sir John Kingman's recommendations that ARGA should be tasked with promoting brevity and comprehensibility in corporate reporting and with assessing regularly the extent to which the reporting framework is relevant to users' needs[1].

We also welcome Sir John Kingman's recommendations that the entirety of the annual report should be subject to oversight from ARGA[2] and that ARGA should have supervision and enforcement powers over those responsible for preparing corporate reporting[3]. In addition, as we suggest below, we support enhancing directors' responsibilities for internal controls, learning from the experience of the US market and the introduction of the Sarbanes-Oxley (SOx) legislation.

4 The responsibilities of the Board and Audit Committee in determining levels of assurance

External audit is just one of a spectrum of ways in which "assurance" about the many different risks facing a company can be obtained. These different risks include those which directly impact financial reporting, those which could impact the business model and, ultimately, viability, as well as risks that are relevant to the value drivers included in a broader business assessment. Different sources of assurance can deliver different levels of comfort; levels of comfort might vary depending upon the nature of the risk, the needs of the user and the type of assurance provider. As we note above, there is currently confusion about the risks addressed by the statutory audit, and the level of assurance provided.

We suggest that a constructive addition to the current regime would be for the Audit Committee (as the sub-committee of the Board often responsible for corporate reporting, internal control and related assurance) to have an explicit responsibility for determining the level and type of assurance needed by company stakeholders over the principal risks faced by the company. This could be achieved by the creation of an "assurance map" setting out:

- The principal risks faced by the company.
- The controls in place to mitigate those risks.
- The key performance indicators relevant to the company (which could be financial or non-financial).
- The information and results needed by users to assess risks, related controls and key performance indicators.
- The assurance available, including who provides the assurance, and how frequently.

The plan for the statutory audit would be part of the assurance map; we suggest below that for large public interest companies it could be appropriate for the auditor to attest to the effectiveness of internal controls as part of the statutory audit and this too would be incorporated. The Audit Committee could also commission the external auditor to provide separate assurance over areas of risk not related to the financial statements. However, any such extension would be at the discretion of the Audit Committee. Similarly, the work of other assurance

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[1] Recommendation 23, p34 of the Independent Review of the Financial Reporting Council
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

[2] Recommendation 29, p37 of the Independent Review of the Financial Reporting Council
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

[3] Recommendations 36 & 37, p43 of the Independent Review of the Financial Reporting Council
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

providers (whether external or internal to the company) would be included in the assurance map. In this way, the assurance map would fall into two distinct parts:

- Risks and controls covered by the statutory audit; and
- Risks and controls subject to assurance, but not as part of the statutory audit, together with details of the level of assurance provided to the company and the assurance provider.

This approach would prompt a constructive discussion at the Board and Audit Committee about the level of assurance required. The assurance map could be presented to stakeholders at the beginning of each audit cycle, thus giving stakeholders an opportunity to participate in the decisions made. It also introduces an element of "future proofing" into the regime; as stakeholders and their expectations change in the future, there would be a mechanism to allow levels and focus of assurance to respond. For example, particularly topical risks (current examples would include cyber and data security) could be incorporated into the regime.

5 Specific areas of focus

There are a number of areas in which the expectation gap is particularly profound, including the auditor's responsibilities for evaluating internal controls, for considering fraud risk, for reporting on going concern and for reporting on performance measures outside of the financial statements. In each of these areas we believe that improvements could be made to today's reporting and audit regime. We have summarised these below. Any changes would need to be accompanied by assertive action from government, the regulator and the audit profession to clarify and better communicate the respective responsibilities of directors and auditors.

Internal controls

We would support the introduction of a strengthened framework of responsibility and reporting in respect of a company's internal controls. At the heart of such a framework would be a clear, public attestation from directors as to the design and operating effectiveness of the company's internal controls, which would be underpinned by:

- A clearly communicated expectation of the level of rigour and diligence to be applied in making that attestation; and
- An accountability mechanism with consequences for directors in the event of non-compliance.

We would also support a requirement for the auditor to make a corresponding attestation on internal control.

In designing and implementing any such regime, there would be a number of key decision points:

- The companies to be brought into scope. We would suggest that the directors' attestation could be mandated for a broad range of companies, particularly where there is significant separation between management and stakeholders. However, auditor reporting could be limited to larger companies of a greater public interest.
- The internal controls to be brought into scope. The US SOx regime, from which many useful lessons can be learned, is focussed on internal control over financial reporting. Given the broader nature of the expectation gap experienced in the UK, we suggest that a wider range of controls over principal risks could be considered. In particular, we recommend that controls over fraud risk should be incorporated into any new regime.
- In the event that the "assurance map" approach that we suggest above is pursued, the scope of the internal controls to be considered could be driven by the Audit Committee's completion of the assurance map.
- The proportionality of the regime - ensuring that the cost/benefit analysis clearly justifies its introduction.

In the UK audit regime, auditors issue a “binary” audit opinion, concluding if the financial statements give a true and fair view or not. We believe that the clarity of this overall opinion is important and that it should be retained. It is a widely recognised, objective and consistently used concept that gives users an unequivocal message about the quality of the reporting of the financial position and performance of the company. However, auditor reporting on internal controls could be more calibrated, providing users with a deeper insight into the company and potential areas of concern, whilst not undermining the opinion on the financial statements.

The introduction of reporting on internal controls could also provide an opportunity to explore the appetite for, and value of, more frequent reporting throughout the year focussed on internal controls rather than company performance. With the advent of technology solutions enabling “hands-free” testing of automated business controls, it is also possible to imagine a regime where some of this reporting, and related assurance, could be provided continuously.

Fraud

In our experience, some occurrence of fraud is inevitable in the corporate world; no proportionate system of internal control or audit can fully eliminate the risk of fraud, particularly where financial impact is relatively low. In our view, more could be done by companies and auditors to help stakeholders better understand the risks of fraud facing a company, the controls in place to mitigate those risks and the relative responsibilities of directors and auditors. This information could be included as part of the assurance map approach we suggest above.

As part of our own Future of Audit initiative[4], we have held several roundtables to better understand stakeholders' views on the scope and purpose of audit. The auditor's responsibility for fraud was a frequent topic of conversation, and we heard that attendees had experienced inconsistency in different auditors' approaches to fraud risk and in the oversight exercised by Audit Committees in this area. We believe that techniques including the use of a fraud diagnostic survey and involving forensic specialists at the planning stage could be applied more broadly than they are today.

There is also opportunity to evolve the audit scope beyond today's model, for example through incorporating assurance over fraud-related controls within an internal controls attestation. We have expanded on all of these ideas in our detailed response.

Going concern

In a capitalist economy where economic reward is linked to risk, it's inevitable that some companies will fail. Whilst corporate failure is a natural consequence of capitalism, it is also the case that unexpected corporate failure can result in distress and harm to vulnerable stakeholders.

We believe that the responsibilities, reporting and auditing regimes in respect of going concern and viability should be reformed to ensure that all stakeholders are provided with the right information to enable them to make more timely and better decisions about their relationship with a company. Companies will still fail, but unexpected failure will be less likely if stakeholders have a clearer picture of the risks that could lead to failure, and can make better decisions as a consequence.

Key elements of reform could include:

- An overhaul of the business model, principal risk, going concern and viability reporting regime, resulting in a single, coherent piece of reporting focussed on the directors' assessment of scenarios in which the

[4] www.pwc.co.uk/futureofaudit

business model could break. This reporting should focus on the next 12 months, as required by the Companies Act, with a more qualitative assessment of business model risks that could crystallise beyond that period, not confined to a prescribed "viability period".

- Auditor reporting could then follow the same approach, with reasonable assurance being given on the detailed going concern analysis of the 12 month period.

Consideration could also be given as to whether an annual exercise on going concern is sufficient; directors could be required to evaluate the assumption more regularly, and commission assurance as needed.

In our responses to the questions in the Call for Views (included in the appendix), we have set out our detailed recommendations for granular improvements to bring more consistency to the way in which auditors examine going concern risks, including more frequent use of specialists, and increased focus on external market intelligence (perhaps in conjunction with the new ARGA Market Intelligence Unit)[5].

An important area for reform is the material uncertainty regime, whereby auditors must highlight material uncertainties regarding going concern in their auditor reports. The bar for reporting a material uncertainty is high, and consequently, such reporting can become a self-fulfilling prophecy, leading to a company's demise. We suggest that auditors need another route to highlight potential issues relevant to the going concern assessment which may not (yet) be material uncertainties. The inclusion of a mandatory Key Audit Matter (KAM) on going concern in all public interest audit reports would provide a means of reporting such issues, and we would suggest that there could be an expectation (rebuttable) that the auditors of all reasonably complex companies would have a number of disclosable points to report in such a KAM.

Performance measures outside the financial statements

We recognise that company stakeholders may use information beyond the financial statements in their decision making; in fact there are often non-financial/non-GAAP performance measures that are key "value drivers" critical to assessing the performance and future prospects of a company. Examples include regulatory capital, including risk-weighted assets (banking industry); mineral reserves and resources (extractives industry); sales per square foot (retail industry); and carbon emissions (all industries). Because such measures do not appear in the financial statements, they are not subject to audit, but their inclusion in the annual report leads many users to assume that they must be covered by the audit opinion.

Often, financial non-GAAP performance measures have emerged because today's financial reporting framework has not adapted to the emergence of new value drivers and therefore GAAP performance information gives an incomplete picture. We encourage accounting standard setters to continue to allow the financial reporting framework to evolve to remain relevant. However, in the meantime, we believe that there should be strong encouragement for Audit Committees to consider commissioning assurance over critical financial non-GAAP performance measures.

For non-financial performance measures, we would suggest that the Audit Committee should consider the need for, and source of, assurance as part of the assurance map exercise we discuss above.   In some cases, there may be no recognised framework for the calculation and reporting of such measures and, for common measures, we would encourage ARGA to develop an appropriate framework against which assurance could be given. Even

[5] Recommendation 44, p48 of the Independent Review of the Financial Reporting Council https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

in the absence of such a common framework, if management make clear disclosure of the basis of preparation, some degree of assurance would still be possible.

6 Transparency

An important means by which the audit profession will regain society's trust will be through increased transparency about our activities, both on the part of an individual auditor, through auditor reporting, and on the part of audit firms. The Audit Committee also has a role to play in its public reporting on its activity.

As we explain above, we believe that the clarity of the auditor's overall opinion on the financial statements is important, and should be retained. But we support work to improve the usefulness of our auditor reporting, and we have made detailed recommendations in the appendix on how this might be achieved, including through the inclusion of more subjective narrative, or graduated audit findings in the auditor's KAMs and the introduction of a mandatory, and specific, KAM on going concern. The recommendation we make above that the Audit Committee present an assurance map to stakeholders would further increase transparency over our work.

The large audit firms' Transparency Reports[6] are already rich sources of information about the firms, but we recognise that these documents are not widely read. We would be happy to consider further enhancements both in terms of content (for example, including candid discussions of areas for improvement) and accessibility.

7 Stakeholder engagement

Increased transparency will not assist in closing the expectation gap unless there is also constructive engagement between all participants in the corporate reporting ecosystem resulting in an understanding and acknowledgement of the respective responsibilities of preparers, those charged with governance and auditors.

In our experience, there is currently only a minimal level of engagement between investors (as users of corporate reporting), Audit Committees and auditors. Such engagement that does happen is often the responsibility of specialist governance functions within investment firms who can be distant from those who make investment decisions. A much greater level of mainstream engagement between these parties will be an important part of improving the effective operation of the corporate reporting ecosystem.

We believe that other changes which take account of the needs of various stakeholder groups will also be needed to achieve the level of engagement required. In the Call for Views, an annual assurance meeting is suggested; we would support such a meeting, led by the Audit Committee, attended by the external auditor (and other assurance providers if relevant) who would be available to answer questions, and with all stakeholders invited. The Audit Committee Chair could present both on the results of the audit (inviting the external auditor to comment), and on the planned assurance for the forthcoming audit cycle, prompting a constructive debate on both areas. Areas of particular importance, such as fraud risk and going concern, could be mandatory items on the agenda. The PwC member firm in the Netherlands has already experimented with a similar approach, using the AGM as the forum for debate.

8 Liability

Throughout our detailed response, we discuss areas where the auditor could do more, with the objective of making our audits more useful to stakeholders. Naturally, any such changes will increase the potential risk assumed by auditors and therefore we believe it is important for changes to be accompanied by a re-evaluation of

[6] www.pwc.co.uk/annualreport/assets/2018/pdf/uk-transparency-report-18.pdf

the auditor liability regime, together with a review of responsibilities and accountability throughout the corporate reporting ecosystem.

In our view, consideration should be given to the introduction of an auditor liability cap mechanism to ensure that auditor liability remains proportionate and that liability is shared fairly between those responsible for any failure in corporate reporting. We note that the current provision for liability limitation agreements in the Companies Act has not proved to be acceptable to the market and in our experience is rarely, if ever, used.

9 Other reviews

In giving our views, we are mindful of the other reviews of the UK audit market that have been undertaken, in particular the CMA market study of the audit market, Sir John Kingman's independent review of the Financial Reporting Council and the BEIS Select Committee's inquiry into the future of audit. All of these reviews have raised questions over the auditor's role and responsibilities and could lead to further recommendations for reform. The different timing of these reviews increases the risk that recommendations, and their implementation, could conflict with each other. In particular, we note that audit quality and the future evolution of the audit is critically dependent on the multi-disciplinary firm model which allows ready access to necessary expertise. We encourage BEIS to develop a single, coherent package of reforms which takes account of all of the important work performed.

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As you note in your Call for Views, there is further work to be done, and there will be further calls for views. We look forward to continuing to contribute to this critically important work.

We hope our comments are helpful and if you have any questions or require any further information, please do not hesitate to contact me at

Yours sincerely,

Hemione Hudson
Head of Assurance, PricewaterhouseCoopers LLP

Appendix 1 - Responses to the Review questions

Chapter & Question	**Responses**
Chapter 1 - Definitions of audit and its users *Q1: For whose benefit should audit be conducted? How is it of value to users?* *Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?* *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?*	***(Q1) Value and benefit of the audit*** We acknowledge that many people, beyond a company's equity shareholders, have an interest in a company's financial statements and corporate reporting and therefore, explicitly or implicitly, have an interest in the assurance available over that reporting, including the audit. These people can include customers, suppliers, employees and tax authorities. We think the responsibility and duty of care of the auditor should continue to be only to the company and to the body of shareholders of the company, consistent with the obligations faced by directors under existing company law. However, we recognise the wider societal expectations of company reporting and of the audit profession and we are open to a discussion about how our audit might evolve to reflect the needs of wider groups of stakeholders, whilst noting the need for the debate on auditor liability to progress concurrently. ***(Q2) Confidence in the entity vs the financial statements*** In terms of whether the audit should increase confidence in the company itself (for example its behaviour, its culture, its viability), or "just" in the financial statements, we believe that the purpose of the audit should be to promote trust in the financial statements, although we note that the scope of the audit could be expanded (for example to cover the effectiveness of internal controls, as discussed in more detail below). We do not believe the audit will always enhance confidence in the entity itself. Indeed, sometimes the financial statements and related audit report may highlight issues which could diminish confidence in the entity by accurately reporting concerns. ***(Q3) Clarity regarding the purpose of audit*** The current lack of clarity around the purpose of the audit and for whom it is conducted could be improved. More clarity could be achieved by amendments to legislation, but there is potential for this to go unnoticed by the wider public, who, arguably, are those most unclear about the purpose of an audit. Any clarifying changes to legislation would need to be accompanied by a programme of engagement designed to increase public understanding of the purpose of the audit. Our Future of Audit initiative[1] is one example of such a programme. We suggest that the new regulator should also be tasked with the objective of increasing societal understanding of the purpose of audit.

[1] In November 2018 we launched our Future of Audit initiative by sending a letter to over 7,000 businesses and investors to canvas stakeholder views on how the audit should evolve for the future. As part of the initiative, we held five roundtable events across the UK (Birmingham, Manchester, Belfast, Edinburgh and London) from December to February, with 150 businesses, investors, academics and other stakeholders attending. To complement the qualitative views expressed in the roundtables, our online forum and one-to-one meetings, we conducted an online survey of the business and investment communities to capture their views on a range of issues debated. We had nearly 400 respondents, split roughly equally between the two groups.

Chapter 2 - The 'Expectation Gap'
Q4: Do respondents consider there is an expectation gap?

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

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?

(Qs4,5) The expectation gap
In our view, there is a clear expectation gap between the legal and regulatory definitions of the scope and purpose of today's statutory audit and current auditor responsibilities and the public's expectations of the same. Whilst the concept of an expectation gap in audit is not new, following the failure of a number of high profile UK companies, such as Carillion plc, BHS and Patisserie Valerie, the focus on what an audit does and what it is expected to do has intensified (including from the press, investors, Government and regulators) and it is critical that it is considered as part of the Review.

The expectation gap has several dimensions, which we would characterise as relating to:

- who the audit is for - there is a lack of clarity over the purpose of audit and for whom it is conducted;
- the timeliness of reporting - not quick enough, not real time;
- the nature of risks covered - audits largely focus on the risks relating to the financial statements, not the broader risks to an entity such as cyber risks or other operational risks;
- the extent of comfort about the future of a company - audits do not prevent company failure;
- the extent of comfort over corporate behaviour, risk appetite and culture, including many types of fraud and compliance with laws and regulations; and
- a more general lack of understanding about the scope of an audit - because the financial statements are packaged in an annual report, those less familiar with audit often have the perception that the entirety of that report is audited.

(Q6) The "delivery gap"
Quality inspection results reported by external regulators such as the Audit Quality Review team of the Financial Reporting Council (FRC) do identify some issues with aspects of audit quality and there have been well-documented instances where audit quality has fallen short of requirements. Although firms such as ours have extensive systems of quality management and we believe that the vast majority of audits that we perform are undertaken to a high standard, as a profession, we have not been sufficiently responsive to stakeholder concerns. There is a trust issue that needs to be addressed and we are committed to working to improve and address those concerns.

Audit quality
As any delivery gap is evaluated, it will be important to reach a consensus about what high audit quality means. In our view, high audit quality increases the level of trust in the financial statements. High audit quality is achieved through the auditor having the competence and capability to design and execute an audit that thoroughly addresses relevant risks and will therefore identify problems in the financial statements being audited, if problems exist, AND through the auditor having the moral courage to tackle any problems that are identified.

The FRC focuses chiefly on compliance with the auditing and accounting standards when judging high audit quality. Where areas of non-compliance are identified it is very often the case that the audits were still of sufficiently high quality to detect material misstatements in the financial statements.

When it comes to stakeholders, our survey as part of the Future of Audit initiative showed a striking difference between what investors think constitutes high audit quality and the corresponding views of company directors and management. When asked to describe a

	'high quality audit', the groups identified the following: Investors: financial statements that are accurate and reliable; an auditor who is trustworthy, honest and has challenged management; an auditor who has sufficient experience with the industry and who understands the business. Companies: an audit that gives value for money, is done efficiently, uncovers something previously unknown and gives no surprises during or after the engagement; an auditor who gives appropriate challenge and understands the business. Based on these observations, it is clear that there is currently no consensus on what constitutes high audit quality; the answer is most likely a combination of these different views. A common definition of high audit quality would help drive a more balanced public narrative around audit and ultimately could increase trust in audit.
Chapter 3 - Audit and wider assurance *Q7: What should be the role of audit within wider assurance?* *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?* *Q9: Are the existing boundaries between internal and external audit clear?* *Q10: To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?* *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?*	***(Qs7,8,11) The role of audit*** In our view, audit is just one of a spectrum of ways in which "assurance" about the many different risks facing a company can be obtained. Other assurance sources include: ● the company's own reporting and risk assessment, including reporting on going concern and the risk of fraud; ● the activity of, and reporting by, the Audit Committee, including the Audit Committee's assessment of the effectiveness of external and internal audit and the significant issues the Audit Committee has considered relating to the financial statements; ● internal controls attestations by management (see later in the response); ● the work of internal audit; ● specialist assurance in various areas such as climate risk or customer service ● a robust "helpline" programme for the reporting of complaints and allegations and system for addressing them. In addition, there are a number of ways more informal assurance can be gained, for example from analyst reports or external influencers like social media and review websites. In the future, once the new regulator, ARGA, is established, assurance could also be obtained through ARGA directing a company to commission a "skilled person's report"[2] on a particular area of risk. So, in our view, it is not the case that the auditor is the only assurance provider. That said, there are some basic characteristics of providing assurance that we regard as critical, depending upon the degree of assurance required. For example, the higher the level of assurance demanded, the more important are independence, objectivity and competence of the provider; this means that the external auditor, who is held to high standards by ethical codes, can make a particularly significant contribution. One way in which we have been constrained by the independence requirements applied to audit firms is in our ability to partner with technology firms to accelerate the development of audit tools.

[2] Recommendation 47, p49 of the Independent Review of the Financial Reporting Council https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

The "Assurance Map"
Just as there are a range of different sources of assurance, we think there can also be a variation in the level of assurance provided. This is likely to vary depending upon the nature of the risk, the user of the assurance and the amount of the assurance needed than the industry or sector.

A useful exercise would be for company directors to create an assurance map to determine the assurance needed by their stakeholders. This could be done as follows:

1) Identify the principal risks at the company, financial, business and operational.
2) Determine what information (financial and non-financial; inside and outside the financial statements) relates to each risk and how that information is controlled.
3) Determine which stakeholders would be most impacted by these risks (including the wider group outlined above).
4) Determine the information and results are needed by those stakeholders to assess the risks, related controls and key performance indicators.
5) Determine the assurance available, including who provides the assurance, and how frequently.

The assurance map could be published by the Audit Committee at the beginning of an audit cycle, giving stakeholders the opportunity to comment and, if necessary, challenge the level of assurance planned. It would include details of the planned statutory audit and also other planned assurance work, whether provided by the external auditor or by another assurance provider.

This approach would enable the boundaries of the statutory audit to be clear, together with the duty of care and liability assumed by the external auditor in delivering that work. Other assurance work commissioned by the Audit Committee in completing the assurance map would be structured as a distinct engagement under separately agreed terms with the relevant assurance provider.

We have commented in our responses to later questions where we believe the current definition of the statutory audit could be expanded by the inclusion of an opinion over the effectiveness of internal controls.

(Qs9,10) Internal audit
In the eyes of external auditors, internal auditors and informed management, the existing boundaries between internal and external audit are clear. In the eyes of the public, these boundaries are probably less clear, however, as internal audit reports are not usually published, they are not generally relied upon externally. However, they could be a valuable part of the "assurance map" outlined above.

On a related point, we are not supportive of the prohibition in ISA (UK) 610[3] over the use of internal audit in a direct assistance capacity, and would encourage that prohibition to be examined as part of the Review.

[3] Paragraph 5-1 https://www.frc.org.uk/getattachment/35379d8e-812f-4942-b3e3-6d412209a8c4/ISA-(UK)-610_Revised-June-2013.pdf

Chapter 4 - The scope and purpose of audit *Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?* *Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?* *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?* *Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?* *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"?* *Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?* *Q18: Should such a statement be subject to assurance?* *Q19: Who might be capable of giving such assurance?* *Q20: Is there a case for a more forward-looking audit? What would be the main benefits and risks?* *Q21: Would audit or assurance over financial and*	***(Qs12-14) Internal controls*** We are supportive of introducing a strengthened framework around a company's internal controls. In our experience, the current UK Corporate Governance Code provision 29[4], which asks directors to monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report, does not drive consistent levels of rigour and diligence in UK company boardrooms, or a consistent sense of granular accountability for the system of internal controls. In comparison, the introduction of the s302 requirement in the US Sarbanes Oxley (SOx) legislation, requiring directors to make a public attestation as to the design and operating effectiveness of internal controls over financial reporting, in our view, prompted a significant behavioural change in US companies. We believe this behavioural change was driven by two elements: 1. A carefully communicated expectation of the level of rigour that would be applied in making the s302 attestation; and 2. An accountability mechanism so that there would be serious consequences for directors in the event that the controls they certified were ineffective. We would also support a requirement to increase the scope of the statutory audit such that the auditor reports publicly on the effectiveness of internal controls over financial reporting (including those in respect of relevant fraud risks and those relating to the going concern assessment). Based on experience in the US, the directors' statement and the related assurance meaningfully contribute to the reliability of financial statements and to high audit quality. In designing and implementing any UK regime requiring attestation and assurance over internal controls it will be important to learn lessons and collect best practices from the US and other SOx-type regimes around the world. For example: ● A SOx-type implementation would undoubtedly be costly, time consuming and complex and so careful consideration would need to be given to the companies brought into scope. We would suggest having the directors' attestation requirement apply to a broad range of companies, particularly where there is a more significant degree of separation between management and stakeholders. We would suggest limiting the corresponding assurance requirement to larger companies, for example large PIEs. ● With both the directors' attestation and the corresponding assurance, there will be a need to consider which internal controls are brought into scope - should any new regime be limited to those controls relating to financial reporting, or should other internal controls, such as those mitigating cyber security risks, for example, also be subject to examination? The current US SOx regime is limited to internal controls over financial reporting, assurance over which, as we note above, we support being part of an expanded audit scope. However, given the broader nature of the expectation gap that we have experienced in the UK, we believe that the need for attestation and assurance over a wider set of controls should also be considered, provided that an appropriate framework for attestation could be developed, perhaps in conjunction with ARGA. ● To do this, the Audit Committee could consider the principal risks faced by the

[4] Page 12
https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf

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? *Q22: If so, what information might usefully be subject to audit or another form of assurance and why?*	company, and corresponding controls, and consider whether further attestation and assurance is required, over and above that provided as part of the statutory audit. This would form part of the completion of the assurance map, which we discuss earlier in this response. ● Currently in the UK, auditors issue a "binary" audit opinion, which concludes whether the financial statements give a true and fair view. As we discuss below, we think that the clarity of this overall opinion is important and that it should be retained, although could be supplemented by more subjective narrative, or graduated findings in respect of KAMs. The auditor's opinion over internal controls could be more calibrated, providing a deeper insight into the company and potential areas of concern, whilst not undermining the opinion on the financial statements. In a similar way to the FCA's CASS reporting regime, auditor reporting in this area could be accompanied by management's comments on their planned response and mitigating actions. Part of the criticism over the SOx regime, and audit in general, is that it is a point-in-time assessment. This may always be the case for the audit of many of the elements of the financial statements, as they are often reliant on judgements and estimates based on circumstances at that particular point in time. However, internal controls operate throughout the year. The introduction of auditor reporting on internal controls in the UK could provide an opportunity to explore the appetite for, and value of, more frequent auditor reporting throughout the year - focussed on internal controls. With the advent of technology solutions enabling "hands-free" testing of automated business controls, as company controls and monitoring technologies evolve, it is also possible to imagine a regime where some of this assurance could be provided continuously. ***(Q15) Regulatory framework around going concern*** The current regulatory framework requires directors to consider if the going concern basis of accounting is an appropriate basis on which to prepare the financial statements - and consequently it is often regarded as an accounting policy decision. We believe that framing it in this way undermines the fundamental importance of the judgement which is probably the most critical judgement that the directors make each year in preparing and approving the accounts. The concern is further exacerbated by the fact that the alternative accounting policy (break up basis) is almost never used, and therefore the going concern basis becomes the default approach. We would suggest that the going concern decision should be reframed as a fundamental judgement about the future of the company to be made by the Board in the financial statements process, with specific reporting requirements to stakeholders as a result of their judgement. ***(Qs16-19) Reporting and assurance over going concern and viability*** In a capitalist economy, where economic reward is linked to risk, it's inevitable that some companies will fail. Whilst corporate failure is a natural consequence of capitalism, it is also the case that unexpected corporate failure can result in distress and harm to vulnerable stakeholders. Some recent large corporate collapses have resulted in multiple, sudden job losses, have threatened critical public services or have left pension schemes

unfunded. Stakeholders in these companies feel that they did not have the opportunity to mitigate their risk since they had limited warning of rapid corporate failure.

We believe that the responsibility, reporting and auditing regime in respect of going concern and viability should be reformed to ensure that all stakeholders are provided with the right information to enable them to make more timely and better decisions about their relationship with a company. Companies will still fail, but unexpected failure will be less likely if stakeholders have a clearer picture of the risks that could lead to failure, and can make better decisions as a consequence. Directors should have a primary role in any such new regime, with auditors also playing an important part.

The corporate reporting regime

It's widely recognised that the quality of corporate reporting on the sustainability of the business model, long term prospects and viability leaves room for improvement, as Sir John Kingman[5] and others have remarked. This problem needs to be tackled as a precursor to a re-design of an associated audit model. If companies become more transparent and insightful about risks and their future prospects, including details of their sensitivity analysis and headroom, there will be more scope for auditors to comment on this in their reporting. There are a number of ways in which companies could be more robust and transparent including:

Going concern statement - Unless there is a material uncertainty, companies are not required to give a narrative disclosure in connection with going concern other than (in the case of premium listed companies applying the UK Corporate Governance Code) to confirm that the board thought it appropriate to adopt the going concern basis of accounting. Some companies do include a more detailed explanation, but this is not a requirement. We believe companies should be encouraged to make specific going concern disclosures even when they are not reporting a material uncertainty. As we explain above, we think that framing the going concern decision as a decision regarding a basis of accounting is unhelpful.

Risk reporting - Principal risk disclosures could be more specific and better illustrate the interdependencies between the risks as well as related sensitivities. They could also be clearer on how far forward they look and could better describe the period over which the risk might crystallise and how that might happen.

Viability statement - The viability statement could be improved in a number of ways, including being more robust in its description of the genuine long-term prospects facing the company, sensitivities around assumptions about the longer term future and by focusing on individual events and conditions rather than making generic statements. It might also consider the company's risks and opportunities relating to technological, environmental and social changes, and any other 'megatrends' that are potentially relevant to the future prospects and sustainability of the business. Currently, there is too much focus, in our view, on the viability period, which is often simply the company's business planning period, with not enough attention given to the preparation of the surrounding risk and scenario disclosures.

[5] Paragraph 3.22, p51 of the Independent Review of the Financial Reporting Council
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

Notwithstanding this, rather than try and reform the viability statement in isolation, referencing the question asked by Sir John Kingman in his review of the FRC[6], we recommend that consideration be given to replacing the current viability statement regime with a much more robust going concern assessment and disclosure.

Despite good intentions, the viability statement has become, in many cases, boilerplate and vague. Replacing it with a more robust going concern statement where the directors set out their business model and key risks that would threaten that business model, could be a clearer, more logical approach than having two separate disclosures.

In performing their diligence before writing this more robust going concern statement, the directors should define the risks that could "break" that business model, and provide commentary over those risks including any mitigating factors. A useful approach to doing this may be to incorporate a reverse stress testing regime, similar to that used in the financial services industry. The current viability statement regime asks directors to define (and explain the rationale for) the period of the assessment, and we have seen a tendency to default to an assessment period of 3-5 years. Under our suggested approach of a more robust going concern statement, we think it would be more meaningful not to define one single viability period (beyond the minimum 12 months required for going concern), but to focus on the circumstances that could cause each of the key risks to materialise, over what time period that could happen and what the associated impact could be.

Under existing accounting standards, the directors would still be required to specifically refer to the next 12 months in their more robust going concern statement, and could do this by highlighting the risks materialising in the next 12 months and how they would be managed or mitigated.

The auditor's assurance would mirror this assessment, with reasonable assurance in the first 12 months.

Consideration could also be given as to whether an annual exercise on going concern is sufficient; directors could be required to evaluate the assumption more regularly, and commission assurance as needed.

(Q20) Should today's audit become more forward looking?

Today's audit is already required to be forward looking, as it incorporates an assessment of the directors' going concern conclusions. In addition, an auditor is often required to consider future projections when examining key judgements on carrying value, for example in respect of goodwill. We do not believe that the audit needs to be more forward looking but, as we have explained above, we would suggest that the going concern reporting regime could be reformed to give better information to stakeholders. Better information, with associated assurance, would naturally increase the levels of trust in the reporting of this critical area.

There are also elements of our audit approach to going concern which today we apply in particularly high-risk situations. We recommend that some of these techniques could be applied more broadly to bring more consistency to the way in which auditors examine

[6] Recommendation 52 of the Independent Review of the Financial Reporting Council https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

going concern risks. These include:
- Increased focus on the macro impacts that may be relevant to a company in the future.
- Social media scanning for indications of customer and stakeholder sentiment.
- Targeted involvement of specialists from other non-audit parts of the firm, in the risk assessment process to analyse “how could this company fail”. These specialists could also be used in the execution phase of the audit.
- Utilisation of data techniques in the risk assessment to calculate relevant ratios and z-scores that may give an indication of future issues.

In the future, audit procedures on going concern could be further enhanced through:
- Drawing on market intelligence from a number of sources, not just the auditor’s own assessment, including: intelligence from the ARGA Market Intelligence Unit (when it is created) and major institutional shareholders, who we suggest should also have a “duty to alert”.
- Creating going concern SMEs within the audit practice who “qualify” by doing a cycle of experience in a deals team, through working on working capital reviews or by gaining audit experience of a challenging going concern scenario (all of which are made possible by a multi-disciplinary firm structure).
- Encouraging management to extend their “look forward” period in their assessment to make it less of a rigid cliff-edge. This would then better inform the auditor’s assessment over the 12 month going concern period. In the event that our recommendation of a combined going concern/viability regime is introduced, the extension of the “look forward” period would be naturally incorporated.

We also believe that the auditor should be more transparent around the work they have performed over going concern and viability, through more specific and precise narrative in the audit report; a mandatory Key Audit Matter on going concern for PIE audit reports could be considered. However, increased disclosure will not help bridge the expectation gap unless stakeholders better engage with the audit process. Ideas for prompting this engagement include:
- Pro-active presentation at the AGM (as well as answering questions from shareholders) about relevant aspects of the audit, including the work over going concern. This is explored further later in our response.
- The Audit Committee could share the audit plan (prior to the audit) with the shareholders and ask for their feedback specifically on the audit approach on going concern. Depending on the feedback received and after approval by the Audit Committee the auditor could, if necessary, adjust the plan. See later in our response.

We welcome the fact that both of these suggestions are already being considered in the Review.

Other suggestions for changes in this area
The changes we have suggested above could increase the quality and consistency of today’s audit procedures in the area of going concern. More significant changes could include:
- As noted in earlier in our response, we are supportive of the introduction of a strengthened framework around a company's internal controls with the directors taking greater accountability for the company’s risk management and internal controls system and making an explicit public statement about their

effectiveness, taking any relevant lessons from the operation of the Sarbanes-Oxley regime in the US. This could include a specific focus on the controls around the going concern assessment and/or on those risks (and related controls) which, in extremis, could break a company's business model. Assurance over these controls would form part of the statutory audit.

- Performance of extended procedures (akin to a working capital review) on a targeted subset of companies (perhaps those with a material uncertainty or a company identified by ARGA's Market Intelligence Unit). It could be that such work is commissioned as one of the "skilled person reviews" that is being suggested by Sir John Kingman in his recommendations for ARGA.

The material uncertainty regime

Material uncertainties in respect of going concern appear only in a very small number of audit reports. This is because the bar for a material uncertainty is very high. Once a material uncertainty is disclosed, the demise of that company can become a self-fulfilling prophecy. We suggest that auditors and the company need another route to highlight potential issues relevant to the going concern assessment which may not (yet) be material uncertainties. The reporting of such issues needs to become more commonplace, and therefore create less risk of having an explosive impact on the market. The inclusion of a mandatory Key Audit Matter on going concern in all PIE audit reports would provide a means of reporting such issues, and we would suggest that there could be an expectation (rebuttable) that the auditors of all reasonably complex companies would have a number of disclosable points to report in such a KAM.

This may be what the FRC is aiming to achieve from its consultation on ISA (UK) 570 *Going Concern*[7] which includes a proposal for increased disclosures in the audit report over the audit procedures performed and key observations relating to going concern.

Other considerations

Many of the suggestions above would not be easy to implement and the cost/benefit would need to be assessed. Important points to be considered in the design and implementation of any solutions include:

- Any increase of the audit scope must be carefully communicated in order to avoid an inadvertent increase in the expectation gap.
- Any degree of expanded assurance in this area is likely to require a range of knowledge and skills and the need to rely even more on the work of specialists (we note that this is one of the major benefits to audit quality of having a multidisciplinary firm structure, allowing easy access to such in-house specialists).
- Changes to the current audit scope in respect of going concern could provide more assurance to investors and others that the business was "safe". However, unless there is a corresponding consideration given to the statutory auditor liability regime, there is a risk that this could be seen as akin to an insurance policy, with an expectation that the assurance provider should be sued if a company fails.

[7] https://www.frc.org.uk/getattachment/c6a969db-a720-4d69-87fa-1567e970ce24/;.aspx

(Qs 21,22) Assurance on information outside the financial statements
From our Future of Audit initiative we know that investors use information beyond the financial statements and our survey indicated that they would value assurance over some of that information. In fact, there are often financial and nonfinancial performance measures that are key "value drivers" critical to assessing the performance and future prospects of a company. Examples include regulatory capital, including risk-weighted assets (banking industry), mineral reserves and resources (extractives industry), sales per square foot (retail industry), and carbon emissions (all industries).

In thinking about what information might be subject to assurance and by whom, it is important to first distinguish between the different types of information and whether they correspond to a principal risk (which could be done via the assurance map described above).

Financial and non-financial performance measures
Because a company's financial statements are included in an annual report, those less familiar with audit often have the perception that the entirety of that annual report, including non-GAAP financial performance measures, is audited. This is not the case. Such measures are not currently part of the scope of the audit, although they are considered for consistency with the financial statements and the auditors' knowledge gained from the audit and in the context of the auditor's assessment of the directors' statement that the annual report taken as a whole is fair, balanced and understandable.

Often, financial non-GAAP performance measures have emerged because today's financial reporting framework has not adapted to the emergence of new value drivers and therefore GAAP performance information gives an incomplete picture. We encourage accounting standard setters to continue to allow the financial reporting framework to evolve to remain relevant. However, in the meantime, we believe there should be strong encouragement for Audit Committees to consider commissioning assurance over critical financial non-GAAP performance measures. Although noting that this would be outside the scope of the statutory audit, usually, we expect that it would be most appropriate for the external auditor to perform this work.

In implementing such a change, it would be important to consider:

- Defining what is meant by "critical". There is a danger that if only certain measures are assured, it could result in "cherry picking" by management. A potential solution would be to require those measures that are related to a principal risk and that are most difficult to reconcile to GAAP numbers to be subject to assurance.
- In some cases, there is no recognised framework for calculating and disclosing financial non-GAAP performance measures, so a framework would need to be created to ensure consistency and as a basis for assurance. For common financial non-GAAP performance measures, this could be developed by the regulator, building on the ESMA[8] or FRC[9] principles for disclosure of such metrics as a starting point. Even in the absence of a recognised framework, it could still be possible to give some degree of additional assurance over the measures by using criteria used by management and assessing the suitability and clarity of presentation of those criteria. This would, however, mean the

[8] https://www.esma.europa.eu/sites/default/files/library/2015/10/2015-esma-1415en.pdf
[9] https://www.frc.org.uk/getattachment/cd978ef7-72ad-4785-81ee-e08bb7b7f152/LAB-Performance-metrics-FINAL.pdf

company would need to make their basis of presentation disclosures much more robust.

Non-financial performance measures, including sustainability information, even when included in the Annual Report, are not included in the current scope of the audit. A company can voluntarily obtain assurance over this information under International Standard on Assurance Engagements (ISAE) 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*[10]. We would recommend that this information, if material and related to a principal risk, also be included in the assurance map so Audit Committees can decide how much assurance they think stakeholders need and who would be the best provider.

Culture and other "intangible" aspects to a company
There are certain other areas where stakeholders have expressed an appetite for assurance with one of these being corporate culture. In our survey as part of our Future of Audit initiative, a large minority (43%) of the investor respondents said they would support including corporate culture, ethics and behaviour in the central scope of the statutory audit. This was echoed in our roundtable events around the country, in which participants said that because the auditor gets a clear picture of a company's culture during the audit, they would like auditors to find a way to provide information about it to stakeholders.

We have experience of providing assurance over corporate culture in certain specific circumstances. Our view is that, with the right standard/framework setting out indicators of a culture that would lead to financial reporting integrity, and, most importantly, robust disclosure by a company, public assurance could be provided over these areas. We would recommend that Audit Committees should consider inclusion of such areas within the assurance map discussed earlier in our response. We have discussed the possibility of reporting on an organisation's culture later in our response.

Other reporting considerations
We believe that real time reporting on the effectiveness of a company's systems and controls over financial information is a near term possibility, as company controls and monitoring technologies evolve. This assurance that the company continues to be well controlled could be of more value than a point in time opinion (see our response earlier in the area of internal controls).

We would also recommend that, for UK listed companies, the auditor's report (or a version of it) be issued at the same time as the company's preliminary announcement. From our regular discussions with the investment community, we know that one of the main reasons they do not always read the auditor's report is because it is not timely enough. In their view, the fact that audit reports can be issued two or more months after the year end dilutes their usefulness.

[10] https://www.ifac.org/publications-resources/international-standard-assurance-engagements-isae-3000-revised-assurance-enga

Chapter 5 - Audit Product and Quality

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

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?

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

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

Q27: What would prevent such 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?

(Qs23,24) Value and quality of audit

We believe that it is important to consider separately the value and quality of the audit product from the effectiveness of the audit process. The former largely relates to the "expectation gap" whilst the latter relates to the "delivery gap". The means of closing each gap is entirely different. Any "delivery gap" needs to be closed by improving audit quality under the current audit model, whereas the expectation gap would be closed by evolving that model to better meet expectations of what the model should do.

Our audit partners and teams do comment consistently that the regulatory regime creates pressure to focus on the documentation on the audit file, even in less important areas. However, in our experience of performing audits, the exercise of completing the audit file is not undertaken at the expense of exercising the required considered judgement. That being said, the regulatory approach needs careful calibration to ensure that it encourages the audit profession to focus on developing a deep understanding of business model and risk to underpin its audits - rather than incentivising auditors to plan to achieve regulatory compliance.

(Qs25-27) Audit reports/opinions

When considering the binary audit opinion and also the potential for graduated disclosure of auditor conclusions, these are two distinct areas that we believe should be addressed separately. The "audit opinion" refers to the overall true and fair opinion that covers the entirety of the financial statements. However, when talking about auditor conclusions, these usually relate to those reported for each individual key audit matter which currently support the overall true and fair opinion.

The audit opinion

In our view, the binary audit opinion the financial statements should be retained. It is a widely recognised, objective, consistently used concept that gives an unequivocal message about the quality of the reporting of the financial position and performance of the company. This view is backed by results from our survey as part of our Future of Audit initiative where over 60% of investors and businesses surveyed supported the continued use of an overall binary opinion. If there is a need to modify the opinion there is a recognised framework in place under auditing standards, if circumstances dictate (qualification, adverse etc). In addition, an emphasis of matter can also be used to draw attention to a particular area of the accounts, for example events or conditions leading to significant doubt about the going concern of the company. This means that there are already mechanisms to deal with situations where a clean "true and fair" opinion is not appropriate.

However, in situations where there is an issue that does not rise to the level of a modified opinion or emphasis of matter, there is little room in the opinion itself to highlight this. Nor does the binary opinion give insight to stakeholders on the qualitative nature of the audit judgements. We believe that both of these shortcomings can be addressed through the narrative and the auditor's conclusions included in the key audit matters.

The auditor's conclusions

The current requirement for the description of key audit matters in audit reports is that, "where relevant, key observations arising with respect to those risks" shall be included. In our survey as part of our Future of Audit initiative 85% of investors surveyed told us that they want auditors to provide more narrative explanations about the results of the audit, with 77% favouring some type of graduated findings.

In our experience, the requirement to include "observations" is widely interpreted, and is often met through a brief confirmation that "no material exceptions arose". Providing a more graduated disclosure of auditor conclusions could give more meaningful insights. For example, stating that while a discount rate applied to cash flow projections in a goodwill impairment assessment falls within a reasonable range, in our view, *it is at the upper end of that range and therefore more conservative.* Or that a particular assumption in a pension liability calculation is within a reasonable range, *but is less conservative than in the prior year*. In addition to contributing to the understanding of the areas of sensitivity, these type of conclusions could illustrate the challenge and scepticism applied by the auditor.

However, to ensure comparability and consistency it would be important for a reporting framework to be developed (via collaboration between the regulator and the profession), that sets parameters and gives guidance on writing these graduated findings.

Further narrative
In terms of including further narrative in the audit report, there is already a requirement to do this for key audit matters identified in the audit as well as information on materiality and scope of the audit. Since the requirement to include key audit matters began in 2013, many of these "extended audit reports" have become more insightful, containing useful information about where the auditor focused and the work they performed. That said, we suggest that further improvements could include:

- More description of the debate that took place between the auditor, management and Audit Committee prior to resolution of an issue. This would also be a helpful way of illustrating the level of challenge, rigour and professional scepticism applied by the auditor. We recognise that there is a tension here between the need for the auditor, management and the Audit Committee to have constructive debates, which are ultimately resolved, and the desire from external stakeholders for more transparency.
- One of the barriers to writing auditors' reports that are truly insightful and interesting is the clear guidance in auditing standards that the auditor should seek to avoid the description of a key audit matter providing original information about the company (Paragraph A36 of ISA (UK) 701 *Communicating key audit matters in the independent auditor's report*[11]). This acts as an important constraint on the commentary that an auditor can provide. We suggest that the Review consider this when exploring ways of making auditor reporting more engaging, recognising that any such change could have significant ramifications for auditor risk and liability.
- The reports could be written in a more engaging "personal style" by the audit partner, using "plain english" techniques.

- Ordering of the audit report could be revised so that the areas that are most company specific are at the front and the sections that are likely to be common amongst all audits are included at the end, or even in an appendix.
- To some extent, it is inevitable that key audit matters will be similar in content,

[11] https://www.frc.org.uk/getattachment/b250cf61-407f-4b1e-9f1c-e959174e1426/ISA-(UK)-701.pdf
[12] Pages 207-213 in the 2018 Annual report https://www.hsbc.com/investors/results-and-announcements/annual-report

type and number to the previous year, as the nature of the business and the audit approach often does not vary significantly every year; this should not detract from their usefulness. That said, identifying which key audit matters are new, highlighting changes in key audit matters disclosed in the prior year, and why, would be helpful.

Extended audit reports are largely only required for public interest entities, so including such additional insights would be limited to this subset of companies. Consideration could be given as to whether the extended audit report regime should be applied to other entities.

Notwithstanding all of the above, no matter how audit reports are improved, the issue may still remain that, in our experience, only a small proportion are read. In our survey as part of our Future of Audit initiative, less than half of investors (46%) said they read the audit opinion in detail, although a similar number (42%) said they scan it. They are more interested in qualifications and exceptions (78% said they read those in detail), key audit matters (62%) and going concern conclusions (59%). We believe, therefore, it is critical that the Review not only consider the content of audit reports, including how to make them more useful, but also the means by which constructive engagement between those with an interest in the audit and auditors can be promoted.

(Q28) Producer-led audit

We do not agree with the assertion that the audit is “producer-led”, although we recognise the perception issues that exist and need to be resolved.

That said, there is a lack of engagement from shareholders and from other company stakeholders on issues such as the scope of audit, the concept of audit quality etc. Having a more active, informed and regular dialogue between all members of the corporate reporting ecosystem (preparers, users, auditors, those charged with governance) would help deal with the perception issues and would also be constructive in helping close the expectation gap.

We also observe that there are many recent examples of innovation in the audit process, in particular in the use of technology. Technological innovation is achieved through combining the domain expertise of auditors with technology providers who can provide both technical expertise and suggest alternative solutions to delivering the audit outcome. Innovation is enhanced by the combination of ideas and alternative thinking these parties provide. The technologist input may come from other parts of a multi-disciplinary firm or external parties. However in the context of an audit, ensuring that the innovation meets the required audit objectives and standards is important and the blended use of auditor and technologist achieves this outcome. Examples of innovation in technology achieved in this manner include:

- The development of data analytic tools that standardise and scale the identification of unusual items and exceptions relative to auditor determined criteria. Technologists’ and auditors’ combined skills to develop solutions to challenges such as: the significant volume of data that has to be handled to achieve this; the importance of maintaining and evidencing data quality; and the balance between consistent standardisation and allowing the auditor risk-based flexibility; and the need to distill outcomes into user consumable results formats.
- The development of tools powered by machine learning to rapidly identify higher

	risk items in large fields of data that require auditor assessment has been achieved through combining experts in artificial intelligence development, with those experienced in providing assurance over Enterprise Risk Management data quality and integrity, with auditors who have the knowledge of the characteristics considered high risk; and ● The introduction of robotic process tools to increase the efficiency and accuracy of basic audit tasks, where the process expert (an auditor) works alongside a technology developer to map the actions required to complete the basic audit task accurately in order for them to be codified.
Chapter 6 - Legal Responsibilities *Q29: What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?* *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?* *Q31: Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?* *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?*	***(Q29) The role of auditors in respect of compliance with laws and regulations, including capital maintenance*** In our view, the existing standards on the auditor's role in respect of compliance with laws and regulations are appropriate, including the difference in audit approach to matters which may materially affect the financial statements, and other matters. However, we recognise that directors, auditors and various stakeholder groups do not have a shared understanding of the practical implications of these standards, and the related directors' responsibilities, in particular in the area of capital maintenance. We support proposals to bring more clarity to the area. **Capital maintenance - distributable profits and legality of dividends** It would be possible for auditors to opine on the amount of a company's distributable profits determined by reference to a set of annual accounts on which the auditor has provided a true and fair opinion. However, this opinion would not give the comfort that dividends had been legally proposed and paid because the law, under both the Companies Act and common law, is more complex than that. For example: ● Where a dividend is proposed to be paid out of profits that arose after the last annual accounts were prepared, interim accounts must be prepared and, in some cases, filed at Companies House. There is no requirement for these interim accounts to be audited. ● Under common law a company cannot lawfully make a distribution out of capital. Thus, the directors of a company must consider, both at the time of proposing a dividend and at the time it is paid, whether there are sufficient distributable profits. In practice, this means that even when a dividend has been declared, and that fact is disclosed in a set of audited accounts, the directors must consider whether the company has incurred any losses since the last reporting date at the point of paying the dividend. If auditors were to be expected to provide an opinion on compliance with each of these legal requirements, it would require a significant extension in the scope of the auditor's work. For example, in the first case the auditor would be required to examine the interim accounts and opine on the profits arising since the last reporting date, while in the second case the auditor would need to conclude, on the very day of dividend payment, that losses have not arisen since the previous year end. In either case, it would introduce a process that could significantly restrict the timing of UK companies paying dividends, for example by having to wait for an audit process at each stage as dividends are passed up a chain of holding companies.

Capital maintenance - solvency and directors' fiduciary duties
In addition to the above, directors are subject to fiduciary and other duties, including the obligation to safeguard the company's assets and take reasonable steps to ensure that the company is in a position to settle its debts as they fall due. Directors must therefore specifically consider whether the company will still be solvent following payment of a proposed dividend. In reaching their decision they must take into account both any change in the financial position of the company since the last balance sheet date (the common law requirement described above) and the future cash needs of the company.

As we explain above, there would be timing issues if auditors were required to opine on whether directors had met these fiduciary duties at the point of paying a dividend.

Capital maintenance - auditor responsibilities
There would be considerable practical and cost implications if an auditor were to be required to determine whether the directors have complied with all of their duties at the point a dividend is paid. However, the current audit regime requires the auditor to verify that the financial statements have been prepared in accordance with the Companies Act, and this means that auditors need to be satisfied that dividends which have been paid during the year were permissible under the applicable Companies Act provisions.

We would support ICAEW and ARGA promoting a greater understanding (and potentially enforcement) of directors' duties with regard to paying dividends, and of related auditor responsibilities.

As a starting point a higher profile for (and possible expansion of) the section of Tech 02/17 '*Guidance on realised and distributable profits under the Companies Act 2006*'[13] dealing with directors' duties could be constructive.

(Q30) Distributable reserves and public expectations
We do not believe that any perceived inconsistency between company law and accounting standards as regards distributable reserves inhibits auditors from meeting public expectations.

Public concerns around dividend payments tend to be greatest where a dividend is paid shortly before a company fails. There is no evidence that differences between concepts of profit determined under accounting standards and the legal capital maintenance regime played any part in any of the recent high-profile cases. Whether the accounting standards were properly applied (for example, whether impairments were properly recognised) is a separate consideration. In fact, most of the recent cases of companies making unlawful distributions arise from administrative oversight (primarily, failure to file interim accounts) rather than lack of distributable profits or any confusion about the amount of distributable profits because of the accounting rules applied.

We agree that accounting principles enshrined in both IFRS and UK standards have moved away from reliance on notions of realised profit. This is consistent with the development of accounting theory globally over recent decades. The one constant has been for the financial statements to give a true and fair view of the performance and financial position of a company. But the 'true and fair view' is a fluid concept - a matter

[13] https://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-02-17-bl-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006.ashx

confirmed by Dame Mary (now Lady) Arden in her 1993 opinion on the true and fair requirement[14]: “The task of interpreting the true and fair requirement cannot be performed by the Court without evidence as to the practices and views of accountants. The more authoritative those practices and views, the more ready the Court will be to follow them. They respond to such matters as advances in accounting and changes in the economic climate and business practice. The law will not prevent the proper development of the practices and views of accountants but rather, through the process of interpretation, will reflect such development.”

There have for many years been differences between the concept of profits available for distribution and profits determined in accordance with accounting standards for financial reporting purposes. Some associate adoption in 2005 (alongside all other EU member states) of IFRS reporting for listed groups as the point at which reporting lost sight of the capital maintenance concept. However, many differences were apparent under previous UK reporting standards too.

The legal framework for determining profits available for distribution is contained in both common law and the Companies Act 2006. The underlying principle is that the capital of a company is there for the protection of creditors and it cannot be eroded by using it to pay dividends, meaning these must instead be paid out of distributable profits.

This legal principle is backward-looking, based on whether there were sufficient distributable profits at a point in time. But it is the potential impact on a company’s solvency, and its ability to settle its debts as they fall due, that ought to be front in mind when declaring a dividend. That is not to play down the importance of capital maintenance, but the recent high profile cases of BHS and Carillion have raised questions about the prudence of dividend policy in the context of declining fortunes. Neither the Companies Act nor common law notions of capital maintenance would have a part to play in that assessment. Only the fiduciary duties imposed on directors require consideration of future solvency.

We believe that the concept of capital maintenance needs to be broader and based on the accounting rules actually applied by companies (i.e. IFRS), rather than being reliant on determining whether a profit is realised. And this notion of capital maintenance needs to be underpinned by a statutory requirement to consider the impact of a dividend on a company’s solvency, effectively enshrining the directors’ fiduciary duties in law and imposing a similar obligation on the company itself - an approach the Government seems interested in exploring, based on its response to last year’s consultation on insolvency and corporate governance. This would be not unlike the system recently applied in Australia, where ‘profits’ and ‘net assets’ tests, determined in accordance with accounting standards, are supplemented by requirements that a dividend is fair and reasonable to the company’s shareholders as a whole and doesn’t materially prejudice the company’s ability to pay its creditors.

(Q31) Disclosure of distributable and non-distributable reserves

We do not support the introduction of a requirement to disclose the amount of distributable and non-distributable reserves. It is companies, not groups, that pay dividends, and parent company balance sheets are typically a poor indicator of the distribution capacity of a

[14] Para 2 of https://www.frc.org.uk/getattachment/37378397-de7d-4376-9c22-74318f1bc433/T-F-Opinion-21-April-1993.pdf

group. For example, a parent with few reserves may sit atop a subsidiary with a pool of reserves and free cash, and therefore have ready capacity to make distributions. Conversely, a parent with accumulated realised profits may be restricted from making distributions, for example by other debits in equity arising from a share plan, agreements with pension scheme trustees, banking covenants, or simply a lack of cash. Therefore, the concerns raised by some investors are unlikely to be substantively addressed by requiring a more detailed analysis of the legal reserves of a group's parent. Indeed, it may even encourage a 'window-dressing' mentality which is of negative value to users, and dysfunctional for groups.

There may also be significant practical considerations to consider. It is one thing for the directors of a company to conclude that there are 'enough' distributable profits, but it will require more effort to determine what the total amount of distributable reserves might be.This will especially be the case for profits and losses arising earlier than 1980, which was when the capital maintenance regime in its current form was introduced.

We believe there are more effective and useful solutions, and support the proposals suggested by the FRC's Financial Reporting Lab[15]. Since the Lab first made its recommendations in 2015, the practice of providing some disclosure of distributable profits, or at least dividend capacity or the risks to dividend policy, has developed. In its response to last year's consultation on insolvency and corporate governance, the government indicated that it expects companies to make better disclosure of capital allocation decisions, including dividend policies, in the context of new disclosure requirements on compliance with s172 of the Companies Act 2006[16]. However, it is important to recognise that the introduction of a statutory requirement to disclose distributable profits would not do anything to change the behaviour of those companies that might already have questionable dividend policies.

There are many reasons why disclosure of amounts of distributable profits would not be the best solution to what has become something of an emotive debate. However, if there was to be a requirement to make such disclosure (which, by legal necessity, would have to be determined at the individual company level as there cannot be any concept of 'group' distributable reserves), there is no reason why that could not be subject to audit. Such an undertaking would need to be designed carefully, with both reporting and audit considered together. See further our response on the role of auditors above.

(Q32) Adequate accounting records
This question asks whether the bar for auditors in assessing the adequacy of accounting records should be raised. We suggest that first it would be appropriate to consider whether the requirement for directors to keep adequate accounting records should be clarified. This would, in turn, enable auditors to evaluate compliance with any higher bar.

Adequacy of accounting records is an outcome of effective systems and controls and so one way of approaching this would be as part of a requirement for directors to give an attestation over internal controls, as we discuss earlier in our response to questions, with auditors also giving assurance.

[15] https://www.frc.org.uk/getattachment/96ac6006-7a5a-4c69-8c30-010191139ec4/Lab-Project-Report-Disclosure-of-dividends-policy-and-practice.pdf
[16] https://www.legislation.gov.uk/ukpga/2006/46/section/172

Chapter 7 - The Communication of Audit Findings *Q33: Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?* *Q34: Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?* *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?*	***(Q33) More open dialogue*** We support more open dialogue between the auditors and the users of financial statements, whether it is through better disclosure in extended audit reports, including more detail of the discussions that occur between the Audit Committee and the auditor (see earlier in our response), or through more open dialogue at annual general meetings. **Annual general meetings** We recognise that there are some in the investment community (whether institutional or retail) who do not consider engagement with auditors or companies on audit matters to be a priority. What is important is that those who do want to engage are able to do so. We would need a mechanism to make that work and any changes to the protocol for engagement would of course need to be mindful of the Market Abuse Regulation and the need to ensure that inside, or price sensitive, information is made available to all shareholders at the same time. Furthermore, to make engagement effective it will be important to ensure that both parties communicate in a useful way, for example focusing on relevant information, not using jargon, and ensuring that the timing of the engagement is appropriate. This could be helped by the auditor taking a more prominent role at the AGM. The law already allows questions to be put to auditors in advance of the AGM, in practice, however, our experience is that such questions are extremely rare. To improve this level of engagement the auditor could present the results of the audit at the AGM. This is already happening for all public companies in The Netherlands, minutes of which are put on company websites, and has proved successful in opening up the dialogue, as can be seen from research published in 2015 by the Dutch professional body NBA[17], which found that: ● The average number of questions asked of the auditor at an AGM where the auditor presented increased by over 50% compared to when there was no presentation. ● Some representatives of shareholders also proactively sent a letter with topics that they find important in advance of the AGM season. ● Shareholders expressed their appreciation with the more transparent information provisioning in the extended auditor's report and at the AGM. It is important to note, however, that even with this additional presentation there was still limited attendance at meetings by shareholders. The regime could be further developed if the Audit Committee were to present the assurance map, described earlier in our response, setting out the planned assurance for the forthcoming year. We would be happy to put you in touch with individuals at our PwC member firm in The Netherlands if you would like to learn more about this. The pros/cons of any changes that might lead to greater communication and dialogue would need careful consideration so that further confusion about responsibilities throughout the reporting ecosystem is not created. For example, any AGM presentation would need to emphasise that the primary responsibility for corporate reporting lies with the directors, and therefore questions to be posed to the auditor should seek to explore

[17] https://www.nba.nl/globalassets/themas/thema-corporate-governance/accountant-in-ava/het_verhaal_achter_de_controle_2015.pdf

	audit judgements, rather than the judgements made by the directors in preparing the accounts. Greater communication could also likely lead to increased reliance which could, in turn, have consequences for extending auditor liability. At a minimum, to help combat this, we think any enhanced in-person communications should be a “joint presentation” between the Audit Committee and the auditor. We note also that today’s AGMs are often poorly attended, and that physical “in person” meetings are a form of engagement that could be superseded by digitally facilitated dialogue.
Chapter 8 - Fraud *Q36: Do you believe that users’ expectations of auditors’ role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?* *Q37: Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?* *Q38: Would it be possible to devise a ‘reasonable person’ test in assessing the auditor’s work in relation to fraud detection?* *Q39: Should auditors be required to evaluate and report on an audited entity’s systems to prevent and detect fraud?*	***(Qs36,39) Fraud - expectations and auditors’ responsibilities*** Per ISA (UK) 240[18], the auditor’s objectives are: “(a) To identify and assess the risks of material misstatement of the financial statements due to fraud; (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) To respond appropriately to fraud or suspected fraud identified during the audit.” Also per ISA (UK) 240, “The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management”, *not with the auditor.* In our experience, at least at a conceptual level, these objectives are usually understood by stakeholders. In particular, they understand that an audit can only be designed to identify material errors and fraud, and may not even identify all such issues where there is extensive management collusion. However, in practice, expectations of materiality may well differ between stakeholders and auditors and in addition, these expectations tend only to be focussed on *after* an issue has occurred. We suggest that it would be helpful for companies and auditors to do more to help stakeholders better understand the risks of fraud facing a company, the controls in place to mitigate those risks and the work auditors have performed in relation to the risks. This could be achieved through: ● firstly, more transparency on the part of the company, including an improved disclosure regime setting out the risks of fraud and how they are mitigated; ● secondly on the part of the Audit Committee, describing what assurance they have chosen to commission over those fraud risks and controls; and ● finally on the part of the auditor, describing the work performed. Including the relevant risks of fraud as part of the assurance map suggested earlier in our response would also help stakeholders to better understand the risks and responsive assurance. There are also a number of ways the audit itself could change in respect of work performed to address relevant fraud related risks. These range from making the performance of today’s audits more consistent in the way they address fraud risk, for example by involving experts more frequently, to evolving the audit scope beyond today’s

[18] https://www.frc.org.uk/getattachment/5dc29cef-bb77-40f9-88f5-4c1cec215f5c/ISA-(UK)-240_Revised-June-2016_Updated-July-2017.pdf

model. We have expanded on these further below. That said, although we are open to doing more on the risk of fraud, by doing so, there is a risk that we exacerbate any expectation that auditors are the key means by which fraud will be detected. It will be important to have a coincident review and re-emphasis of directors responsibilities and accountability in this area.

We also believe that there should be strong whistleblower programmes as core elements of anti-fraud processes and controls, as well as whistleblower programmes sponsored by regulators, in order to enhance management's focus on and ability to detect fraud. This, coupled with more focus on the accountability of those who are responsible for running the company and those individuals who interact with the auditors during the audit process (as discussed in our response below), would also have a positive impact on audit quality, as it is always better where those interacting with the auditors are being transparent, open and honest. Knowledge of the protection available, and potentially even having more incentive for whistleblowers to report, could encourage more people to come forward.

Performing today's audits more consistently
Some of the techniques used to address fraud risk in today's audits could be applied more broadly in order to create a more coherent and consistent audit response to fraud. including:

- Using a lower materiality for certain areas of the audit where the auditor's risk assessment or knowledge of industry-specific issues indicates an increased risk of fraud.
- A valuable input into the auditor's risk assessment and a way to ensure more company involvement and accountability in the assessment of relevant fraud risks could be through a Fraud Diagnostic survey that is completed by selected employees of the company, and reviewed by those charged with governance. A tool of this sort is currently being used by PwC audit teams in The Netherlands. We would be happy to put you in touch with individuals in our PwC member firm in The Netherlands if you would like to learn more about it.
- Involvement of forensic specialists in the risk assessment process for a subset of engagements (eg high profile audits or perhaps where the Fraud Diagnostic survey mentioned above has identified a particular risk).
- Ensuring that a member of the audit engagement team has deep fraud-related experience, obtained, for example, through completion of a cycle of experience with a forensic investigation team or through experience in an earlier audit with major fraud-related issues.
- Looking more at external indicators of potential fraud risk, for example social media scanning.
- Using technology tools to look for suspicious activity within a company for example email assessors and corporate intelligence tools.
- Establishing a more formal, well-understood and confidential process to enable employees and external parties to communicate concerns about potential fraud directly with the auditor. This could be facilitated through a secure portal or other technology solution.
- More transparency from the Audit Committee, describing what assurance they have chosen to commission over those fraud risks and controls and then the auditor, around the risk of fraud, the procedures undertaken to mitigate the risks.
- The auditor could also engage in more open dialogue around the risk of fraud including presenting on this area at the AGM.

	Increasing the scope of the audit As noted earlier in our response we are supportive of the introduction of a strengthened framework around a company's internal controls with the directors taking greater accountability for the company's risk management and internal controls system and making an explicit public statement about their effectiveness, taking any relevant lessons from operation of the Sarbanes-Oxley regime in the US. We are also supportive of a requirement for the auditor to report publicly on the effectiveness of internal controls, whilst noting the need for any such requirement to be implemented in a proportionate manner. One way to evolve the audit in the area of fraud would be to make controls responsive to relevant fraud risks one of the minimum areas that would be required to be included in both management's attestation and the auditor's opinion over the effectiveness of the relevant internal controls. **Other considerations** None of the suggestions above would be easy to implement and could come with additional cost and risk. There are a number of areas that would need to be considered in the design and implementation of any changes: ● Any expansion of the audit scope must be carefully communicated to avoid an inadvertent expansion of the existing expectation gap. ● While it would be possible for an auditor to perform more of a "forensic" audit, requiring additional highly detailed procedures, such additional work would come at significant cost. Implementation would need to be proportionate and risk based. ● Any degree of expanded work in this area is likely to require a range of knowledge and skills and the need to rely on the work of specialists (we note that this is one of the major benefits to audit quality of having a multidisciplinary firm structure, allowing easy access to such in-house specialists). ● Any increased risk taken by the auditors in this regard would need to be accompanied by an appropriate re-consideration of the auditor's liability regime. ***(Q37) Existing auditing standards*** In our view, existing auditing standards <u>do</u> provide clear messages about the importance of assessing and addressing fraud risk and applying professional scepticism. However, it is inherently difficult to embed a mindset into written guidance, so, as suggested above, there may be ways to supplement auditing standards with more tangible reforms, such as additional training and experience for auditors. ***(Q38) Reasonable person test*** We do not believe that it would be beneficial to develop a reasonable person test in such a specialised area. Instead, as noted above if the auditor focusses on the specific fraud prevention and detection controls (as a complement to management's attestation on these controls), that is a better way of providing a greater level of assurance.
Chapter 9 - Auditor Liability *Q40: Is the audit profession's willingness to embrace change constrained by their exposure to litigation?* *Q41: If there were a quantifiable limit on auditor liability, how might this lead to*	***(Qs40-42) The auditor liability regime today*** As we note earlier in our response, an important dimension of the expectation gap is the misunderstanding of "who the audit is for". In bringing more clarity to this area, it will be important to clarify the auditor liability regime at the same time. We support the principle of today's liability regime, where the auditor owes a legal duty of care to the company's shareholders as a whole - although we suggest that the regime could be further clarified through codification in legislation, rather than through reliance on case law.

improvements in audit quality and/or effectiveness? *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?* *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?* *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?*	Whilst we support the principle of today's UK liability regime, our recent experience is that there can be an "imbalance" in the way that perceptions of responsibility, and also of liability, are shared throughout the corporate reporting system. We believe that the threat of costly litigation and regulatory penalties may be significant factors in making the audit market substantially less attractive to new entrants. To address this imbalance, we suggest that: ● The codification referred to above should also reflect a proportionate split of responsibility between the auditor and company directors. ● There needs to be appropriate focus on the accountability of those who are responsible for running the company and those individuals who interact with the auditors during the audit process. The recommendation by Sir John Kingman that "non-member" directors should be held accountable for their actions is a positive step forward in this regard; furthermore, in serious cases, where the auditors have clearly been misled, the existing framework, under section 501 of the Companies Act 2006[19] (which make it a criminal offence) could be effectively utilised. ● Consideration should be given to the introduction of an auditor liability cap mechanism which ensures that auditor liability is proportionate and has regard to what is fair and reasonable in the circumstances. That cap could be set by reference to the size of the company in question, or could be a multiple of the audit fee. We note that the current provision for liability limitation agreements (pursuant to section 534 of the Companies Act 2006[20]) has not proved to be acceptable to the market and in our experience is rarely if ever used. In earlier parts of this response, we have explored how auditor responsibilities could be extended in the future. As the scope of the audit evolves, it will be important to allow the liability regime to evolve alongside it, to ensure that a proportionate auditor liability regime is maintained and that the attractiveness of the audit market does not deteriorate. We believe that a liability cap mechanism would be a sufficiently flexible regime to allow such an evolution, together with a review of the responsibilities and accountability throughout the corporate reporting ecosystem, as discussed above. ***(Q43) Audit quality*** We do not believe that any of these suggestions would result in a deterioration in audit quality. Our professional ethics, compliance with auditing standards, our strict regulatory oversight and enforcement (which will be strengthened further by the Kingman recommendations), our own internal quality processes and reputational considerations for both individual auditors and the firm, would all ensure this would not be the case. In fact, a clearer rebalancing of responsibilities between auditors and preparers of accounts should increase the rigour and quality of accounts preparation, which in turn will enhance the quality of the audit process. ***(Q44) Professional indemnity insurance*** With regard to professional indemnity insurance, PwC has had professional indemnity insurance in place for some time, with the cost of the insurance cover being borne by the whole of the firm, not just the audit practice.

[19] http://www.legislation.gov.uk/ukpga/2006/46/section/501
[20] http://www.legislation.gov.uk/ukpga/2006/46/section/534

	However, we anticipate that it may be difficult for challenger firms to obtain insurance cover at an acceptable price from the market given the potential exposure to large claims if they are to undertake FTSE 350 audits. Capped liability arrangements may help by attracting insurers to reconsider the current cover available to auditors, particularly of larger companies. However, adding a whole set of extra potential claimants (by extending the duty of care to all people who might rely on the audit of the financial statements) is not likely to encourage any confidence on the part of insurers to provide cover, even if that liability is capped.
Chapter 10 - Other issues *Q45: How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?* *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?* *Q47: Are there aspects of current audit procedures or output that are no longer necessary or desirable?* *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?* *Q49: Does today's audit provide 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?* *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?* *Q52: Would interaction between shareholders and*	Technology in the audit ***(Q45) Technology in audits today*** Audit will always include, at its heart, human judgement from experienced audit professionals as a critical element. That being said, disruptive technologies are transforming the many other elements of the role of an auditor: - By automating simple audit tasks, external auditors are able to focus more on the complex, judgemental risks. - Data analytic technologies are converting previously unstructured journal transaction data, into structured, consumable data. - Global Enterprise Resource Planning systems are used for consistently capturing all audit activity The use of technology has improved audit quality and insights and there have been a number of significant advancements made over recent years. We are continuing to develop the use of tools, including, for example, the use of drones to assist with inventory counts and the use of artificial intelligence to help identify unusual transactions. We note that in developing the use of technology in the audit process, the regulatory environment can sometimes be a constraint. In establishing ARGA, the new regulator, it will be important to ensure that the infrastructure is sufficiently agile and skilled to allow the regulatory approach to evolve at the same speed as innovation in the audit firms. ***(Q46) Technology in audits tomorrow*** In performance of today's audits, technology is not currently extensively used by auditors to address a broader range of issues (although it is worth noting that non-auditors are using technology to address a broader agenda, which could be relevant to audit as it evolves, for example, technology used by forensic specialists to scan email communications). Most of the investment currently has been aimed at developing tools to automate and enhance existing audit processes, as described above. However, if assurance over non-financial risk becomes more common, there are a number of emerging technologies which have the potential to become central to the work involved. For example, using natural language processing technologies to deal with large bodies of unstructured data could facilitate assurance over non-financial areas, such as contract compliance. We can envisage technology in the future playing a role in enabling assurance to evolve to consider a much broader range of issues. Auditor communications ***(Q51) Current shareholder views on audit reports*** As we have discussed earlier in our response, there is little evidence that shareholders

auditors outside the AGM be practical and/or desirable? *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?* *Q54: What assurance do shareholders currently obtain other than from audit reports?* *Q55: In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?* *Q56: How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgements underlying the audit report?* *Q57: Should the basis of individual auditors' remuneration be made available to shareholders?* *Q58: Do respondents view audit costs as generally too high, about right or insufficient?* *Q59: Would users of financial statements wish more detail on the make-up of audit fees?* *Q60: Is the profitability of the audit function sufficient to sustain a high-quality audit industry?*	read audit reports beyond checking that the audit report is unmodified - there is virtually no interaction between shareholders and auditors in relation to the content of the audit report. We are not aware of the extensive use of AI for analysis audit reports at the moment, although we can see it happening in the future where the ability for intelligent machines to analyse and translate large quantities of structured data and produce plain English summaries is harnessed and used in relation to audit reports, to help produce succinct user-friendly summaries which are easier for shareholders to review. ***(Qs 52,53) Interaction with shareholders*** We believe that there is merit in exploring the option of publishing the audit plan as it would encourage stakeholders to engage with the audit process at an early stage, and to raise concerns they may have about the auditor's planned areas of focus. It may require more education about the audit in order that the majority of shareholders were able to understand some of the implications of the audit plan and possibly a more standardised reporting mechanism as audit plans can contain varying levels of detail depending on individual circumstances. As an alternative option, as described earlier in our response,we think there may be more value in the Audit Committee (on behalf of the Board) creating an assurance map and sharing that with stakeholders for discussion and comment. This could be a more understandable and holistic approach which addresses the needs of a broader group of stakeholders than those particularly interested in the financial statements and the statutory audit. With either option, it should be the Audit Committee who shares the audit plan or the assurance map and takes responsibility for responding to stakeholders on the decisions made and the level of assurance required. In terms of the other assurance that shareholders currently obtain other than from audit reports, see our earlier discussion around the spectrum of assurance. ***(Q56) Demonstrating professional scepticism*** Auditors are constantly challenged during audit inspections on how they have been professionally sceptical, and it can be difficult to demonstrate it through the documentation on the audit file. Scepticism is a behaviour and mindset, which is difficult to evidence through documentation alone. However, we are continuing to work on the clarity of our audit documentation, including capturing the challenge we exercise, in order to help demonstrate our professional scepticism to the regulator. Externally, high quality Audit Committee reports, detailing the discussions that the Audit Committee has had with both management and the auditors, should be a good source of evidence of scepticism applied throughout the accounts preparation process. In our experience, the quality, precision and depth of Audit Committee reporting is not yet consistent. Enhancements in the audit reporting regime could provide further evidence of scepticism and challenge. As we discussed earlier in our response, we are supportive of consideration of a regime whereby auditors can present their findings and/or take questions at the AGM as this more tangible "live" format may go some way towards helping shareholders evaluate the auditor's scepticism.

(Q55) Reporting on culture

As part of the requirement to understand and evaluate internal controls (ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*[21]), auditors must evaluate a company's control environment, including whether management has created and maintained a culture of honesty and ethical behaviour. In practice, we may look at, for example, whether there is an established code of conduct, and observe behaviours during meetings with management. There are few specific audit procedures in this area and this evaluation is not made public in the audit report. Part of the difficulty in specifically providing assurance over and reporting on culture is that there are no agreed standards as to what a "good" culture is.

If there were to be an agreed standard which set out the indicators of a culture that led to financial reporting integrity then it could be possible to do more detailed work to assess a company's culture against that standard. The agreed standard would need to be:

- Research based, ensuring that there is a strong link between the cultural indicators and the resulting level of integrity of the financial statements.
- Relevant to all entities, whether large or small, groups or individual organisations and in all industry sectors.

In the absence of a standard, assurance could be provided against the company's own cultural standard. The Provisions under Principle O of the 2018 UK Corporate Governance Code[22] state that the board should establish procedures to manage risk, oversee the internal controls framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long term strategy. This would include ensuring that the control environment, including attitudes and culture relating to risk and control. In this case the board themselves would come up with a cultural standard that they believe is right for them and auditors could perform a review to determine whether actual culture and behaviours are in line with that standard. This standard would need to be consistent over time and it may also be appropriate for auditors to determine whether that standard is appropriate given the nature of the business, the risk appetite and other factors.

The Audit Committee could consider the need for this type of assurance and who should provide it, as part of its completion of the assurance map exercise which we suggest earlier in this response.

Under such an approach, the following additional procedures could be carried out in order to determine the alignment of an organisation's behaviours against the agreed standard:

- Interviews, focus groups and surveys with employees to understand their attitude with respect to financial risk and control, and importantly what it is within the organisation that causes them to have that attitude. To do this we would consider six behavioural levers - leadership, communication, people practices, reward and recognition, organisational structure and the external environment.
- Review of minutes of Audit Committee meetings, board meetings and other senior leadership meetings, particularly with respect to decisions taken around accounting treatments, policies or the audit process. Some of these meetings could also be observed.
- Review of communications sent to finance teams around the financial year end

[21] https://www.frc.org.uk/getattachment/0737b946-b24a-441d-a313-54e0a90f9e7d/ISA-(UK)-315_Revised-June-2016.pdf
[22] https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf

accounts close or consolidation process, in particular to look at the explicit and implicit messages these send around the importance of audit and financial integrity.
- If applicable, review of correspondence with sector regulators.

All of the above could be performed by the external auditor as a piece of assurance additional to the statutory audit, but it could also be the case that other assurance providers are more suited to providing assurance over an entity's culture. Whomever provides that assurance, to be meaningful, as noted above, there would need to be an agreed standard around what makes a good culture. Without an agreed standard it would be possible to give assurance that an organisation is meeting its own disclosed culture objectives, but this would not be as meaningful as assurance that the culture itself was appropriate.

The value of audit

(Q47) Current audit procedures

We do not believe that there are aspects of current audit procedures or output that are no longer necessary or desirable. We are aware of issues on audits of smaller entities regarding the extent of work on controls that is necessary if an auditor does not seek to rely on the operating effectiveness of internal controls - this is an area that needs to be kept under review, particularly if technology enables auditors to perform substantive testing more effectively on larger populations.

(Q48) Calibrating the value of audit

Today's audits provide reasonable assurance, which is a high level of assurance, However, there are inherent limitations to an audit, as explained in ISA (UK) 200[23], and as a consequence we agree that a zero failure regime is not attainable (nor desirable if a proper cost/benefit analysis is taken into consideration). It would be helpful for an analysis of the root causes of recent company failures to be undertaken to establish whether the audit should or could have identified the issue and led to earlier reporting of potential issues.

We have discussed earlier in our response the lack of a common definition around what actually constitutes audit quality. We noted that in our view, consistently high quality audits will increase trust in corporate reporting, and that high audit quality is achieved through the auditor having the competence and capability to design and execute an audit that thoroughly addresses relevant risks and will therefore identify financial reporting problems if they exist, AND through the auditor having the moral courage to tackle any problems that are identified.

Using this definition as a base, we would suggest that the value of audit should therefore be judged by the degree to which trust in corporate reporting increases. This could be assessed by measuring the extent to which corporate reporting is used (nowadays, measurement is facilitated through online access) and/or by surveying the views of users of corporate reporting. In addition, a mature regulatory environment should include a consensus on the definition of high audit quality, with the provision of information to support stakeholders in assessing auditors against that definition.

(Q49,50) Value for money

[23] https://www.frc.org.uk/getattachment/aa24dd60-5ca4-4cec-8c67-ac470b82f931/ISA-(UK)-200_Revised-June-2016.pdf

We believe that audits today generally provide value for money. Much of the value of an audit is unseen. For example, it acts as a deterrent against fraud and often results in constructive feedback which enables management to improve systems of financial reporting and internal controls. That said, as noted in our other responses, we welcome the Review considering whether there should be an increase in the scope of audit and/or other assurance to better meet expectations and be of more benefit to both shareholders and a broader range of stakeholders.

We also suggest that the Review could consider further economic or academic analysis to research the economic value associated with audit more deeply.

***(Q57) Disclosure of auditor remuneratio*n**

We are supportive of disclosure of the "basis" of the remuneration of audit partners by audit firms. This could include a narrative regarding the way in which remuneration is calculated, how incentive arrangements work, the opportunities for increases and reductions in income and the ways in which audit quality measures influence all of these arrangements (note that our annual Transparency Report already includes disclosure of remuneration arrangements). However, we are not supportive of public disclosure of actual remuneration of individual audit partners, either in a company's financial statements or elsewhere. Individual partner remuneration is driven by many other factors, outside their responsibility for audits of individual companies. These could include internal quality or leadership roles, people management roles, tenure etc. We do not believe that this individual disclosure, and the level of detail that would be required to explain it, would assist stakeholders in their assessment of audit quality, particularly when balanced against the privacy concerns that such disclosures would raise.

(Q60) Profitability and a high quality audit function

Currently, our audit practice is profitable. In order to sustain this, to access the expertise needed to deliver high audit quality, and to make the investment needed to maintain high audit quality, we draw on our multi-disciplinary firm and network for economies of scale accruing from common investment programmes and support functions.

Today, we face an unprecedented level of change and an increasing quality hurdle, driven by public expectations and regulatory demands. As would be expected, we are constantly vigilant of the changing nature of our cost base and the competitive dynamics of our market. As these evolve, particularly during the current period of change, it may be necessary for audit fees to increase as a consequence

We note also that profitability is not the only factor critical to quality delivery; our abilities to recruit top talent, and to access a range of skills and expertise from across our multi-disciplinary practice are also essential.

(Qs58,59) - for users to answer