Response to the Call for views on the Independent Review into the Quality and Effectiveness of Audit
June 2019, London Stock Exchange Group

London Stock Exchange Group (LSEG) welcomes the opportunity to respond to the Independent Review into the Quality and Effectiveness of Audit. LSEG's response to this call for views is from our perspective as both a market operator and a FTSE 100 listed company which is subject to external audit.

London Stock Exchange Group (LSEG) is a global financial markets infrastructure business. Its diversified global business focuses on Information Services, Risk and Balance Sheet Management and Capital Formation. The Group supports global financial stability and sustainable economic growth by enabling businesses and economies to fund innovation, manage risk and create jobs. The Group can trace its history back to 1698.

In Capital Markets, the Group operates a broad range of international equity, ETF, bond and derivatives markets, including London Stock Exchange; Borsa Italiana; MTS (a European fixed income market); and Turquoise (a pan-European equities MTF). Through its platforms, LSEG offers market participants, unrivalled access to Europe's capital markets.

The markets which LSEG operates are international in nature – for example the AIM market currently has over 900 companies with operations in over 80 countries. In the past 10 years alone, £500bn in equity capital has been raised by companies on London Stock Exchange, and since its launch in 1995, over 3500 companies have joined LSE's AIM market – raising over £100bn in growth capital.

In considering the quality and effectiveness of audit, and subsequently any changes which should be made, it is important to take into account the global nature of companies which operate within the London market, and the global competitiveness of the UK.

The specific importance of audit with regards to public markets

Transparent, informative and accurate financial reporting is a critical component of well-functioning public markets. The external audit function helps to provide confidence that the information given to investors and shareholders on a company's financial position and performance has been reviewed by independent non-executive directors and a suitably qualified and independent third party. This allows investors the ability to make informed choices about how to allocate capital. Well-informed investors and shareholders are an important part of the economy. External audits can help to enhance transparency within public markets, which is to the benefit of the market, companies, investors, and ultimately to the broader economy.

There is an intrinsic reliance on audit in public markets. This reliance increases as the scale and complexity of a company's operations increases. Other than in select circumstances, numbers as reported in the main financial statements are an amalgamation of numerous underlying transactions, across different business lines.

Whilst day to day disclosure is governed by securities law and listing/market operator rules, unaudited half yearly results are required (presented in a form consistent with full year audited numbers; for listed companies this may be reviewed by an auditor but will not be opined on) and any ad-hoc announcements in between will need to articulate the financial impact on the business.

Critically, audited financial information is the foundation used by the research community to create financial estimates. It is these consensus-built numbers which will drive investor behaviour.

The importance of audit is further reflected when one considers other activities and transactions within capital markets. For example, shares are often used for purposes of collateral, for incentivisation, or other transactions. The knowledge that a company will be audited and that valuations will be based on financial information which is subject to audit helps provide confidence in the use of those shares.

The 'expectation gap'

As this Review notes, the directors of a company hold the primary responsibility for the fate of the company. This is a concept well understood in public markets. However, there is not a uniform understanding of the nuances of the interaction of director responsibility with the audit process.

Audits are an expression of an opinion by the auditor on whether the financial statements are prepared in accordance with an applicable financial reporting framework. Audits are not intended to provide absolute assurance of the future viability of a company. It is also important to note that the financial statements subject to audit are prepared by the management of the company. All the auditor can provide is reasonable assurance about the financial statements.

In considering the expectation gap, one needs to recognise that investors cannot be grouped in a homogeneous mass. Investors with less experience of financial markets are, sometimes less likely to understand the nuances, assumptions, and judgement used in both the preparation of financial statements, and the audit of those statements.

In public markets, issues with audits are often associated with company failures. In such a scenario, there may be investors who question whether an auditor has indeed properly discharged their function. Investors and users of audits can sometimes expect the auditor to uncover what in some instances can amount to sophisticated fraud events. Investigations into company failures can take many years – after which the evidential threshold to allow conviction in a court may not be met. It is therefore difficult to expect an auditor, operating in a more limited timeframe, who may have had information concealed from them, to be able to identify all the issues which may have led to a failure.

Auditor liability

In the context of public markets, there is an increased risk for an auditor that in the event of a company failure, retail investors will be impacted. In considering auditor liability, one must also clarify the expectations of an auditor to identify what the liability attaches to. External audit is only intended to provide reasonable assurance; hence a company failure does not necessarily mean an auditor failed in their duty.

In an environment where there are increasing calls for investor protection and, given the potential uncertainty about when liability could apply, the risk of legal action and the subsequent associated costs, one would reasonably expect auditors to either expect to be compensated for the risk they are taking or to avoid it. The former could significantly increase the costs associated with a public listing and increase the cost of share ownership. The latter could result in reduced competition in the number of firms providing this service.

Investors and the audit product

While audited financial statements are important products which investors, and those who advise them, consider when deciding on the allocation of resources, it should be recognised that in relation to public markets, this is not the only piece of information they consider. Experienced investors carry out fundamental analysis and consider other inputs before making their final decisions. News releases, company presentations and additional information in annual reports all go into the broader decision-making process.

Specific comments on questions

Definition of audit and its users

Questions 1 to 3

Question 1

An audit is intended to provide confidence that the information prepared on a company's financial position, by the management of the company, has been reviewed by a suitably qualified and independent third party. In its current form, an audit report is addressed specifically to the shareholders of a company. This could potentially be expanded to include other stakeholders, or potential stakeholders, however one must question whether an extended audience would change the nature of the auditors' final product, and also the amount of work which needs to go into producing their opinion, along with the associated costs. If an increased audience requires the auditor to cover other areas beyond the financial statements, it may be the case that auditors are not suitably qualified to do that. Regardless of intended audience, it is important that the fiduciary duty of the board should not be less than that of the auditors.

Question 2

It is the fiduciary duty of the board, and in particular non-executive directors, to monitor the health of an entity. This is not the function of the audit. Enhancing confidence of users in the entity itself would require different levels of expertise from traditional auditing. Furthermore, commentary on the broader health of the entity would require more subjective considerations, which lends itself to a different role.

Question 3

Yes, greater clarity regarding the purpose of an audit would be welcome. A good example of an area where further clarity would be welcomed is in providing a formal definition of the term "materially correct".

The expectation gap

Questions 4 to 6

Question 4

Yes, there is generally an expectation gap between what users of financial statements and the public expect from an audit and the formal requirements under UK law and auditing standards. There are widely different requirements from different stakeholders. A typical retail investor has entirely different requirements and expertise from a major pension fund investor. Corporate failures soon after a clean audit report present auditing in a bad light, but these are sometimes attributable to unforeseen one-off events, rather than a failure of the audit.

Question 5

Further education of the wider population of the purpose of an audit would be a good step towards addressing this gap. This would help create clarity about the specific role of audit, and thus better manage expectations. At present, it appears that audit reports are often not read by investors and other stakeholders, despite the fact that they appear to be relied upon.

Question 6

Audits by their nature are backward looking and report on whether financial statements are materially correct. It is difficult to objectively challenge management assertions regarding cash flow forecasts and other forward looking (and therefore subjective) information. Even if some subjective review was required, the auditor may not be best qualified to provide it.

Audit and wider assurance

Questions 7 to 11

Question 7

Traditional auditors are not adequately qualified to comment on other areas, given their lack of appropriate expertise and the time spent in the business.

Question 8

The independent non-executive directors (INEDs) are the shareholders' first line of defence, not the auditors. INEDs can, and should, challenge executive management on its forecasts and decisions. They are in the position of knowing the entity's business far more intimately than an auditor ever could. Assurance should arise from the quality of the decision-making process; a quality process should yield quality outputs. Internal audit provides assurance on the effectiveness of the internal control and risk management systems to INEDs and the Board.

Question 9

Consistent with auditing standards, external auditors place little reliance on the work of internal auditors. The independence of an external auditor could be questioned if they spend too much time with the business.

Question 10

If external auditors used evidence obtained from work performed by internal auditors in drawing conclusions, this would bring into question the independence of the external auditor.

Question 11

Auditors are free to invest in innovating their audit product if they so choose. Independence should not be compromised in this respect. The control environment, effectiveness and efficiency of the business and improving the company is the role of the executives and board of directors, not the auditors. It is difficult to assess the quality of the audit product other than through the signed opinion.

The scope and purpose of an audit

Questions 12 to 14, 17, 20 and 21

Question 12

There is already significant risk management disclosure in a set of financial statements. It is not clear what form additional requirements would take and could end up leading to duplication and confusion. Risk management is already a key role of the Board (supported by second (risk) and third (internal audit) lines of defence) and it would be duplicative to the role of INEDs if this was subject to audit.

Question 13

A company has a Board and INEDs in particular who are supposed to assess the effectiveness of an entity's system of internal control. It is not, and should not be, the role of the auditors. If auditors were to have a role related to this, they could help provide more transparency by explaining that these are management opinions/assertions rather than facts or that the approach is reasonable and controls based to provide more transparency.

Question 14

Auditors should not report publicly on the effectiveness of internal controls; their role should be clarified and made more explicit. The audit report should be clearer on the approach taken by the auditor and why. The requirements of large and small companies are completely different - for example, smaller companies are less likely to have Audit and Risk Committees – therefore a one size fits all approach is not always practicable.

Question 17

Yes, largely. Corporate failures are sometimes the result of unforeseen circumstances rather than forecasts being wrong. However, it is the directors of the company who are best placed to comment on this. Stress testing of forecasts would be useful, but it is not clear external auditors are best qualified to perform them. Explaining under which circumstances a company may fail would be beneficial, to the extent that this does not reveal sensitive information. INEDs should be assisting the shareholders in the understanding of the business. Auditors expressing doubt on a company's future plans may precipitate failure. Auditors do not run the company and cannot prevent a failure. In that context, we may want to examine the viability statements, what level of protection is afforded by them and what any changes to auditing mean from the perspective of modelling that goes into their creation.

Question 20

A more forward-looking audit seems to be challenging in practice. Auditors can only check the process, not the actual outputs. They are not market experts. A process similar to goodwill impairment testing on "internally generated goodwill" (i.e. not recognised), a stress test of future cash flow forecasts, might be a useful process that could indicate the future prospects of the company. Introducing future-proofing of audit statements into the process could raise the cost and reduce the diversity of the auditing sector.

Question 21

Quantitative KPIs can be audited, but this wouldn't necessarily enhance their reliability in predicting the future. Responsibility for the accuracy of the KPIs remains with the company.

Audit product and quality

Questions 23 to 28

Question 23

A precursor to considering either the value and quality of the audit product, or the effectiveness of the audit process is to define the role of the auditors more clearly.

Question 24

Auditors are required to carry out audits to agreed standards and record any necessary evidence to show that the work carried out was satisfactory. Anecdotal evidence shows that auditors often concentrate on completion of the file to the detriment of the overall audit process, especially where it is known in advance that an inspection is likely.

Question 25/26

The financial statements of a company are either materially right and meet the level required or they do not. Currently the “threat” of a qualified audit report is usually sufficient to alter the behaviour of a company. The current UK audit report of several pages allows plenty of scope for an auditor to express more nuanced opinions if necessary. However, this is rare in practice, largely due to commercial sensitivity to anything except a “clean” audit report. Informative insights should come from the directors: the auditors may be able to confirm (or otherwise) the veracity of these statements.

Question 27

The risk aversion of auditors associated with potential liability issues and the ongoing relationship with the client leads to detailed reports without clear conclusions.

Question 28

The audit industry has been quite innovative in their audit approaches. For example, driven by cost cutting and competition, the IT systems used in auditing have developed rapidly.

Legal responsibilities

Questions 29 to 32

Question 29

Auditors should not have a role in determining whether directors are complying with relevant laws and regulations. This is not and should not be within their remit. The company lawyers and relevant regulators should be looking at this.

Question 30

The inconsistency between company law and accounting standards does inhibit auditors from meeting public expectations. In order to resolve this, company law and accounting standards should be aligned.

Question 31

Yes, this makes sense and is simple to introduce.

Question 32

The existing regulatory requirements effective in setting the bar for auditors are at a high enough level.

The communication of audit findings

Questions 33 to 35

Question 33

It is not desirable or necessary for there to be an annual assurance meeting open to all stakeholders because this places additional responsibilities on the auditors. The AGM is already a forum for shareholders to ask questions. In addition, shareholders have shown limited interest in public meetings – for example, see attendance at AGMs.

Question 34

The audit report already provides information on where judgement has been used. It is not clear that it would add much value or indeed in some instances be appropriate, for further transparency of the communication between the auditor and the audit committee.

Question 35

The current audit report allows adequate scope for the auditors to highlight any concerns they have. This would seem to be sufficient, and therefore remove the need for further enhancements to the audit report.

Fraud

Questions 36 to 39

Question 36

As with the broader role of audit, users' expectations in relation to fraud detection are not consistent with legal requirements. It is not the role of auditors to seek to detect fraud. It is the company's role to detect fraud through internal control and risk management processes. Educating users on what is expected would be a welcome step.

Question 37

As it is not the role of the auditors to detect fraud, the auditing standards do not engender a fraud detection mindset, and there is no reason for them to do so. The nature of the auditors' work is not designed to discover fraud, nor do they do sufficient work to systematically detect fraud. There is also an issue of materiality to consider. Not all frauds are material in the context of financial statements.

Question 38

Fraud detection is the primary responsibility of management via effective internal controls and internal audit testing.

Question 39

Under present law, an auditor already reviews the internal controls of a company in forming its opinion.

Auditor liability

Questions 40 to 44

Question 40

Risk of litigation does play a role in constraining change in the audit profession.

Question 41

Auditors' liability should not be limited. If the auditors have "skin in the game", then they are more likely to be incentivised to perform thorough audits. Limiting the liability would not improve the audit process.

Question 42

While Company law does not make auditors liable, when one looks at practice, one sees that an element of liability and therefore accountability already attaches through precedent and case law.

Question 43

As outlined in 41 and 42, changing the auditors' liability is unlikely to significantly improve the audit process, and indeed could make it less effective.

Question 44

The inability of firms to obtain the desired level of professional indemnity is a very relevant consideration. It is particularly of importance in relation to smaller audit firms.

Other issues

Questions 45, 46, 49, 51 to 53, and 57

Question 45

New technology is widely used in audits today and helps auditors carry out their role, as described under UK law.

Question 46

New technology enables a greater number of reviews to take place in a shorter amount of time, and also allows a greater amount of analysis to take place.

Question 49

In order to properly answer this question, there needs to be clarification of the role of auditors. At present, expectations are so varied that for some parties the answer would be positive, while for others, it would be negative.

Question 51

Audit reports tend to be mostly read by those in the accounting profession and few others.

Question 52

It is unclear that interaction between stakeholders and auditors outside of the AGM would be of particular value.

Question 53

Interest in audits from shareholders often only reaches high levels when something goes catastrophically wrong with the company. It is not clear that an ex ante process would garner much interest.

Question 57

It is not clear what benefit this would provide.