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London  
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7 June 2019

## TheCityUK: Response to the independent review into the quality and effectiveness of audit

Dear Sir Donald,

I write in response to the call for views published on 10 April 2019. TheCityUK is the industry-led body representing UK-based financial and related professional services (FRPS). In the UK, across Europe and internationally, we promote policies that drive competitiveness, support job creation and ensure long-term economic growth. The industry contributes nearly 10 per cent of the UK's total economic output and employs 2.3 million people, with two thirds of these jobs outside London.

Audit plays an essential role in the wider economy, particularly supporting the effective functioning of lending, underpinning trust in capital markets and attracting inward investment. Beyond Brexit, ensuring that our globally-leading FRPS industry – and its constituent parts – continues to thrive, will be key to the UK's continued success. Our audit industry is a core element of that ecosystem.

In considering the work of your review, and broader linkages with related activity, we would highlight the following key points:

- Audit is a **vital part of the wider FRPS ecosystem** and a national asset that plays a critical role in underpinning the attractiveness of the UK as a place to invest and do business.
- Businesses, auditors and those who use audit accounts to invest and lend **recognise the benefits of reform** that enhance **accountability, transparency and quality** and deliver positive outcomes for firms, investors and lenders.
- Any reform to the sector must be made carefully and not in isolation to mitigate any **unintended consequences** that could **impact business, competitiveness and the wider UK economy**.

An audit sector that is reformed carefully to enhance accountability, transparency and quality will deliver positive outcomes for firms, investors and lenders and more robustly enable its critical role in underpinning UK attractiveness.

We hope the views of TheCityUK will be helpful in assessing the issues discussed. We look forward to continuing to engage on these issues to ensure possible proposals for reform put UK competitiveness at the core of the government's agenda.

Yours sincerely,



Marcus Scott  
Chief Operating Officer | TheCityUK

Our response to the core themes discussed in the call for views is set out below:

## **The audience for, and value of, audit**

Auditors have a primary duty to the company's owners in line with the core purpose of audit. An audit is a vital mechanism that assists owners of companies in assessing the stewardship of directors and in turn provides an important stimulus for directors to undertake their fiduciary responsibilities.

Audit also contributes towards a common language and point of financial reference for the UK economy which helps make corporate financial information more transparent and accessible to prospective investors, suppliers, purchasers and other stakeholders who can make informed decisions about where they align their business interests and activities.

It is a vital part of the wider FRPS ecosystem and a national asset that plays a critical role in underpinning the attractiveness of the UK as a place to invest and do business:

### **Audit builds trust and transparency**

- The UK, and all modern market economies, are dependent on trust. By providing reasonable assurance under a common audit framework, in respect of financial statements prepared by management under consistent accounting rules, independent audit helps build that trust. In doing so, it plays a role in reducing possible inappropriate business, accounting or reporting practices which might otherwise exist. Audit also contributes to a common language and point of financial reference for the UK economy which helps make corporate financial information more transparent and accessible to prospective investors, suppliers, purchasers and other stakeholders who can make informed decisions about where they align their business interests and activities.

### **Audit helps capital formation in fragmented markets**

- The private and public investment and financing market in the UK is vast and diverse. Audit is a key part of the ecosystem which helps give otherwise uninformed and dispersed investors and other stakeholders the confidence to participate in that market. In so doing, audit helps bridge the gap between entrepreneurs who need capital, and investors and lenders who provide it and who are looking for a return.

### **Audit facilitates the creation of liquidity and reduces the cost of capital**

- By helping build trust in corporate economic fundamentals, audit helps create the conditions in which equity and fixed income markets can operate, and facilitates the trade in financial instruments which provide market liquidity. By helping to create these conditions, audit helps to reduce the cost of capital for UK businesses, giving them the opportunity to compete more effectively.

By contributing to transparent and effective markets, audit enables a wide range of stakeholder engagement in and with the UK economy. In particular:

### **Long-term savings and effective retirement planning**

- As a watchdog over UK plc, audit helps create the conditions in which UK employees and the funds and insurers to which they entrust their savings can make long-term investment decisions and plan effectively for retirement and long-term health.

### **SME and corporate lending**

- Audit is a building block providing the UK banking, private and peer-to-peer lending communities the confidence they need to back small and medium sized businesses and foster innovation and grass roots growth in the UK economy.

### **Capital investment**

- By helping to build trust in the UK economy, audit supports long-term and sustainable investment in UK industry through initial public offerings, mergers and acquisitions and domestic and foreign direct investment. This in turn creates jobs, promotes innovation and growth, and increases the competitiveness of UK industry on the world stage.

## **Fair and effective public spending**

- By contributing to trust and transparency in corporate financial statements, audit facilitates the effective and timely harvesting of tax by HM Treasury for the public purse. In turn, audit of the public sector helps to ensure spending on public services is open and transparent, and that public sector bodies are accountable for the funds they receive and disperse.

In addition, audit shines a light on the stewardship of companies and provides management and audit committees with valuable feedback on corporate governance, risk and control frameworks and management strengths and weaknesses. Audit provides a rigour and scrutiny which leads to incremental improvement in the quality of management and of corporate governance, reinforcing the trust in the UK economy required for long-term investment and growth.

## **Enhancing audit for its users and stakeholders**

Overall, the quality of audit in the UK is high. Some high-impact corporate failures have, however, had an impact on market confidence. To ensure audit remains relevant and delivers value across the UK economy, and to address the underlying issues of trust and confidence in audit and the audit market, it should seek to achieve three key outcomes to enhance the degree of confidence of intended users and stakeholders. This relates to both the entity and its financial statements:

**Accountability** – boards and executives need greater accountability and effective sanctions to address poor management in the same way as auditors already have, some of which were explored in the Kingman report.

**Transparency** – government and regulators should expand the scope of audit to enable better review of management assumptions and greater detail on discussions with management in the audit opinion to provide greater assurance for investors and lenders. We discuss the expansion of scope in more detail below.

**Quality** – improvements in quality must be supported by improvements to standards, better use of technology, and long-term investment in technology (which requires scale).

## **The scope of audit**

To realise these outcomes, we believe there needs to be a critical review of the scope of the audit process itself. Key issues which need to be considered for potential change – with the associated incremental costs balanced against potential additional benefits – in this context include:

- Expanding the scope: Consideration should be given to an enlarged scope of audit beyond, as is currently required, reasonable assurance that the financial statements and accounts prepared by management provide a “true and fair view” and are free from material misstatement whether caused by fraud or error. In particular, consideration should be given to implementation of rules providing for a more detailed interrogation of fraud risk by auditors, and more explicit narrative comment on such matters in the audit opinion. This could include consideration of the broader evolution of corporate reporting to an increasingly integrated financial and non-financial basis. It may therefore be logical for auditors to provide assurance not just on the financial statements, but also on other key financial and non-financial key performance indicators and the holistic view of performance, position and prospects these would provide when taken together.
- Nature of assurance provided: Consideration should be given to:
  - The adequacy of the current “going concern” statement. It could be argued that the current “material uncertainty” sign off is too blunt an instrument. Consideration should be given to allowing for a focus on deeper review of management assumptions and greater detail/colour in the audit opinion.
  - Narrative reporting: The current audit reporting framework is in many respects a series of binary pass/fail statements. Consideration should be given to providing auditors with guidance, including a consistent reporting framework, to enhance the depth and breadth of gradation and narrative content in the audit opinion.

- Ensuring transparency for stakeholders: Whatever the scope and basis for audit going forward, there needs to be greater clarity for stakeholders as to the nature of the testing the auditor carries out, and the level (limits) of assurance which the auditor can provide.

Any possible expansion of the scope of audit should consider and clearly identify who benefits and why. For example, more specificity on going concern and viability with specific assurance on the latter, as well as more specific disclosures on fraud, would benefit both shareholders and wider stakeholders and better protect against unwanted outcomes which have the potential to impact on employees and supply chains.

However, any review, and ultimately any change in scope must be considered carefully. Any changes, however facilitative or useful, have potential to come at a cost and cause some disruption to those who participate in, and benefit from, audit and its output. The approach to reform of the scope and purpose of audit must therefore be considered, and evidence-based, in order that the objectives of all stakeholders can be met in a proportionate manner.

For example, the CMA has acknowledged that the literature they reviewed has not established a clear link between mandatory joint audit and audit quality. While there is no evidence that audit quality is lower in a joint audit regime, the assertion that it may result in higher audit quality is not evidence-based.

## **Legislative and regulatory change**

The audit sector is heavily regulated and audit output highly prescribed. Consideration must be given as to whether the current legislative and regulatory instruments facilitate and permit the effective use of tools (including technological tools) now available to auditors.

In addition, there is clearly interdependence between audit quality and accounting standards. In particular, standards are open to interpretation, so a user of audited financial accounts needs to be able to understand the accounting assumptions on which the accounts are based in order to interpret them effectively. However, any possible reforms of accounting standards should be considered against the wider regime of international accounting standards, bearing in mind investors' requirements for global comparability.

In looking at any redefinition and change to the scope and purpose of an audit, TheCityUK believes it is important to also consider the purpose of financial accounts and statements. For example, there may be utility for both those who produce audit reports and those who benefit from them in requiring that a company's accounts are more specific about insolvency risk, particularly where that risk is high.

Capital distribution is a key element in investment decision making and a functioning market economy. Audit is central to this process and if some of the changes discussed in this response – and in the audit market study update paper – progress, the capital distributions regime will in turn and by default be strengthened. This would be a good thing.

However, it would be logical to consider how accounts can be supplemented to provide information directly relevant to the capital distribution regime and how auditors should audit that additional information.

We therefore believe it is important that ongoing review of audit purpose and scope be undertaken in conjunction with an appropriately scoped review of accounting standards and the overarching legislative and regulatory framework governing auditors, their roles, and reporting requirements.

## Conclusion

The quality of audit and of auditors in the UK is generally high. Auditors are held to high levels of professionalism and accountability by professional bodies and are subject to the oversight of the Financial Reporting Council. However, even a small number of high-profile corporate scandals (whether the auditors were at fault or not) causes potentially significant market disruption.

It is therefore right that this review and other related activity considers the ongoing evolution of the current audit model. More broadly, the corporate reporting framework should be enhanced to be both reflective and forward looking to provide investors and wider stakeholders with a more holistic view of the company's value. A key aspect of this debate is how the corporate reporting and associated external assurance framework can provide dependable data and narrative on a company's viability and resilience. This includes the need for early warning mechanisms if issues which could impact on the company's viability and resilience arise. Achieving such an outcome would provide enhanced levels of assurance and protection for investors and wider stakeholders alike.

However, we believe it is in the interests of both investors and wider stakeholders that possible future change is undertaken through wide consultation, avoids greater cost burdens on clients and is done with appropriate care to protect a national asset. Therefore, proposals should:

- Put UK competitiveness and the avoidance of unintended consequences at the core of the government's agenda. Assessing any proposal, including possible reform of business environment/audit and/or corporate governance regime, in that context is especially important in the uncertain environment created by Brexit.
- Be aware of the risks of inhibiting the UK's ability to be competitive by creating a new regime not aligned to global standards. Business will simply move elsewhere, taking employment with it.
- Recognise that multidisciplinary firms offer diverse and rewarding career development pathways for talent from many backgrounds<sup>1</sup>, and the ability of firms to attract and retain the best people should not be affected adversely by potential reforms.

**TheCityUK**  
**June 2019**

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<sup>1</sup> Six of the top 50 Social Mobility Employer Index 2018 employers are multidisciplinary audit firms: <http://www.socialmobility.org.uk/wp-content/uploads/2018/07/SM-Index-Top-50-2018.pdf>.