Severn Trent Plc

Severn Trent Centre
2 St John's Street
Coventry
CV1 2LZ

Tel 024 7771 5000
Fax 024 7771 5871

www.severntrent.com
www.stwater.co.uk

07 June 2019

Brydon Review
Orchard 1, 1st floor
Department for Business, Energy & Industrial Strategy
1 Victoria Street
London
SW1H 0ET

Dear Sirs

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Further to the publication of the Calls for Views, please find enclosed Severn Trent's response to the topics and questions of relevance.

We note that the present Call is neither exclusive nor exhaustive and further topics may be explored in due course. In the event the Review publishes additional Calls for Views and undertakes deeper research as it develops conclusions, Severn Trent will be happy to respond.

Should you have any queries on the enclosed response, do not hesitate to get in touch.

Yours faithfully

James Bowling
Chief Financial Officer

Q1: For whose benefit should audit be conducted? How is it of value to users?

In our view, a company audit should be beneficial to all users of a company's financial statements. While it is of principal interest to shareholders, debt investors and creditors, it should be understandable and relevant to other stakeholders such as customers and employees.

The current structure of the typical audit report does not lend itself to this:

- Auditors address their reports only to the members of the company.
- Auditors typically include a Bannerman paragraph, with the intention of limiting their liability, which may reduce the confidence of other readers in the relevance of the auditor's opinion to them.
- The audit opinion does not cover all parts of an annual report. It is often difficult for readers to follow which information has been assured by the auditor and is therefore covered by the auditor's opinion, and which is not assured by the auditor and is the sole responsibility of the directors.
- Many audit reports appear to be written more with an eye to limiting auditor liability than to using plain English to explain the extent and outcome of the assurance undertaken.

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements? And

Q20: Is there a case for a more forward-looking audit? What would be the main benefits and risks?

We welcome the FRC's proposals to increase the work auditors are required to perform in relation to the going concern concept. However, we believe that further extension to the scope of audits to enhance the degree of confidence of intended financial statement users in the entity, would not be a sensible response to recent corporate failures.

While it is debatable whether viability statements are working as intended, it is clear that it is the directors' duty to assess future viability and so they are best placed to convey the appropriate level of confidence in their company's viability to readers of the financial statements, not the auditor.

In our view, it is unreasonable to expect auditors to be either willing or able to assure the future consequences of directors' decisions or future events, in every instance, to the satisfaction of all financial statement users.

Furthermore, the cost of auditors trying to reach such a level of assurance would be significant, even for well run, highly solvent companies; it would be of doubtful value (as trying to assure the future inevitably is); and it would surely increase the risk of users looking first to auditors to provide confidence, rather than directors, who have the primary duty in this regard.

Q4: Do respondents consider there is an expectation gap?

It is clear that there is an expectation gap between what users of financial statements expect from an audit and what is required under law and auditing standards – and that this is a public interest issue.

In addition to some of the ideas included in the report on how the audit scope should change in order to close the gap, consideration should also be made of how to "reset" the expectations of users of financial statements.

The expectations gap is perhaps widest in respect of corporate failures. Company failures happen every day, and they will always be a feature of dynamic economies where taking risk is the means to earn the equity returns expected by shareholders.

However, company failures are often misdiagnosed by the general public as due to shortcomings in existing company law, accounting practices or auditing standards. The review should perhaps first look at how to correct such misconceptions, before over-regulating in compensation.

Of course, in those instances where bad behaviour, recklessness, weak regulation or inadequate enforcement of standards and laws are to blame for corporate failure, we are supportive of robust action against those responsible.

Notwithstanding our comments above, we do believe that improvements to the audit process could play an important part in narrowing the expectations gap, including:

- Making audit reports much easier to understand, written in plain English, to clearly indicate what has and has not been/cannot be assured by the auditor, and why; and
- Moving away from the current "binary" audit opinion to a more graduated disclosure of auditor conclusions.

Q21. Would the audit or assurance over financial and 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?

Given the increasing focus by stakeholders on indicators of a company's health and future prospects that are not included in the financial statements, the extension of assurance to cover such information could be of benefit to users. The assurance of such information need not be undertaken by the auditor of the financial statements, and for some information other assurers would be more qualified to provide an opinion.

This would require a framework to establish clarity on the scope and nature of the assurance requirements and the respective responsibilities of management and the auditor or assurance provider. Such a framework might be set out in law, the Corporate Governance Code or standards established by BEIS.

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

In our view, the binary nature of audit opinions is contributing to the current expectations gap. As the report observes, modified opinions are extremely rare, and the pass/fail nature of the opinion, coupled with the very high "pass" rate, may be giving a misleading impression of the soundness of some companies' financial statements.

A more graduated disclosure of auditor conclusions, tailored to the individual company's position and the directors' financial reporting decisions, could provide valuable information to users of financial statements about the company's past performance and financial position. For example, better disclosure of significant judgments or key estimates in the financial statements, coupled with an audit report that evaluates the soundness of the judgments involved and any implications for the quality of earnings and risks to future cash flows, might enable users of financial statements to make a more informed assessment of the company's future prospects, on which to base their own investment and commercial decisions.

If graduated disclosure is to be adopted, it must be accompanied by auditing standards that ensure consistency of approach across auditing firms.

We think this could be a better way for auditors to communicate their assurance findings than an annual assurance meeting, given the relatively low level of attendance at shareholder meetings across the FTSE.

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?

It appears that users of financial statements currently have a higher expectation of the role of the auditor in detecting and preventing fraud than is required under UK law and auditing standards.

Fraudulent activity is difficult to detect, as perpetrators are usually intent on concealing it – and so extending auditors' responsibility to detect fraud would significantly increase the level of assurance work performed, and the cost of every company's audit. This would be of doubtful value to the majority of companies that already have extensive controls to prevent and detect fraud, as is expected of directors under the duties set out in the Companies Act.

Auditors and regulators could do a better job in informing the general public on the purpose of the company audit, and its limitations as a means to prevent and detect fraud.

More robust exercise of investigation and enforcement powers by the relevant agencies and regulators in cases of fraudulent behaviour and negligent assurance would also help to restore the public's confidence in the overall governance framework.