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Independent Review into the quality and effectiveness of audit - call for views:

Submission from Simon Henry, Independent Director

Dear Sir Donald Brydon

Context of response

I am a concerned finance and business professional with many years of experience in corporate governance and as a recipient of external audit services. I have served on 3 top 10 FTSE boards for a combined total of 15 years, 8 of which were as a CFO with responsibilities for financial reporting, statutory audit activity and the internal control framework. I have significant international experience including dealing with regulators in the UK, US, EU and China. I currently serve as audit chair of two plcs, and have contributed broadly to various developments in governance and audit.

On behalf of the companies I currently serve as Audit Committee chair, I have already signed off two company responses to the Brydon review 'call for views'. By their very nature those responses reflect a range of views within the companies. I have also consulted with organisations such as the 100 group of CFOs, CIMA, and the big 4 audit firms themselves. The views expressed in this response are my personal view based on 37 years of professional experience, and as such they may conflict in relatively immaterial ways with the other responses I have approved.

I am not an alumni of the big 4 or any other audit firms. I am a Fellow of CIMA, and also sit on the CIMA Advisory Panel.

My relevant career experience includes

- 8 years as CFO of Royal Dutch Shell plc ending 2017
- 5 years as NED of Lloyds Banking Group, including 2 years as Audit Committee Chair
- 2 years as NED of Rio Tinto plc, where I have just taken over as Audit Committee Chair
- 18 months as NED at the UK Ministry of Defence, including Chair of the Audit and Risk Assurance Committee, dealing with the National Audit Office as auditor
- 2 years as an Independent Director of PetroChina Ltd, Beijing
- Previously, Membership of the 100 Group Committee of FTSE CFOs, and Chair of the European Round Table CFO Taskforce

While views expressed below are my own, as an ex Committee member of the 100 Group I confirm my support for their detailed response to this review, as well considered, constructive and representative of the views of the CFO community.

Preamble

The variety of current reviews into corporate governance and the audit market are in part a reaction to the aftermath of the global financial crisis in 2008. The so-called crisis of capitalism and the subsequent loss of trust in business and overall corporate governance is a key driver of the many public and political concerns about the audit profession, enhanced by a relatively small number of recent company failures. The current reviews in principle should be targeted at improving trust in financial and broader reporting of the corporate sector, and the quality of assurance thereon provided from the external audit activity.

It must be recognised that UK corporate governance and audit capability, both in terms of capacity and quality, is widely regarded by most of the world as leading practice. Professional services as a whole remains a significant contributor to the UK economy, and the significant number of individuals who develop their business careers originally in the auditing profession should not be underestimated as a major contributor to UK prosperity. This framework and capability is also a significant positive element of UK soft power and influence.

The current reviews represent a clear opportunity to consider scope and overall effectiveness of both statutory audit and governance, potentially in a way that sets a new bar for expectations on a global basis. The obvious flip side to this is that making changes that are purely parochial or not connected to the global nature of this activity, carry the clear risk of damaging this important sector, most likely without addressing the underlying issues.

General requirements and moving to an evidence-based approach

A key requirement at present is that all relevant reviews and recommendations are brought together in a single coherent approach under the BEIS Secretary of State, with major changes addressed via primary legislation and the remit of the newly proposed regulator ARGA. The alternative of multiple fragmented or poorly considered changes, drip feeding into requirements on a variety of bases (guidelines, codes, secondary legislation, etc) will not only have significant negative consequences, it will miss the opportunity to reset standards globally. Such a positive approach by the SoS would also reduce the risk of short-term populist politically or media motivated actions driving outcomes. This subject is too important to the UK economy to be dealt with in soundbites on the basis of a small number of company failures, and inherent prejudices that are not evidence based.

The multiple reviews do highlight that there is not yet an agreed definition of the problem(s) we are trying to solve. The Brydon review would ideally have been concluded before CMA or BEIS Select Committee activities began, with the Kingman review proceeding in parallel. The Brydon review is asking important questions about the scope and purpose of audit, how it relates to key stakeholders and how to address the expectations gap between what audits have historically achieved and broader public perception. Critically the review is an opportunity to define how these evolve in future.

A good outcome would be evidence based having i) agreed the problems to be addressed, ii) removed some of the myths currently distorting debate, iii) improved the quality of statutory audit and governance and critically, iv) having seized the opportunity to extend the UK’s global leadership.

Some of the myths (in bold) that need to be addressed in defining both the problem and potential recommendations, and in dealing with the expectations gap, include:-

1. "**Audit quality is a primary cause of Corporate failure**": Directors are responsible for company sustainability and viability, and relevant legislation is and should be directed at Boards. Auditors may raise concerns, but unless the statutory scope is extended to forward looking statements, cannot be more than a warning light.
2. "**More choice automatically leads to higher quality**": There are clearly duopolies in many sectors (Boeing / Airbus; Coca Cola / Pepsi; Azure / AWS cloud services) that disprove this myth. More choice would improve resilience, but requires careful consideration of how to develop over time the required capacity and capability in new competitors, not the introduction of short term restrictions that inevitably reduce quality.
3. "**Auditors should prevent all fraud**": Audit scope and methodology does not and should not explicitly identify fraud targeted at company assets (theft or loss of assets). Auditors should be able to assess potential misrepresentation in financial reporting statements, albeit in a narrow space given the retrospective nature of statutory accounts. Collusion by executives or Directors is very difficult for auditors to identify. Boards are responsible for appropriate control frameworks, and should be held accountable.
4. "**Auditors are focused on increasing consultancy work for audit clients**": The CMA's own evidence (if not recommendations) refutes this myth. Non audit fees are already limited by EU requirements, and could be easily limited further with little impact given the vast majority of Audit Committees have already acted to limit non audit work well below the official maximum.
5. "**Companies and Auditors are too close**": Ensuring this is not the case is the role of the Audit Committee. In addition, the primary asset (reputation) of Auditors, both as individuals and collectively, depends on this not being the case. Evidence to support this myth has not been produced in reviews to date.

In addition to the above certain other factors are relevant in considering improvements and associated recommendations.

- Virtually all stakeholders agree that improvement in audit quality is necessary, and the prime objective in terms of future expectations. The Brydon review is well targeted to address this. Current regulatory assessment of audit quality tends to focus on process and documentation, rather than outcomes such as opinions and reported insight. The focus here should be on quality of audit outcomes and the subsequent communication with relevant stakeholders.
- The roles of company executives, non-executive directors,, the board and its various committees, shareholders, and regulators are well established and addressed in existing corporate governance legislation and codes. Appropriate measures are already available within existing legislation to take action against those not fulfilling their legal accountabilities. Changes to this framework require careful consideration to avoid unintended consequences, potentially taking lessons from the Senior Management Regime applied in Financial Services.
- Requirements for corporate reporting, and statutory audit of financial reporting, are clearly separate issues. They should not be conflated. New requirements on auditors should not be used to imply or require new corporate reporting elements. Reporting needs should be

addressed through primary legislation or ARGA, with relevant statutory audit requirements following on.

- Over the past 10 to 15 years under the direction of the IASB, accounting standards have increasingly moved towards reflecting potential future economic and business conditions. This has meant that financial statements require high levels of subjective assumptions in order to comply with accounting standards. This is particularly noticeable in the financial services sector, but the treatment of credit impairments, derivatives, leases, asset impairments, pensions, and retirement obligations are examples of material accounting judgements driven by subjective views of future outcomes. There is a clear need not only for reporting to be more transparent about assumptions used and what the implications and sensitivities may be, but for a measure of relevant assurance.
- The Kingman review has recommended a new regulatory body (ARGA) which has broad business and profession support. Provided that there is a single holistic set of recommendations a combination of new or revised legislation including defining the remit of ARGA is the best practical method of executing most actions going forward. The legislation should recognise the need to evolve in future according to global governance standards, and hence not be restricted to the UK environment.
- Shareholders currently have the means to communicate with auditors of a company, but very rarely exercise this right or indeed raise relevant issues with the company or the audit committee. In part this reflects limited capability even within major asset managers as much as any perceived or real lack of opportunity. In practice, the independent auditors report in association with management statements on risk and Committee activities, provide a clear overview of issues of interest. These could and probably should form part of the more regular dialogue between companies and investors.
- Recent FRC investigations into corporate failures have I believe in all cases identified poor company culture as a contributory cause. While this review has asked pertinent questions, I do not believe this issue can be adequately considered in a formal sense the context of external audit. Company culture and values are a key responsibility of executive management, and oversight of actual behaviours is very much a Board responsibility.

Recommendations (in response to questions)

The call for views has a large number of relevant detailed questions under subheadings. Recommendations below are not mapped to specific questions and in some cases overlap with responses on the other ongoing reviews. They are however a coherent response based on broad personal experience. They are not comprehensive as some of the subject areas are clearly best addressed by specific stakeholders.

1. Sarbanes Oxley legislation in the United States has, notwithstanding some of the practical issues of implementation, proved valuable in enhancing both the **quality of internal control frameworks and Management accountability for their effective operation**. I support development of a similar UK requirement to SOX section 404 (Internal Controls), albeit recognising lessons learned around practical implementation. External Auditors should provide a measure of defined assurance around statements made.

2. The **role of the audit committee** and its chair could be more clearly articulated, in terms of accountability for the integrity of financial reporting, the effective operation of internal controls, and communication to stakeholders. This should not however change the fiduciary duties of other directors.
3. The **going concern statement** is currently little more than support for the basis of preparing accounts. It should be more clearly articulated as a requirement to demonstrate available cash flows and liquidity to take the company through the most severe projected economic scenarios in the coming 12 months. This would include qualitative and quantitative statements on Treasury policy in regard to credit facilities, and a link to cashflow projections and associated risks.
4. **Viability statements** do vary widely across companies and sectors, are typically for three years only and have become to an extent boilerplate. They can also be just an extension of expectations on available credit rather than being linked to fundamental cash flows which are driven by the company business model and management risk assessment. I support enhancements to the viability statement, which should include a longer period, focus on sources and uses of cash, clear linkage to potential risks or adverse scenarios, and greater transparency on assumptions used around business model and the macro economic environment.
5. The financial services sector has well established practice on **liquidity requirements** and stress testing of cash flows and balance sheet. Some of this methodology could be a requirement for al sectors, particularly in requiring assessment of stress cases and potentially a reverse stress test to highlight the relative impact of stated risks.
6. To be effective in providing information and assurance to stakeholders both **the going concern and the viability statements require a clear form of minimum assurance**. At present it is likely that the independent auditors report will refer to the statements but there is little consistency in the level of assurance provided. Audit firms currently have the resources and capability to perform more specific assurance, for example in the way that they would do on behalf of companies who are issuing debt or equity into public markets or engaging in M&A activity. This requires using audit firm advisory capability which will not be available if that practice was separate. Although other professional firms could potentially provide this level of assurance they are not as well resourced or professionally focused on such assurance.
7. Taken together, the above four points together with existing observations in the Independent Auditors report (specifically on strategy and risks) should address concerns and the expectation gap that the auditors should contribute to **predicting and potentially preventing corporate failure**. It should however be clearly understood that assurance of any forward-looking statements cannot be performed to the same high standards as historic financial accounts, in part because of the lack of clear consistent and well understood standards. They will also be subject to the safe harbour statement, but the expectation should be that communication is transparent, specific to the company and avoids legal boilerplate language.
8. I **do not support a graduated approach to audit opinion** on the financial statements, the binary outcome is sufficient. There is well-established practice that is clearly understood by primary users of the accounts and to create subjective and artificial levels of assurance would not be helpful either in publishing opinions or interpreting them. I do however

support specific minimum levels of assurance on forward-looking financial statements, the strategy and risk sections of the annual report, and non-financial reporting that is becoming increasingly important in the ESG space.

9. The Independent Auditors report in the annual report should already describe the level of assurance provided on qualitative statements and non financial metrics reporting. It should also be clear that the level of assurance is lower than that suppporting the audit opinion on the financial statement. However, current practice varies and **I would support a mandatory requirement for auditors to provide assurance on qualitative statements and non-financial metrics used in the annual report**. Although this requirement could in practice be met by other professional firms, the current audit firms including their broader advisory capacity remains by far the best placed organisation to provide this service. Additional cost would be minimised, and quality and effectiveness of assurance maximised by providing this assurance from within a single team.
10. For avoidance of doubt, and in summarising some of the above points, **I do not support the splitting of audit firms into statutory audit and advisory activities**. Such a move would undermine and potentially damage fatally the ability of the statutory audit teams to deliver and evolve high-quality audit. It would also significantly impact the quality of recruit and training / retention of staff that provide such a huge economic benefit to the UK.

All of the above recommendations need to considered in the context of the Kingman Review, which has broad support from the Business community, and the CMA review which does not.

If you would like to discuss any of the comments herein, please feel free to contact me at the email or mobile number below.

Yours sincerely

Simon Henry

Independent Director: Lloyds Banking Group plc, Rio Tinto plc, PetroChina Ltd, Ministry of Defence