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June 7, 2019

RE: Call for views - Independent review into the quality and effectiveness of audit

To the Brydon Review Secretariat,

Thank you for the opportunity given to provide our views in relation to your 'independent review into the quality and effectiveness of audit'. As Controller of Royal Dutch Shell plc ("Royal Dutch Shell"), and on behalf of Royal Dutch Shell and its subsidiaries, I am responding to your call for views.

We welcome your broad-based review to examine the purpose, scope and quality of statutory audit practices in the UK which we believe is a necessary complement to other reviews undertaken in respect of the functioning of the statutory audit market. A high-quality audit is in the interest of both our company and our shareholders. As you rightfully mentioned in your review, not everything is broken and consequently we believe that any changes proposed should directly address the objectives set. Whilst a robust review of auditing practice is beneficial it should seek to focus on a clear remit and avoid ad-hoc changes that might inhibit existing best practice. In this respect we urge the Independent Reviewer to also reflect on the learnings that may be derived from the many audits that are conducted to a very high quality and that proportionality is a conscious consideration in determining proposed changes. Reforms should be evidence based, address root causes such that audit quality can be enhanced in a sustainable manner. For example, introducing requirements that would undermine a risk-based audit approach and lead instead to one that is more compliance-driven would only result in more work without producing a more effective audit.

Recently the CMA market study and Sir John Kingman's Review were published. Whilst the primary focus of these reports is different, as also noted in the introduction to the Brydon review, an overlap exists in certain areas. We believe it is important that actions following this review should be taken in conjunction with those addressing the recommendations in the other two reports.

Wider assurance

Chapter 3 of the review mentions 'wider assurance' concerning the statements made by directors of companies. The review is not clear as to what information or disclosures should be subject to wider assurance. Also, an audit has a clear objective and a regulatory framework such as a financial statement framework like IFRS and the International Standards on Auditing (UK), which form the basis under which the audit is conducted. Wider external assurance on disclosures outside the financial statements can only be meaningfully provided where a defined, unambiguous and recognised reporting framework has been set.

The relevance of wider assurance will differ from company to company and also depend on the industry sector in which the company is operating. Companies should have the ability to determine which disclosures are most relevant for their shareholders and stakeholders, and which should therefore be subject to independent assurance.

Communication of audit findings

Chapter 7 of the review raises the communication of audit findings. More transparency in the communication of findings by auditors may be useful for shareholders to get a better insight. It further evidences the directors' accountability towards shareholders as a whole. At the same time, an auditor should continue to be able to report freely to those charged with corporate governance. Both objectives could be met by a more graduated public disclosure in the audit report. Also, disclosure of certain topics as reported by the auditor to the audit committee, such as the auditor's view on key judgements and assumptions applied may provide better insight. The direct and unfettered access the auditor has to members of the audit committee forms an essential element of sound governance, this relationship should not be encumbered by prescriptive disclosure requirements. Equally, care should be taken not to prescribe disclosure of facts or information that could be commercially sensitive or prejudicial to the interest of the company.

You will find our further detailed response to some of the individual questions raised in the appendix to this letter. We have limited our response to those questions that we believe are most relevant to our company and to our shareholders.

Yours faithfully,

Martin J. ten Brink
Executive Vice President Controller

Appendix

This appendix includes our responses to those questions raised, that are most relevant to our company and to our shareholders.

Chapter 1 - Definitions of audit and its users

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

An audit of the company's financial statements, and where applicable an audit of the other aspects of the annual report, should focus on the needs of shareholders for transparent and objective financial information in line with the principle of providing a 'true and fair view'.

Annual reports are also intended to give other stakeholders (including potential investors, creditors and banks) information about a company's activities and financial performance. These parties may rely on the financial statements and corporate governance sections of the annual report. An audit should focus on the integrity of the financial reporting and associated information provided to such stakeholders.

Generally, there is also a wider public interest in the annual report. The information needs of the wider public tend to be more varied and depend on the company or the industry sector, the nature of the topic and the individual stakeholder. External assurance on such disclosures can only be meaningfully provided where a defined and unambiguous reporting framework for companies has been set.

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

There may be selective areas of disclosure in the annual report, most relevant to the primary users of the annual report, where the scope of audit could be considered. The relevance of wider assurance will however be different from company to company and depend on the industry sector in which the company operates. Companies should have the ability to determine which disclosures are most relevant for their shareholders and other stakeholders, to apply external assurance on, rather than having the auditor to provide assurance on all disclosures.

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?

The purpose of external audit should be clearly defined to set reasonable expectations to potential users of the audit report. Amending UK statutory law to make it explicit in terms of its purpose and who it intends to benefit, would be a good starting point for clarifying those expectations, but such expectations should preferably be, or remain, principle based.

Chapter 3 - Audit and 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?

The external audit of financial statements has a clear objective underpinned by a financial statement framework and the International Standards on Auditing (UK), which form the basis under which the audit is conducted.

Already, risk-based scoping forms a key element of how external audits are conducted. This risk-based principle is an essential feature in focusing audit activities on areas of materiality and on where greater judgement or uncertainty may exist. Subject to the industry sector a company operates in, certain specialists skills such as tax, IT and legal are essential to consider the risks relevant to that company. It is entirely appropriate that the principles of risk-based scoping and judgement are retained, which may also be reflected in the level of assurance to be obtained.

For wider assurance we refer to the point made about availability of a defined and recognised reporting framework under our response to question 1.

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?

No. In Shell's experience the current UK independence rules are fine in practice. These rules sufficiently address potential conflicts of interest without restricting innovation. We do however see a threat to market innovation if the UK were to move towards a model of 'audit only firms' or towards a joint audit model. We expect that an 'audit only' model would have a negative impact on the quality of the audit of our company, which requires the involvement of a number of specialists who are outside the audit practice.

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?

The responsibility of the board to annually review the system of risk management and internal control systems and, at least annually, carry out a review of its effectiveness and report on that review in the annual report, is already enshrined in the UK corporate governance code. Whether a more explicit statement adds value depends on what the intent of such a statement would be. The SEC regulatory framework provides for an explicit management report on internal control over financial reporting and disclosure controls. If additional requirements in this regard are to be considered the option of 'equivalence' under such other regimes should be taken into account to avoid duplication and unnecessary effort.

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

In line with the requirements under US rules, where for large cap companies, auditors are required to report on their assessment on the effectiveness of an entity's internal control over financial reporting, we believe that the auditor's responsibilities could similarly be extended in the UK. Again, the option of 'equivalence' under such other regimes should be taken into account to avoid duplication and unnecessary effort.

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?

External auditors should be able to rely on their direct and unfettered access to audit committee members, ideally this relationship should not be encumbered by prescriptive requirements for external disclosure.

It may be beneficial to provide more disclosure on the work of auditors and to report out their results, but it should be recognised that the current format of the independent auditor's report in respect of 'key audit matters' offers auditors discretion to disclose their views and/or assessments. Care should be taken to avoid prescribing disclosure of facts or information that could be commercially sensitive or prejudicial to the interest of the company.

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

The first question to consider may be about the quality of current viability statements and whether directors provide adequate information to shareholders about the assumptions applied and/or scenarios tested in arriving at their conclusion. Going beyond the typical three-year period which forms the current basis of the viability statement, would imply a degree of certainty about future developments on the part of directors, that may be somewhat unrealistic given the uncertainty ranges in various macro-economic variables.

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

Given the inherent uncertainty about future developments means that any assurance over forward looking statements will need to be qualified by the assumptions and judgements applied in arriving at that projection. These qualifications will probably limit the value and insight that can be derived from external audit procedures. Any expansion of audit scope to include forward looking projections should carefully consider this aspect, because otherwise it may contribute only to a greater expectation gap.

Q21: Would 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?

Assurance on specific topics and certain non-financial information would probably be beneficial to certain stakeholders. This would require a clear objective and standard framework against which disclosures outside the financial statements are to be tested, so that users were able to form realistic expectations.

Q22: If so, what information might usefully be subject to audit or another form of assurance and why?

Selective metrics and information on sustainability and environmental performance that are relevant to shareholders could be subject to additional assurance.

Chapter 5 - Audit product and quality

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?

Prescriptive requirements have the tendency to drive a compliance mindset without due regard to the added value of the audit procedures. A risk-based approach benefits companies and shareholders because it allows both judgement and material facts to be considered in assessing areas that will be critical to the understanding the financial position of a company.

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

A more graduated disclosure of auditors' conclusions will enable users of the audit report to get better insight and apply their own judgement on the information provided in the audit opinion. A good start was made by introducing the long-form audit report. Additional measures could include graduated findings on key areas of accounting estimates or judgement.

Chapter 7 - The communication of audit findings

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?

This would be supported because it enables users of the financial statements to get better insight and apply their own judgement on the information provided. Care should however be taken to avoid disclosing information that could be commercially sensitive or prejudicial to the interest of the company, because this may restrict the auditor in its openness to report to the audit committee.

Further reference is included in our responses to questions 14 and 25.

Chapter 9 - Auditor liability

Q40: Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

This does not appear to be the case. For example, in the US per the auditor independence rules, our auditor cannot limit their liability by seeking indemnification from us. We are however not experiencing any constraint in the auditor's desire to focus on audit quality or their willingness to embrace change.

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?

The auditor's use of technology has allowed broad-based testing of all transactions rather than being sample-based, which has delivered insights much more rapidly and precisely. This development benefits the quality and efficiency of audit procedures with further improvements to be expected through the application of technologies such as robotic process automation (RPA), machine learning and more advanced data analytics and calibration tools.