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Dear Sir/Madam

Consultation: Independent review into the quality and effectiveness of audit

We welcome this opportunity to respond to the Sir Donald Brydon's call for views launched on 10 April 2019.

The Royal Bank of Scotland Group plc (RBS) is a financial services group providing a wide range of products to personal, commercial, large corporate and institutional customers and is a constituent of the FTSE 100. As a provider of finance, we are a stakeholder in large and small companies across the UK and beyond.

The 21st century context points to the rise of "fake news" and an ever-faster dissemination of information. Against this backdrop, the need for effective assurance provided by audit has never been more relevant. However, concerns about the quality of audit diminish its value and risk undermining confidence in corporate reporting.

We have provided a structured response rather than seeking to answer individual questions. We do however, reference relevant sections of the call for views, where appropriate.

Summary
The review is timely and provides an opportunity to address a number of areas of growing concern, as well as the opportunity to address emerging trends and practice.

- We recommend that the review establishes clear principles underlying its ideas and proposals. This will enable the development of a clear framework for immediate application and provide guidelines to inform future developments.

- It is time to refocus annual reporting to meet the needs of users. This may mean separate reports for different defined sets of users, each providing the appropriate key performance measures. Combined reports should continue to serve for less complicated or diverse companies.

- A better focus will enable auditors, and perhaps other assurers, to concentrate their efforts on what is important to readers. We consider that for large and public interest entities, this should be towards management and their actions rather than transaction fraud.

- The scope of the audit needs review to better address areas of most public concern and to be risk-based, concentrating effort in the most important areas, and reducing efforts on low value items or internal documentation. We also believe there is some value in having the auditor address investors rather than merely shareholders, and consider enhancements in the forms of reporting.

Expectation gap (Questions 4, 5, 6)
It is apparent that there is a significant expectation gap in respect of the statutory audit. Ignoring this gap will not remove it. The only effective response is to accept that change is needed, and that arguing for the status quo is insufficient. We believe that the critical elements of any enhanced framework are:

- Clear accountability and consequences where actions are not appropriate. This needs to be the case both for auditors, company directors and management.

- Clarity and transparency in reporting and governance.

Concerns as a user of Annual Reports and audit reports
There is a lack of usability in company financial reporting and audit reports that reduces the effectiveness of these documents. We would make the following specific comments:

- Investor presentations are often a more helpful vehicle to obtain relevant and useful information about a company. These presentations better represent the company story, are generally more focused and succinct than financial statements and frequently include information and analysis that is not within other published documents

- Boilerplate reporting has become increasingly evident in company and audit reports. This offers little value. Conversely there is often insufficient information and/or analysis on subjective items that is particular to the company. We note, for instance, that the KPMG submission to the BEIS Select Committee indicated that they believed while the Carillion revenue recognition policy was acceptable against IFRS, it was aggressive compared to peer companies. However, there was no reference of this within its Annual Report. This is information that would be of great value to readers.

- Areas that are important for all users include (i) approaches taken that are out of step with peer companies, (ii) where there are big changes in accounting methodology, (iii) where there are significant (and increasing) risks to viability and/or (iv) where the culture and control of a company is prone to non-compliance with law or fraud.

- Audit reports do not provide enough useful information. The “true and fair” opinion does not provide enough graduated comment. Extended audit reports do not provide helpful information. Shorter more tabulated conclusions would be better, more akin to credit rating agency scorecards.

- Auditor independence is important in providing assurance that the challenge to management is robust. This is undermined where the audit product is under-priced or where firms do not bring sufficient expertise to bear. Audit firms need to be of an appropriate size relative to the clients they report on.

I Desirable outcomes

Any change in the legal frameworks for audit, or corporate reporting, should be justified and deliver clear benefits. We believe any changes should take account of the following factors:

Quality matters
The primary goal is to maintain the UK’s position as a world leader in capital markets. A fundamental element of this leadership arises from the reliability of corporate reporting and the effectiveness of corporate governance.

To achieve this, the formal frameworks need to promote the highest quality of corporate reporting and assurance. The quality of reporting is the responsibility of the Board of directors. Assurance is the remit of the auditors and possibly other independent assurers.

Length
A widening scope of formal requirements and regulations are leading to ever longer corporate communications. This leads to a risk that the most important messages are diluted or obscured. Outcomes that drive shorter, clearer periodicl reporting will be more effective.

Promote use of technology and innovation
Audit is criticised as being an outmoded product. In part this is because it has not developed or evolved as the world and the reporting landscape changes. We believe that there needs to be incentives for both

companies and auditors to proactively progress audit approaches, incorporate technology and modify the means of delivery to match changing needs.

Proportionality
The needs and expectations of a FTSE 100 company are necessarily different to a small business. Any framework needs to respect such differences. In part this is a function of public interest, but it is also a reflection of the breadth of stakeholders.

Risk-based
Audit, in particular, should be risk-based; changes should focus on where risk sits within the value chain, rather than simply extending scope and coverage. Appropriate risk-led changes would also pass a cost-benefit test.

Principles not rules
Frameworks that lead to greater director responsibility are likely to lead to better outcomes. Good audit engagement supports this. Frameworks that rely on detailed requirements rather than principles are more likely to lead to boilerplate reporting and the publication of minutiae of excessive length..

Global consistency
The review focuses on the opportunities to change the UK legal framework in respect of the content and mechanisms for corporate reporting and auditing.

However, many UK organisations also need to engage with overseas jurisdictions for their reporting (eg where they have securities listed overseas). Changes that lead to greater divergence from global standards (of law or reporting requirements) will lead to greater complexity.

Without hindsight
In developing a reporting/audit framework, it is not possible to establish a framework that prevents corporate failure. Frameworks that promote risk articulation, transparency and measures that provide useful and meaningful information about company prospects are nonetheless valuable.

II Application of principles to specific opportunities to improve reporting and audit

We set out below our views on options that have the potential to enhance reporting and audit that put these principles into effect. We set out more detailed reasoning in the appendix. We also discuss ideas that we do not believe will work.

The Annual Report
We believe that the Annual Report should:

- Be addressed primarily to investors in the company.
- Set out information that is relevant to users to form an opinion on the prospects of that company.
- Be accessible and helpful to other significant stakeholders, such as customers, suppliers and employees.

Currently Annual Reports typically include a strategic report that is shorter for smaller companies, but extensive for public interest entities (PIEs). We believe:

1. Annual reports should set out relevant information for key user groups. These stakeholders should be clearly identified by the directors. It should not be necessary to identify all stakeholders, and the information presented to shareholders will be sufficient for many others.

2. The information provided should not require a profit forecast. Reporting expectations regarding future financial information are globally consistent. It is important to provide information on management views and targets; for many companies this is sufficient. To extend this further and to be specific regarding future profitability creates legal issues in many jurisdictions and would not represent a progressive move in terms of reporting. There are some cases where companies, such as start-ups, might wish to go further.

3. A greater focus on the key performance measures would greatly benefit users. Those measures should be determined by management. They should identify the information most important/relevant to them in their evaluation of strategy and the basis of management's ongoing

assessment of actual performance. The reasons for changing such measures should require explanation.

Financial information
The provision of historical financial information continues to carry significant benefit. There is a clear and understood framework that underpins the measurement of historical financial information. This enhances the ability of users to compare companies with each other. The increasing length and detail of this reporting detracts from the ability of users to identify and understand key issues.

An option that merits evaluation is a greater separation of the provision of this historical information from the broader annual reporting of companies. Financial reporting could operate on a six-monthly basis and the Annual Report, at year end, would represent a separate and fuller "company balanced scorecard". The benefits to this approach include:

- A more focused and shorter Annual Report.
- A report based on simpler key performance measures allowing for more targeted messaging.
- Separate publication of financials, in the same format from period to period would allow this important information to be reported in a more unified manner that is easier to compare to peers. For instance the prescribed reporting formats in the US achieve a high degree of consistency.

Shareholders look for long term value creation. Reporting should support this and focus on how, and whether, management delivers long term value and the performance measures that demonstrate its success or not. Frequent reporting (such as quarterly) does not promote this goal. A better balance needs to be struck between keeping the market appraised of recent trading performance, or changes in prospects, and the provision of detailed information that more statistical-based users may desire for modelling purposes.

Audit
The simplification of the Annual Report, along with a more focused remit will enable a more effective audit approach:

(i) Audits should cover quantified information across the full Annual Report. Non-financial measures are becoming more important in general company assessment and valuation. It is important that audit addresses this change.

(ii) Users expect reported information to be "accurate" (undefined). It is therefore essential that auditors specifically report on the true, fair, and balanced presentation of this broader set of information.

Cost-benefit
Audits must be assessed on a cost-benefit basis. There is considerable benefit to users from the assurance offered by an external audit. However, auditors can and do only spend a fraction of the time that a company itself devotes to its activities. It is not realistic to expect auditors to be able to find anything and everything at fault, or that is noteworthy, in a company.

Auditors should focus on "higher value" issues and judgments both in terms of time and expertise, and reduce their effort on lower value box-ticking/compliance/documentation. Technology and artificial intelligence should help support such a change.

The auditor does have the benefit of looking across the organisation. They should continue to perform a full organisation wide risk assessment. However, there is the opportunity to agree that lower risk issues/areas be reviewed by alternative assurance providers. The auditor would focus on the areas they agree with those charged with governance as representing most risk.

Scope
There are specific areas that auditors are generally expected to address in their audit work. We consider that a number of these areas require refinement:

1. Fraud
   Management is responsible for ensuring the prevention of fraud. In the case of most listed companies, and PIEs, this includes an internal audit department. Therefore, auditors should not need to test for lower level fraud as part of its statutory audit. It may be appropriate for the auditors to comment on whether they believe management processes are likely to be effective.

Auditors should have a greater responsibility to specifically assess whether management is overriding internal control processes or taking fraudulent actions. Management acts as company stewards and shareholders and other users need protection from malpractice on its part – this protection should be provided by auditors.

2. <u>Compliance with law</u>
The breadth of law makes it challenging for auditors to be able to spot all failures in legal compliance. Like fraud, the directors have primary responsibility for setting up and running the business to ensure the company meetings its legal requirements.

In a similar manner to fraud, auditors can, and should, play a role in ensuring that the directors operate within the law. There are certain areas of law where shareholders have a direct interest in understanding whether management complies with legislation. Key examples include:

- Trading while insolvent
- Operating *ultra vires*
- Failure to comply with the relevant laws of those exchanges that trade in the shares or debt of the company
- Paying dividends unlawfully

3. <u>Viability</u>
Good management forecasts future business activity, including working capital projections and the necessary funding to maintain and develop the business. An effective audit will include a review of these matters, and should at least require confirmation of the financing measures existing at the reporting date.

We note that where companies look to acquire another business, and/or engage in initial share offerings, that it is normal practice to provide more extensive reporting on working capital. We see no reason why the regular audit model could not learn from this and offer more formal reporting in a similar manner.

4. <u>Culture</u>
Investors increasingly recognise the importance of a company's culture in building sustainable value. It forms part of Environmental, Social and Governance (ESG) standards. There is a place for more formal reporting on culture as part of a wider remit across all ESG areas.

5. <u>Reliance on management</u>
A key role performed by the auditor is to provide a robust challenge to management. Auditors often seek management representations as part of their audit evidence. Since this assumes an implicit reliance on the assertions of management, we question whether such assertions represent appropriate evidence in providing a robust challenge. One area we consider this to be especially important is the challenge to the financial forecasts of management, and how these affect financial reporting.

<u>Form of auditor reporting</u>
For audits to be effective, the presentation of the results of that audit must be clear and capable of highlighting any causes for concern.

We believe that the following characteristics are critical for an effective and informative audit opinion:

- The audit report should be addressed to investors. This follows our view that the Annual Report should, similarly, be addressed primarily to investors.

- It should include a pass/fail threshold that is clearly communicated. We consider that "true and fair" currently meets this standard.

- We recognise that a graded report that includes more opinion from the auditor has potential value. However, we note that directors are not asked to self-grade their own reporting, and we believe that graded reports may expose directors to additional legal liability. A consistent and broader scorecard, which operates in the credit rating industry, may offer a helpful tool to allow reporting to be extended.

- There may be a place for longer form reports by auditors. This would not need to be part of the Annual Report document and could be provided separately. This should not stop the inclusion of some form of audit report within the Annual Report itself, with reference to longer form documents that provide more detail.

- There may be some advantage in having the auditor speak as a set piece at the AGM. We note that this was previously a common practice that has largely ceased because of a general lack of perceived benefit to the attending shareholders.

Liability issues
Effective change will need to address the expectation gap that exists regarding clear accountability and/or consequences for both directors and auditors.

(i) Directors
We note that, following the introduction of the Senior Managers' Regime for financial institutions, there are now differences in the levels of accountability between those entities and other corporates.

(ii) Auditors
We believe that there are legitimate grounds to question whether the current framework for auditors remains suitable. While audit firms themselves carry unlimited liability, most partnerships are of a limited liability nature. Audit partners may face professional sanction, but do not face the same legal liability as directors.

Further, auditors do not carry the same duty of care across all forms of their reporting. For example, their support for bond issuance provides a duty of care to sponsors rather than investors. We therefore also believe that there is a case for reviewing the duty of care model for auditors to improve the effectiveness of the assurance that is already being provided.

Providers of assurance
We see no need to restrict the provision of all assurance to registered auditors. However, we do believe that there is considerable value in the holistic perspective that an auditor brings.

We therefore believe it is right that the auditor, as part of the risk assessment and planning, should evaluate the high and low risk areas of a client. The auditor should present these areas to those charged with governance and then agree those areas that they should focus on and those areas of lower value that other assurance providers can cover.

In such a model, the auditor would still be responsible for performing an effective risk evaluation but would not be responsible for the quality or outputs of other assurance providers.

Conclusion
There is a need for the Brydon review to re-appraise the current framework for audit, along with the implications on corporate reporting. Change is needed. The scale of the expectation gap is creating an unacceptable level of public concern about the overall quality of UK corporate governance.

There is a real opportunity to simplify the existing framework, provide clearer roles and responsibilities, and develop the current UK model as the world-leading standard. We must, however, avoid over-regulating the wider market or over-extending the role of the audit.

We would be happy to meet to discuss our comments in more detail if this would be helpful.

Yours faithfully

Katie Murray
Chief Financial Officer

APPENDIX

We set out below our views on options that have the potential to enhance reporting and audit. We also discuss ideas that we do not believe will work.

What is the purpose of the Annual Report and Audit? *(Questions 1, 2, 3)*

We consider that the primary purpose of the Annual Report and the audit is to allow potential investors (debt or equity) to evaluate whether they put capital at risk. The two aspects they are looking for information on will be:

1. Does the company merit an investment?
2. How risky is that investment?

Individual users will reach their own decisions using the information provided by management and the appropriate assurance from the auditor.

The company will set out a narrative encompassing many performance indicators that set out the commercial and social purpose it pursues, how it seeks to achieve that purpose and the related risks. We note that additional users will have specific interest in these aspects. For instance:

- The commercial and social purpose will be of interest to the communities the company operates in and may have value to customers and other groups.
- The riskiness of the company will have interest to suppliers and employees given that they have a vested interest in the company's success.

However, since it is investors that put capital at risk, they carry the greatest risk (variability of return) to the success or failure of the company.

What should Annual Reports cover?

Currently Annual Reports typically include a "front end" document that is shorter for smaller companies, but extensive for public interest entities (PIEs). We believe:

1. Audit reports should cover quantified information presented in the front end. The current basis of audit reference is insufficient, with auditors only raising issues if inconsistent with audited information. However, users expect all presented information to be accurate. The audit should cover all key drivers of the company engagement with its stakeholders.

2. Annual Reports should set out relevant information for key user groups. These stakeholders should be clearly identified by the directors. It should not be necessary to identify all stakeholders, and the information presented to shareholders will be sufficient for many others.

3. The information provided should not require a profit forecast. Expectations on future financial information are globally consistent. It is important to provide information on management thinking and targets, but to extend this further to be more specific on profitability can create legal issues in multiple jurisdictions and does not represent a progressive move in terms of reporting. There are some instances where there is appropriate, such as with start-ups, which could be addressed as special cases.

What will improve the quality and transparency of company reporting?

Company reporting already provides a focus on key performance indicators. However, many of these are not core financial metrics that are within the full scope of the audit.

We believe that a greater focus on the key performance measures would be of greater value to users:

1. Those measures should be determined by management. They identify the information of most importance/relevance to management in its evaluation of strategy and the basis of its ongoing assessment of the company's actual performance.

2. The Annual Report should provide more information, such as tracking performance, regarding these measures and the actions management take to grow the value of their business. It may be relevant to consider, like for non-GAAP measures, the relevant external frameworks these measures are drawn from (such as IFRS, regulatory, climate conventions etc).

3. The Annual Report should also set out the key risks to the delivery of management targets and preferred strategy.

4. These factors, and their basis of preparation, should be fully subject to audit. This reflects that they represent key value drivers.

5. We do not believe that an independent body should stipulate those measures since this would be inconsistent with how management choose to run their company. Part of the audit process should be to challenge management which uses measures inconsistent with its internal decision-making processes or if there is clear inconsistency with common market practice.

What is the role of historical financial information?

With an increasing focus (including by investors) on a wider concept of social value rather than a pure economic (financial) value basis, it is clear that historical financial information is only part of the overall picture. It does not capture the full-spectrum of value creation.

The provision of historical financial information carries significant benefits, including:

- There is a clear, understood and tested framework that underpins the measurement of historical financial information. This enhances the ability of users to compare companies with each other.

- This understanding largely reflects the fact that this framework has been applied over many years. Some of the recent challenges and criticisms levelled at IFRS in particular reflect concerns about moving away from a clear historical basis of measurement to methods more akin to "current cost accounting", such as fair value and the greater use of "forward looking information". The relative volatility and perceived unreliability of this data challenges traditional forms of assurance.

However, the direction of IFRS standard setting increasingly recognises that historical bases of measurement no longer properly align with company valuation. This points to the need to reduce the emphasis on historic financial information in contrast to other measures, resulting in a reduced volume of such information within an Annual Report.

Additionally, the mixed model (set out below) has led to far longer and more complicated disclosures and commentary to support explanation of the primary measurements:

- Historic cost continues to be used for most non-financial assets and liabilities, where value is based on the economic value (cash paid/received) at initial measurement with no update for replacement cost or a reassessment at current prices.

- Fair values increasingly drive financial assets and liabilities, where value is based on current expectations of price. In many cases these are subject to ambiguity and judgment. Disclosures are extended in an effort to explain

- More recently, this concept has expanded into a greater use of "forward looking information" in an effort to establish what will happen in the future and how much of this future change should be "captured" in current measurement. Again this requires extensive disclosure to explain. It is also highly subjective since it requires assumptions on future performance.

This complexity tends to lead to a reduction in the ability of users to understand company value, requires the need for more expert intermediaries (such as analysts and brokers) to provide a "translation" of these results and points to a greater perception that values do not correctly capture the value of a company.

How should financial performance be reported?

Companies, especially those that are listed, typically provide updates on financial performance every three or six months as a matter of course.

An option that merits evaluation is a greater separation of the provision of this information from the broader annual reporting of companies. Financial reporting could operate on a six-monthly basis with the Annual Report, at year end, representing a fuller "company balanced scorecard".

- This would allow for a more focused and shorter Annual Report. It would encourage language that is accessible to a broader readership. The use of more detailed financials is often focused on a smaller group of specialised users, such as analysts and credit rating agencies.
- A report based on simpler key performance measures would allow for more targeted messaging, be simpler to follow and make it easier to highlight key issues. It would be important that these measures referenced common calculation frameworks.
- Separate publication of financials, in the same format from period to period, would allow this important information to be reported in a manner that is easier to compare to peers and would provide appropriate information on economic performance, affecting dividend and balance sheet based valuation assessment.

Some consideration of international consistency will be important. For instance, regimes such as for US listed entities may limit the benefit of companies fully embracing the above.

Should the audit scope be changed?

The simplification of the Annual Report, along with a more focused remit enables a more effective audit approach:

Non-financial measures are of increasing importance in the assessment of a company and its valuation. It is important that audit addresses this change. Therefore, audits should cover the full Annual Report.

Users expect reported information to be "accurate" (undefined). It is therefore essential that auditors specifically report on the fair, faithful and balanced representation of this broader set of information.

Further, we believe the role of the auditor should be, primarily, to challenge management in high risk areas and critical judgments.

- The audit scope should allow the auditor greater freedom to agree with those charged with governance that some matters, agreed as being of lower risk, can be delivered through alternative assurance providers.

- The methods used by the auditor should, however, reflect this need to robustly challenge management. In light of this, we question whether it is appropriate to allow auditors to place reliance on written representations from management. This indicates an implicit reliance on those representations. If an auditor is unable to obtain sufficient independent verification on matters that affect statements in the Annual Report then we believe this fact should be more clearly disclosed.

- A key area for the auditors to provide robust challenge on is the financial forecasts of management, and how these affect reported financial results.

What specific changes in scope should occur as a result of this?

1. <u>Fraud</u> *(Questions 36 – 39)*
   Currently, auditors develop their audit work to address the potential risk of fraud. However, auditors will not find all fraud in a company:

   - Auditors typically indicate that they are unlikely to spot management-led fraud. This is because it is easier for senior individuals to set up processes that by-pass normal control and audit activities.
   - Small frauds by staff are generally at levels that do not materially influence the results of the company overall and are, therefore, not the primary target of audit testing. Random samples may detect such fraud but there is no guarantee

   We believe that auditors should have a greater responsibility to specifically assess whether management is overriding internal control processes or engaging in fraudulent actions. Management act as company stewards and malpractice on its part is something for which shareholders and other users need protection. Auditors should provide this.

   On the basis that management is responsible for ensuring the prevention of fraud, auditors should not need to test for lower level fraud as part of their statutory role. It may be appropriate for the auditors to comment on whether they believe management processes are likely to be effective.

2. Compliance with law *(Questions 29 – 32)*

The breadth of law makes it challenging for auditors to be able to spot all failures in legal compliance. Like fraud, the directors have primary responsibility for setting up the business to ensure that the company meets its legal requirements.

However, in a similar manner to fraud, auditors can play a role in ensuring that the directors themselves operate within the law. There are certain areas of law, where shareholders have a direct interest in understanding if management does not comply with legislation. Key examples include:

- Trading while insolvent
- Operating *ultra vires*
- Failure to comply with the relevant laws of those exchanges that trade in the shares or debt of the company
- Paying dividends unlawfully

We believe there is a compelling argument that the audit should target any such failures by management. Wider failings would then be attributable to the processes and procedures established by management.

We agree that it will often be appropriate for auditors to consider escalation of non-compliance with appropriate bodies, should management be unwilling to do so. However, we would contrast that position with, for example, a suggestion that auditors raise matters of legal concern directly without the prior involvement of management. An example would be Lord Tyrie's letter to BEIS, which suggested a duty on auditors to report breaches of competition or consumer protection law directly to the CMA.[1] The introduction of any such duty would raise a number of fundamental legal questions. Any proposals taken forward on this point would require very careful consideration, legal analysis and consultation.

3. Viability *(Questions 15 - 22)*

Currently auditors focus on the "going concern" principle, which is the ability of the company to expect to remain viable for the following twelve months (or more). Listed companies also provide a viability report that reflects risks to its longer term (usually three years or more) prospects. A number of company failures appear to indicate that the existing "going concern" approach does not adequately address the risk of company failure as, while many organisations present fairly "boiler plate" disclosure on viability that does not provide the necessary increased assurance.

However, it is our view that reporting on the extent to which management has effectively set a company up to avoid company failure must be a central part of an effective audit.

We note that where companies look to acquire another business, and/or engage in initial share offerings, that it is normal practice to provide more extensive reporting on working capital including whether a company has established appropriate mechanisms to support its business. It is used in these situations mainly because there is generally less available information that validates the sustainability of the business in question. We see no reason why the regular audit model does not learn from this.

While we recognise that there is a potential cost issue in including this type of reporting within the audit, we believe that seeking a report on the working capital of a company may offer a more comprehensive assessment of a company's viability/sustainability which can be easily understood. At the very least the auditor should formalise checks on the existence of the financing in place.

4. Culture *(Questions 55, 56, 57)*

There is now a far higher recognition of the importance of the culture and ethos of an organisation in contributing to long term social and economic value. This is recognised within the standards on Environmental, Social and Governance (ESG). As such, we believe that independent comment on the wider culture in a company and validation of statements made in that respect are of importance to users. Key aspects that should be set out are:

[1] Letter dated 21 February 2019, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/781151/Letter_from_Andrew_Tyrie_to_the_Secretary_of_State_BEIS.pdf

- What are the standards of behaviour for the organisation?
- How effectively are these implemented and monitored?
- How consistent is the treatment of individuals within and outside the organisation?
- Specifically is the approach towards general staff consistent with the treatment and approach towards senior management?
- Does risk awareness play a central part of the corporate culture?

We believe that the auditor should provide explicit comment on this.

For all of these items we believe it is appropriate to consider the outputs of this auditor reporting being available to the wider group of potential investors in the group, whether debt or equity.

How should auditors report their findings? *(Questions 25 – 28)*
For audits to be effective, the presentation of the results of that audit must be clear and capable of highlighting any causes for concern.

Audit reports currently offer blanket assurance in the form of a "true and fair" opinion but generally do not point to other concerns or issues. Efforts to improve company audit reports (at a listed level) have resulted in longer reports. However, we question how effective these longer reports are in terms of identifying relevant issues, especially in areas where the company might "fail". Notwithstanding this, we believe such reports may aid comparability between organisations by evaluating the topics identified by auditors against peer organisations.

We believe that the following characteristics are critical for an effective and informative audit opinion:

- Addressed to current and potential investors (equity and debt)
- Inclusion of a pass/fail threshold that is clearly communicated. We consider that "true and fair" currently meets this standard.
- We recognise that a graded report that includes more opinion from the auditor has potential value. However, we note that directors are not asked to self-grade their own reporting, and we believe that graded reports may expose directors to additional legal liability.

How should auditors interact with shareholders? (Questions 33, 34, 35 and 51 - 54)
We considered two options with respect to AGM engagement in audit matters as follows:

1. Naming the individual partner in the auditor approval vote.
   While this might highlight the individual accountability, we consider that the audit report already provides this transparency. Further, this change would lead to the need for EGMs if there was an unexpected change in the partner. On balance, we do not believe that this measure would provide the desired benefit.

2. Auditors to present at AGMs.
   Historically it was relatively common for auditors to present their reports at AGMs. This practice has largely ceased. With longer audit reports, we question whether a formal reading of the audit would offer value. However, we do consider it important that the auditor has the right to speak at an AGM, and it may be that the auditor should be required formally to state that there are no matters they wish to raise. This would place a greater onus on auditors to consider whether there is additional information they need to provide.

3. As an extension, we do not believe that a separate forum for users to engage with auditors would be helpful. Instead, it would, it is likely, lead to a separate channel of complaints that would detract from the auditor's ability to focus on key risks.

Do audits cost too much? *(Question 23 & 24)*
Audits must be assessed on a cost-benefit basis. There is considerable benefit to users from the assurance offered by an external audit. However, auditors can and do only spend a fraction of the time that a company itself devotes to its activities. It is not realistic to expect auditors to be able to find anything and everything at fault in a company.

A well conducted audit represents a considerable benefit to users, and offers value. To simply layer low value "compliance" activities into an audit will considerably increase the cost without offering any added value. The re-focus of the auditor and its resources towards the most important issues and risks in the company represents good value for the associated cost.

While the work of Audit Quality Review highlights deficiencies in the general work of auditors, one of the unintended consequences is that auditors invest far more effort (and cost) in simply maintaining good quality documentation on their audit files and broad coverage on all aspects of their audit. We believe that this is increasing the time and effort spent on less important matters.

- While maintaining good records is a critical practice in recording the challenge provided by a firm, this aspect does not itself point to a high quality audit.

- Auditors should be incentivised to focus their efforts and documentation on how they design and plan their audit and specifically capturing challenges to management.

- Activities to ensure appropriate coverage, testing and follow through should incur far less time where the associated risk is not high.

As a result we believe that the current approach places coverage and process above actual quality in evaluating, challenging and concluding on the choices of management. We believe that greater emphasis should be placed on the quality of the challenge to management.

Is there a place for alternative providers of assurance? *(Question 7)*
The audit model will benefit from greater competition. Allowing non-audit firms to provide assurance over certain aspects of the Annual Report will encourage a greater variety in assurance models and outputs.

However, we believe that one of the benefits the auditor brings is their broad view across the organisation. There are times when auditors will observe issues that fall between “silos” within a company and highlight issues that are not otherwise captured.

For this reason, we do believe the auditor needs to retain broad responsibilities in discharging the audit. One opportunity would be for the auditor to complete a full enterprise-wide risk assessment and report these findings to those charged with governance. The auditor would recommend that its own work is directed towards higher risk issues and key management judgments, and they would recommend that certain areas do not require audit but could be addressed through alternative assurance provision. Those charged with governance would then determine whether the auditor, or an alternative provider, performs work and reports on these matters.

Can technology make a difference? *(Question 45 & 46)*
Companies in evaluating an audit appointment will often look at the capabilities of bidding firms in respect of their willingness and ability to deploy innovation and technology, including artificial intelligence. In our experience, the success of auditors in demonstrating this is limited. Auditors increasingly seek to mine greater volumes of data and undertake detailed analytics. While their presentational capability to visualise data can exceed the capabilities within an organisation, their basic data analysis does not.

We would like to see auditors take bolder steps in leveraging new technologies and ideas to enhance their audit. We believe there is a particular role for automated robotic processes to provide an effective and efficient means of covering volume and low risk processes. They offer comprehensive coverage, often on a real-time basis and are likely to be cost efficient. This would potentially allow auditors to focus more specialist and experienced resources on higher risk issues. This would improve overall quality.

How should we use hindsight? *(Question 48)*
In a market-driven economy there will always be corporate failures. Hindsight can lead to inappropriate conclusions about the causes of those failures. Schools of view are sometimes based upon unrealistic expectations of the information available at the time of reporting/audit.

The value of looking at failures and near misses with hindsight is to provide an opportunity to improve the processes and governance steps taken with a view to making improvements.

There could be a stronger link made by the regulator on investigations into failure (or near misses) and specific recommendations and actions taken to adjust approaches to better address the causes of that failure. Sometimes the focus on seeking to find fault detracts from the opportunity to learn from the event. In many cases failures will be multi-faceted and not down to the actions (or inactions) of a single individual.

Should auditor liability change? *(Questions 40 - 44)*

As a financial institution the liability of our directors and senior management now includes the need to adhere to the Senior Managers Regime of the Prudential Regulatory Authority. This exceeds the legal requirements and sanctions laid out in the Companies Act.

This model does not map to the liability that attaches to individual audit partners. While the responsibilities of the auditor do differ to those of a director, we consider that there are legitimate grounds to question whether this framework remains appropriate.

We further note that auditors actively seek to limit the scope of their work and the duty of care they extend. For example, auditors will normally report on bond issuance programmes to the banks that underwrite those issues. However, this assurance does not extend to potential investors in the bonds themselves.

We believe that a consistent duty of care framework should exist for an auditor that covers the reports provided about the normal operations of a company. We believe that reports delivered by the auditor within the broader assurance model should be made available to the same user group as the Annual Report.

What other changes did we consider but not recommend?

1. UK framework for control effectiveness *(Questions 12, 13, 14)*
   There is a view that the UK should implement its own version of the US Sarbanes-Oxley Act. We note that the UK Corporate Governance Code already expects directors to make statements on the design and testing of the controls over financial reporting. There is neither the same requirement to positively assert the effectiveness of these controls nor for the auditors to validate this assertion nor to confirm publically the accuracy of the Company's Annual Report in all material respects.

   The US model has much to commend it, but observers note that the controls aspect can lead to a box-ticking mentality. The accompanying changes that occurred relating to director accountability are often overlooked. The CEO and CFO certifications increase the focus of management resulting in more formalised internal control measures.

   RBS is listed on the New York Stock Exchange so already complies with Sarbanes-Oxley. While we see the benefits of clear accountability for any organisation, we question the benefit of the same formality in control testing for smaller organisations.

   Furthermore, in the case of larger companies, we do not support the adoption of a similar model in the UK on the basis it would dilute the principles-based approach that exists and operates well. We believe that extending director assertions may be sufficient.

   In both cases effective audit should already address potential failures in the control environment.

2. Differing levels of audit *(Questions 7 – 11)*
   We have considered the benefit of multiple audit "products" that might provide opportunities for companies to select different levels of assurance (such as "standard" or "enhanced"). This has the potential to promote innovation amongst auditors and even encourage companies to seek higher levels of audit, which may be attractive for shareholders.

   Conversely, this may introduce further complexity into audit which would not be helpful. Also, it is likely that companies facing financial hardship would be less willing to spend more money on audit. However, if audit is meant to help prevent corporate failure, then it is precisely these companies that need the highest quality of audit. Companies may be incentivised to reduce the level of audit comfort, which is contrary to the original objective.

   We continue to be supportive of measures that encourage audit firms and companies to build new and innovative approaches to audit. However, we remain of the view that the "core" product must remain consistent across all companies.