Schroders

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Brydon Review
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Department for Business, Energy & Industrial Strategy
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By e-mail to: brydonreview@beis.gov.uk

Dear Sir

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

We welcome the independent review into the quality and effectiveness of audit. We attach our response to the questions raised which have been prepared from our perspective as a FTSE 100 company subject to audit and an institutional investor using the audited reports. Our goals are aligned with those of our clients – the creation of long-term sustainable value for our shareholders and all our stakeholders.

Our overarching view is that we want to see a material improvement in the quality of audits. Without this we see little benefit to them and believe trust in them is undermined. Ensuring a quality audit should therefore be a prime objective but this in itself raises questions as to the quality of current accounting standards. We see a fundamental problem with the standards and without proper reform the actual audit will always be liable to not meet expectations.

It is essential that the current concerns over audit quality and the expectations gap are addressed and trust re-established in the audit product. This should be a priority over extending the scope of audit or assurance. We do, however, support the need for the quality of viability statements to be improved and for this to be included in the auditor's opinion.

Yours faithfully

Richard Keers
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Response to specific questions

Definitions of audit and its users

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

Originally audits were conducted primarily for the benefit of shareholders. However, over time companies have grown in importance, and as a result they now have more complex stakeholder relationships. We believe that audit should also serve their needs, in particular for creditors,

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(including debt holders and pension fund trustees) as well as customers, suppliers and employees. We think this would encourage a more rounded approach to audit. This also aligns with the move to demonstrate that companies are there for a wider purpose than the maximisation of profits.

High quality audits ensure that all stakeholders have trust and confidence in the information reported. It may be appropriate to link the beneficiaries of audit with section 172 of the Companies Act here and the stakeholders directors "have a regard to" when promoting the success of a company.

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 is a clear link between this question and the question relating to viability statements (17) where we see a role for audit in enhancing the degree of confidence in the entity.

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?

Yes. We would like to see greater clarity on the purpose of the audit that reflects the needs of audit users. In terms of for whom it is conducted please see our response to question 1 above.

The "expectations gap"

Q4: Do respondents consider there is an expectation gap?

Q5: If so, how would respondents characterise that gap?

We do believe that there is an expectations gap. As the call for views points out, the core audit requirements have largely remained unchanged since their introduction in 1947 but more judgement should now be made by companies when preparing financial; statements. Reporting on the future viability of the company and on sustainability and environmental factors covered elsewhere in the call for views are examples.

Furthermore, technology today means that many of the things that audit was originally covering, for example the correct calculation of manual ledgers, are less relevant. In addition, a greater amount of a company's value comes from intangible assets and accounting standards have evolved so that more judgement is required. So it is unsurprising that an expectations gap has emerged.

In thinking how to close this gap we would stress that audit cannot be considered to be a replacement for strong controls and the commitment by directors to run the company properly.

Q6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

Yes, we believe there is a 'quality' gap between auditors' responsibilities and how they are being met. In particular the greater amount of judgement that is required due to the move from historic cost accounting to fair value accounting.

We believe that audit should challenge management and directors in relation to the valuation of goodwill and intangibles and adopt professional scepticism. We note the FRC's audit quality review reports in informing this view.

Audit and wider assurance

Q7: What should be the role of audit within wider assurance?

As investors it can be difficult to determine what has been audited and what has not, and those subject to a reasonable or limited assurance letter. More consistency and clarity in this area would be welcomed.

In our experience the differences in the work conducted to provide assurance and audit can be similar. However the liability issues around the two categories means that audit is more expensive. We believe that assurance plays an important role in the corporate reporting framework but this role should be clear.

Equally, we challenge the usefulness of some of the disclosures that are currently required to be audited or assured that appear in the annual report. It may be appropriate for some requirements to be removed from the annual report to a digital platform, and these may be assured as appropriate. Examples include the remnants of the directors' report, statements on modern slavery, directors share interests, share capital information and much of the corporate responsibility reporting around carbon. We believe that this should provide an appropriate level of disclosure for stakeholders, and may even ensure that there needs are met in a more timely fashion that currently. In general we would also like to see consideration of digital solutions in terms of presentation of the financial statements.

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?

We would agree that the scope of what is covered could legitimately vary depending on the business sector in question, and the nature of the entity's business risks. Two sectors that would benefit from additional scrutiny are banks and their capital ratios and risk weight assets (RWAs), and energy companies' reserves (as noted by paragraph 67 of the call for views). However given the complexity we would suggest the need for a wider consultation on this point given the cost implications for the sectors affected.

Q9. Are the existing boundaries between internal and external audit clear?

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

We believe the boundaries are clear in the UK. In our experience our external auditors use our internal auditor reports to focus on those areas highlighted in internal reports where issues have been identified and require follow up or remedial action.

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?

On balance we consider that the current eligibility requirements for external auditors focus too much on independence. Independence alone does not ensure quality which we see as a key requirement. Whilst we support the need for the auditor to be independent so they can properly challenge the directors' judgements, more pragmatism is required in terms of the eligibility requirements. Currently, independence can be undermined through non-material breaches of independence rules e.g. an auditor having a bank account with the entity he is auditing, or an investment in a mutual fund the audited firm manages.

As we noted in our response to the Competition and Markets Authority's recent study, the market structure of the audit market in the UK means that many companies have a lack of choice when it comes to auditors (audit firms can be precluded from participating if they provide prohibited non-audit services) which can impact both quality and innovation. With such limited choice, investors question whether audit firms are really competing on quality issues and innovating sufficiently to improve quality.

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?

Yes, we agree and accept that directors should review and report on internal controls. If directors cannot confirm that their control systems are working then this would be a clear indicator of the company being in trouble. Given that these issues were also raised in Sir John Kingman's report on the FRC with a specific recommendation to BEIS (Recommendation 51) we suggest that there is a wider consultation on this point.

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

We think the current requirements are adequate.

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?

We would question the usefulness of publically providing the auditors views since in our view there is a very real risk that this becomes boiler plate. For example we would expect where controls are seen as only just adequate they will be reported as adequate.

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

Q16: Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?

Given the recent high profile failures, we do not consider that the regulatory framework in relation to going concern is "fit for purpose". We believe going concern should be superseded by changes to the viability statement and the position that statement should play in terms of providing assurance.

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

We have long been focused on enhancing the quality of viability statements so that they are more effective. As well as writing to UK companies on the issue in 2015 we were very supportive of the IA Guidelines issued in November 2016. These set out what investors would like to see in viability statements and echo the points that we have raised with companies:

<u>Consider longer time horizons.</u> The majority of companies adopted a three year time frame with a few, such as major utilities and property companies, looking longer to five years. There should be more differentiation between companies and viability statements should address a longer timeframe than three or five years given the long-term nature of equity capital and directors' fiduciary duties.

<u>State clearly as to the why the period was chosen</u>. The FRC's Guidance states that in determining the length of the assessment period the factors to be considered include: the board's stewardship responsibilities; previous statements – particularly when raising capital; the nature of the business and its stage of development; and investment and planning periods. We consider directors should be clear as to why they have selected the particular timeframe and address wider factors, as set out in the FRC's Guidance, in determining the period. In particular, the specifics of the company's business and sector need to be considered, and not only its business cycle but its investment cycle as well.

<u>Differentiate time horizons for prospects and viability.</u> A company may have different plans to cover short, medium and long-term horizons. The disclosures around prospects should address the long-term strategic plans and look longer than the period over which viability is assessed. Directors should separate their assessment of prospects from their assessment of viability. The former then gives them the opportunity to demonstrate that they have considered the future of the business over the long-term.

<u>Sustainability of dividends</u>. Investors provide companies with equity or risk capital. The dividends received are an important return on that capital and investors would welcome the viability assessment addressing the sustainability of those dividends.

<u>Stress testing</u>. Each of the specific scenarios considered in any stress testing should be disclosed, together with the likely outcomes. The specific mitigating or remedial action taken should be disclosed, together with an explanation of what could cause the risks to crystallise, the likely impact and how this could be mitigated or managed. Whilst required for companies in the financial services sector, companies in other sectors should also undertake reverse stress tests and disclose the scenarios considered.

We would like to see these matters reported more widely than is currently the case.

Q18: Should such a statement be subject to assurance?

Q19: Who might be capable of giving such assurance?

We believe that the viability statement would benefit from having a level of explicit assurance around it. This could ensure that the process in around forming such statements were robust an in line with investor expectations outlined above.

We consider that the statutory auditor would be best paced to give such assurance. Given that these are forward looking statements, we note the fact that directors have a safe harbour in the Companies Act for such statements and if auditors are to provide assurance, then the safe harbour may need to extend to them.

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

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?

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

There is a wide range of corporate reporting which falls outside the scope of the audit that has evolved over time.. We set out below the main information that is currently unaudited and where we would welcome some or better assurance.

<u>Non-GAAP measures, in particular adjusted earnings and KPIs</u>.

Under IFRS management have to report additional information, non-GAAP financial measures, if the minimum line items required by IFRS are insufficient to enable investors to understand the financial position, financial performance and cash flows. Thus EBIT and EBITDA are often reported on the face of the Statement of Income and Expense, and revenue or operating income excludes certain expenses on the basis they are non-recurring. These measures can be helpful to investors and can convey changes to the business that are separate from those that may be considered unusual, infrequent or not representative of underlying trends. This can help in the analysis of future trends and if included in the financial statements then these measures are subject to an audit.

There are also non-GAAP financial measures in the narrative part of the annual report and other corporate reports such as preliminary announcements, for example, return on capital employed or invested capital, as well as non-financial measures and industry specific indicators, such as same store sales. The combination of non-GAAP financial and non-financial measures with the audited accounts conveys more than either dataset on its own. However, with the former:

- It is not always possible to see how they have been calculated.
- It is not clear whether they have been consistently calculated over time. Companies, even in the same industry, can use varying methods such that there is a lack of comparability.
- The subjectivity in how they are calculated make them prone to management bias. The adjustments can be opportunistic with business as usual items being treated as exceptional. Invariably non-GAAP financial measures paint a more favourable picture than GAAP.

<u>Preliminary results.</u>

We believe that more investors rely on preliminary results announcements than the annual report, which is published after a delay. In our experience most of the work for the annual report is completed by the time of the preliminary results. If there was an appropriate review of what should be in the annual report and what could be delivered digitally (as per our answer to question 7) we believe that reports could be issued with the preliminaries. Additional barriers include the need to have the report printed and the logistics of releasing a report down a RNS.

Sustainability and environmental issues.

In recent years companies' disclosure of sustainability and environmental issues have become increasingly important to investors as they seek to integrate these factors into the investment process.

In Europe, this recently took a major step forward with the Non-Financial Reporting Directive. From 2017 approximately 6,000 companies are required to report non-financial information (NFI) under the Directive. However, there is no requirement to have this audited – auditors only have to check it has been provided.

In this context, there is some dissatisfaction with the quality and consistency of the information. The variety of reporting standards and frameworks around sustainability and environmental issues can cause practical problems for investors in assessing a company's approach to these issues and comparing reports between different companies and industries. As awareness of the materiality of sustainability and environmental issues increases, investors have higher expectations for it being timely, comparable and verifiable. However, it is often inconsistent, not available or not verified. Also it is difficult for investors to determine what has been audited and what not, and understand what it meant by a reasonable or limited assurance, especially when we are seeing these KPIs feed into remuneration. These matters need to be addressed.

Other Issues

Q.51. What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

As fundamental active investors annual reports are an important part of our investment processes. We explicitly look at and track accounting quality and use it as a measure of governance quality and overall quality in both fundamental and quant strategies. We use a mix of both manual and AI approaches to do this.

However, annual reports tend to be published sometime after the events to which they relate and are backward looking. Analyst briefings, investor meetings, strategy presentations and stock exchange announcements, are also important. The important thing being that these communications can ultimately be referenced to the annual report that has been subject to a quality assurance – the external audit.