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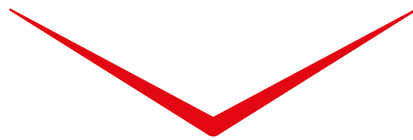
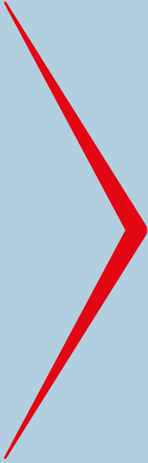
Financial reporting: who does what?





This publication explains in simple terms who does what in the financial reporting system for UK companies with full main market listings.

It is intended to serve as background reading for our 2019/20 'The future of audit' thought leadership essays. They, inter alia, are designed to inform the various inquiries relevant to audit and regulation in progress at the time of writing, including by Sir Donald Brydon, Sir John Kingman, the CMA and BEIS.

We hope this background paper will help directors, politicians, investors and policymakers understand the complex relationships between boards, auditors, shareholders and others, and the regulatory regime within which those relationships operate.

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Financial statements: at the heart of the financial reporting system

Financial reporting needs to improve, and everyone involved – preparers, auditors, audit committees, shareholders – needs to do more. This is no mere exhortation: all of these players are required by law, regulation and various codes to play an active part in ensuring that the financial statements, which sit at the heart of the system, pass the test required of them by law, which is that they give a 'true and fair' view. All of the players in the system, including shareholders, are responsible in different ways for ensuring that the financial statements pass this test.

This overview is necessary because the way that these players interact is less straightforward than it might be. To say that directors prepare financial statements for the benefit of shareholders, and that auditors report on those financial statements to shareholders may be true, but such statements need unpacking and putting into context if we are to properly understand the dynamics of the relationships in the system and the pressures that lead to dysfunction. Among many other things, such simple statements suggest that shareholders are passive recipients of financial information and that their interests alone are relevant. Neither of those assertions is true.

The financial reporting system has emerged over time. Bolt-ons, periodic re-organisations and changes in the business environment have resulted in a system characterised by a certain amount of duplication, internal inconsistency, omission, redundancy and misalignment. The system is less effective than it can or should be.

It is not simply a case of preparers and auditors needing to serve investors better. Preparers and auditors undoubtedly need to do that, but investors and audit committees need to step up their engagement with auditors and preparers, and investors should not rely on audit committees to do that for them. Audit committees need to be more willing than they are now to challenge management, and standard-setters, regulators and government all need to acknowledge and address the inefficiencies and dysfunction in the system arising from decades of ad hoc maintenance.

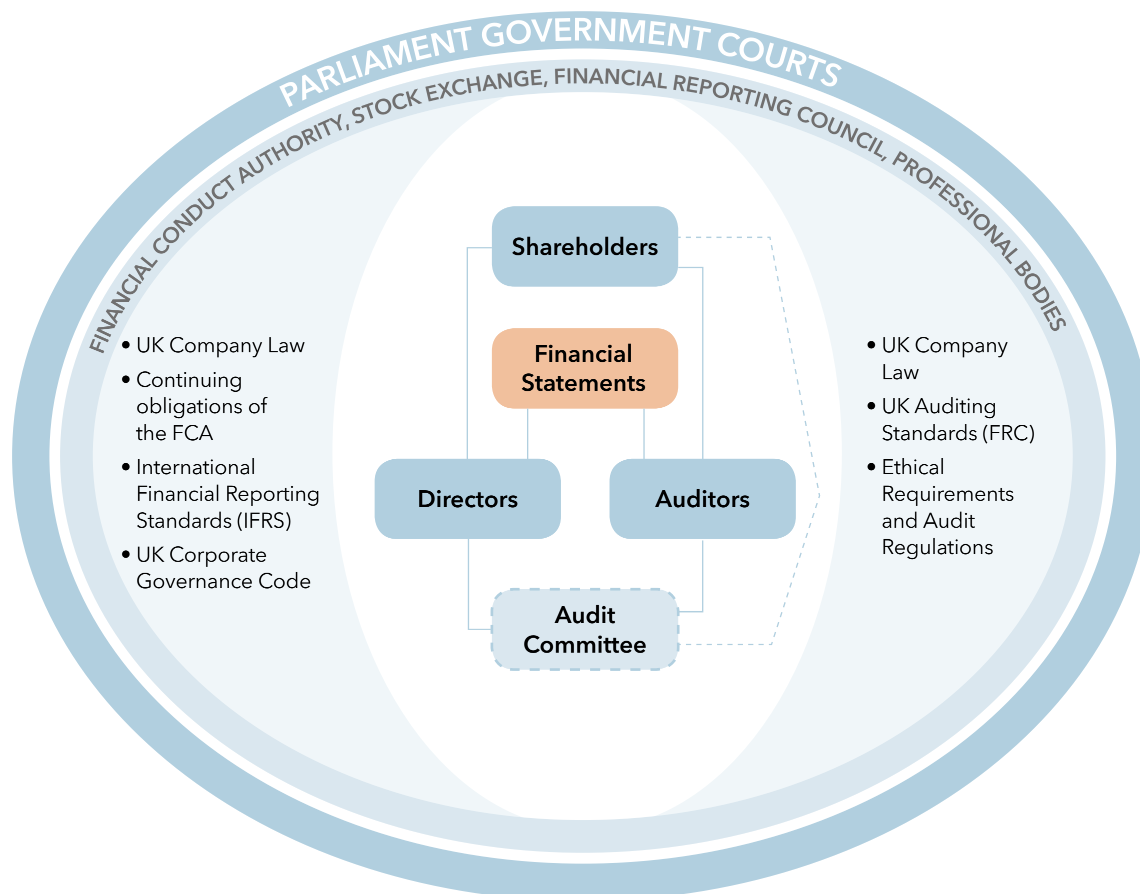
In the last 50 years, the financial statements of listed companies have grown significantly, as have the annual reports within which they are published, as a result of successive waves of legislation, regulation and corporate governance reform, as well as globalisation. Many assume that all of the 'front end' information in annual reports, especially the financial highlights and key performance indicators, is subject to much greater scrutiny than it actually is. It is a common misconception that the 'front end' of the annual report is audited in the same way as the 'back end' financial statements. The only procedures auditors are currently required to perform on the full annual report is to 'read' it for consistency with the 'back end' financial statements and the auditor's knowledge of the business, and to remain alert for material misstatements in information unrelated to the financial statements and the auditor's knowledge.

It is no exaggeration to say that the legislation and regulation governing the preparation of financial statements is a bewildering mess. ICAEW has periodically called for rationalisation in a number of areas, and while we recognise that company law is rarely a political priority, we will continue to press for reform in this area.

The diagram on the next page, together with the rest of the paper, is intended to help readers understand who is involved in the preparation of financial statements, how they are involved, and the role of auditors in challenging those responsible. The paper also highlights areas currently subject to regulatory scrutiny, and summarises the issues involved.

The players: their rights and duties

The diagram below sets out how the various players within the financial reporting system interact.



HOW THE PLAYERS INTERACT

1. **Shareholders** appoint **directors** to serve on the board; the board appoints members of the **audit committee**.
2. The **audit committee** conducts a tendering process and makes recommendations to the board about the appointment of **auditors**.
3. **Directors** propose the appointment of **auditors** to **shareholders**; **shareholders** vote on whether to approve the appointment.
4. **Directors** prepare financial statements; **audit committees** monitor the integrity of financial information.
5. **Auditors** audit the financial statements and perform other procedures on other parts of the annual report.
6. **Auditors** report various matters about the audit to the **audit committee**.
7. **Auditors** report on the financial statements to **shareholders**.

Ultimately, the responsibility for financial reporting in the UK lies with Government, which lays down the legislative framework.

Shareholders range from private individual investors to large institutional investors. They 'own' the company. Shareholders appoint directors to run the company on their behalf. Directors are often also shareholders. The audit committee, comprised of non-executive directors, liaises between auditors and the main board of directors. It is required to act independently to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.

1. SHAREHOLDERS APPOINT DIRECTORS TO SERVE ON THE BOARD; THE BOARD APPOINTS MEMBERS OF THE AUDIT COMMITTEE

Company law requires shareholders to appoint directors. It requires directors to promote the long-term success of the company and in doing so to have regard to the interests of shareholders, but also to the company's relationships with customers, suppliers, employees, community and the environment. The board as a whole, including non-executive directors, has a collective responsibility for all of the decisions of the board.

Directors must not be disqualified from acting as company directors but, other than that, until recently, no formal qualifications were required to be the director of any company. However, as of 2016, the Senior Managers Regime requires, among other things, pre-approval by the regulator of any person holding a role as a 'senior manager' (including all directors) of any bank, building society, credit union, large investment bank or insurance company operating in the UK. And as of December 2019, a similar regime will apply to all firms regulated by the Financial Conduct Authority – which catches any company providing consumer credit.

Principles G and H of the July 2018 UK Corporate Governance Code (the UK Code) established by the Financial Reporting Council (FRC) state that:

- the board should include an appropriate combination of executive and non-executive (particularly independent non-executive) directors, such that no one individual or small group of individuals dominates decision-making, and that there should be a clear division of responsibilities between board leadership and executive leadership of the business; and
- non-executive directors should have sufficient time to meet their board responsibilities, and provide 'constructive challenge, strategic guidance, offer specialist advice and hold management to account'.

Principles N and O of the UK Code state that the board should:

- present a 'fair, balanced and understandable' assessment of the company's position and prospects; and
- establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Presenting a 'fair, balanced and understandable' assessment is generally achieved through the annual report, which generally includes audited financial statements that are required to give a 'true and fair' view under company law.

Meeting the requirements of the UK Code set out above would be impossible without a sound system of internal control, and the audit committee, which is a sub-committee of the main board, has a key role to play in establishing and maintaining that system.

The board appoints members of the audit committee. Under the UK Code and the FRC's Guidance on Audit Committees, audit committees are comprised of independent non-executive directors, at least one of whom should have 'recent and relevant financial experience'. The committee as a whole is required to have competence in the relevant sector.

While all directors have a duty to act in the company's interests, audit committees are also required to act independently, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control. Section 4 of the UK Code states that the committee's main roles and responsibilities include:

- monitoring the integrity of the financial statements and formal announcements on financial performance, and reviewing significant judgements contained therein;
- reviewing the company's internal financial controls and internal control and risk management systems;
- conducting a tender process and making recommendations to the board about the appointment of auditors; and
- making recommendations relating to and approving the auditor's terms of engagement, their independence and objectivity, their supply of non-audit services and their remuneration.

Do audit committees act effectively as a proxy for shareholders?

Recent inquiries have focused on whether audit committees are able to act as a proxy for shareholders effectively, given their members' more general duties as directors, and whether they do in fact protect shareholders' interests, by challenging management and thereby holding executive directors to account.

The recent Department for Business, Energy and Industrial Strategy enquiries into corporate governance included questions about whether company law is sufficiently clear on the roles and duties of directors, including non-executive directors, whether those duties are the right ones, whether the duty to promote the long-term success of the company is clear and enforceable, and about how the interests of shareholders and current and former employees are best balanced.

Audit committees are expected to monitor the performance of any internal audit function as part of their review of controls, and to determine the need for one, annually, if one does not exist – although it would be unusual for a UK company listed on the main market not to have such a function. Part of the role of internal auditors is to help ensure that the systems and controls in place help maintain the integrity of financial statements.

The UK Code requires directors to establish a remuneration committee along similar lines to the audit committee.

2. THE AUDIT COMMITTEE CONDUCTS A TENDERING PROCESS AND MAKES RECOMMENDATIONS TO THE BOARD ABOUT THE APPOINTMENT OF AUDITORS

A legal requirement for mandatory, periodic re-tendering for audits was introduced in the UK in 2013 to deal with perceptions of excessively long association between auditors and the companies they audit. The UK Code requires audit committees to report on the length of the auditor's tenure in their report.

Details of the tendering process are set out in the FRC's Audit Tenders, Notes on Best Practice. The audit committee also makes recommendations regarding non-audit services provided by auditors – permissible services are restricted – and on auditor remuneration.

Data rooms

Among other things, it is now common practice to allow prospective auditors access to a 'data room' in which all of the firms tendering are provided with information about the company based on the incumbent auditor's audit plan. A great deal of work goes into these tenders and the cost of tendering for listed company audits is significant, particularly for firms tendering for a limited number of such audits. That, combined with the additional costs and risks associated with the audit of listed companies, has made tendering for such audits unattractive for some firms.

3. DIRECTORS PROPOSE THE APPOINTMENT OF AUDITORS TO SHAREHOLDERS; SHAREHOLDERS VOTE ON WHETHER TO APPROVE THE APPOINTMENT

There are a limited number of exceptions to the general rule that directors propose the appointment of auditors to shareholders, and that shareholders appoint auditors by means of an ordinary resolution at a general meeting. Company law permits directors to appoint auditors before the first meeting, or to fill a 'casual' vacancy for example, and for the Secretary of State to intervene if no auditors are appointed. Shareholders are not a homogeneous group and do not normally act collectively in relation to a company. They appoint directors to run the company on their behalf and are not generally permitted to interfere with the way directors exercise their duties. However, some duties, including the appointment, re-appointment and removal of auditors, are reserved for shareholders.

Do directors and shareholders ever disagree about who the auditors should be? What happens then?

There have been a few recent cases in which the shareholders of listed companies have voted against the re-appointment of auditors proposed by directors. In such cases, directors have undertaken a tendering process to find alternative auditors. Auditors are permitted to resign their appointment. Company law requires auditors to make a public statement when they cease to hold office, as a safeguard to prevent auditors resigning simply in order to avoid difficult reporting issues, and to prevent shareholders removing them for the same reason.

4. DIRECTORS PREPARE FINANCIAL STATEMENTS; AUDIT COMMITTEES MONITOR THE INTEGRITY OF FINANCIAL STATEMENTS

'True and fair' financial statements are not the same as 'correct' or 'accurate' financial statements, because many figures in the financial statements are estimates. Many estimates are complex, but the vast majority of financial statements, including those of smaller companies, contain numerous simple estimates relating to stock and depreciation, for example. Directors must estimate the value of stock that will need to be written off and the useful lives of fixed assets in order to calculate depreciation.

Company law, EU-adopted IFRS and the continuing obligations of listing govern the content of the financial statements of a listed company and some of the 'other' information listed companies include at the 'front end' of their annual reports. Financial statements include primary statements such as a profit and loss account, balance sheet and cash flow statement, as well as related notes.

Company law requires directors to include in the strategic report a 'fair review' of the company's business and a 'balanced and comprehensive' analysis of its performance and position, a description of the 'principal risks and uncertainties' facing the company and an analysis using financial key performance indicators (KPIs). The FRC's July 2018 Guidance on the Strategic Report contains further detail on what this report should include.

The UK Code also requires directors to perform a 'robust assessment' of the 'principal risks' facing the company and to make a statement to that effect. It requires a statement on whether the going concern basis for the financial statements is appropriate, covering at least one year, and a 'viability statement' covering how they have assessed the longer-term prospects of the company and over what period, typically over 3 to 5 years.

Directors are required by law and regulation to prepare an array of other financial and non-financial information beside the financial statements, and the strategic and directors' reports. These include reports by the audit and remuneration committees, specific information on directors' remuneration, and reports on carbon emissions, diversity, disability and more. The auditors' responsibilities in relation to this information are complex, and they are set out in the next section.

The annual report is made up of information required either by law or regulation, together with any other information directors choose to prepare. While this is required to be 'fair, balanced and understandable' under the UK Code, most of it is unaudited and only the financial statements are required to give a 'true and fair' view.

5. AUDITORS AUDIT THE FINANCIAL STATEMENTS AND PERFORM OTHER PROCEDURES ON OTHER PARTS OF THE ANNUAL REPORT

What does an audit actually involve? The principal purpose of the audit is to enable auditors to form an opinion on whether the financial statements prepared by directors do in fact give a 'true and fair' view, as required by company law, and to report that opinion, together with 'key audit matters' and a variety of other things, to shareholders.

What does giving a 'true and fair' view mean?

Auditors make an important contribution to getting the financial statements right but there is a common misconception that auditors are responsible for the financial statements. Company law requires boards to prepare financial statements that give a 'true and fair' view, thereby demonstrating how they have dealt with the assets entrusted to them by shareholders. Auditors cannot prepare those financial statements for directors, or they would be reporting to shareholders on their own work. Furthermore, while auditors can and do bring pressure to bear on companies to change the financial statements, auditors cannot compel directors to make changes.

If the directors refuse to change the financial statements and in the auditor's opinion the financial statements do not give a true and fair view, either in their entirety or in part, they are required to qualify their audit report, although this is a rare occurrence for a listed company.

For a set of financial statements to give a 'true and fair' view, they must do more than simply comply with the letter of IFRS and company law. Fundamental accounting concepts underpinning IFRS require financial statements to give priority to substance over legal form, and be unbiased and neutral. UK auditing standards require the auditor to 'stand back' at the end of the audit and consider the overall presentation of the financial statements.

While IFRS continues to embody many examples of 'prudent' accounting treatments, neither directors nor auditors are permitted to equate 'true and fair' with a 'conservative' or 'prudent' approach to accounting. This is partly because the idea of prudence as a fundamental accounting concept has in the past been misused by companies to hide profits from shareholders, in the form of 'big bath provisions'.

The term 'prudent' is currently deemed by some to represent a form of bias and it does not appear as a fundamental concept in IFRS. However, the term has been included in the 2018 Conceptual Framework, as just one qualitative characteristic of the concept of 'faithful representation'. The exercise of prudence is now deemed to 'support' neutrality and involves exercising caution when making judgements under conditions of uncertainty, although it does not allow for the understatement of assets or income or the overstatement of liabilities or expenses, nor does it imply a systematic need for more persuasive evidence to support the recognition of assets or income than the recognition of liabilities or expenses. The debate about this continues.

In times of economic growth or optimism, there are significant limitations to the extent to which directors, however instinctively cautious, have licence to prepare financial statements on the basis of conservative or pessimistic assumptions about the future because, as noted above, financial statements under IFRS must be unbiased and neutral. Auditors do a great deal of work on the robustness of management's estimates and they are required to challenge all assumptions in material areas, including widely held positive assumptions about the future. Directors are required to support the assertions they make in the financial statements and to provide that evidence to auditors. But if auditors disagree with management, they too, in practice, need evidence to support their opinion. For example a vague sense that a bull market cannot last for much longer is unlikely to be adequate for these purposes, especially when all of the economic indicators suggest otherwise.

When companies collapse, the 'truth and fairness' of the financial statements is rightly called into question. Directors are responsible for ensuring, and demonstrating to auditors, that the company is a going concern (and therefore that the 'going concern basis' for the preparation of financial statements is appropriate). For their part, auditors are required to consider, as a minimum, a period of one year from the date of the audit report when considering going concern. But not all corporate collapses involve financial statements that do not show a 'true and fair' view. If a company is dependent on a single lender for financing, and that lender suddenly withdraws facilities without warning, thereby precipitating a collapse, the previous financial statements may well have given a 'true and fair view', provided of course that the dependence on the lender was adequately disclosed.

UK auditing standards acknowledge (in ISA 240, paragraph 5) that:

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.

This is a long-established and important principle, and one poorly understood. Auditing is not the same as fraud detection, and a properly performed audit does not, and cannot, provide a guarantee that no material misstatements exist in the financial statements. If it did, it would be more akin to an insurance

policy, or a policing activity, than an audit. Even if an insurer prepared to underwrite the risk could be found, the premium would be prohibitively expensive as the quantum of risk would be difficult to determine without performing an audit. And no police authority guarantees to detect all crime, still less apprehend all criminals.

The audit opinion is just that, it is an opinion, albeit an expert opinion, based on assessed risk and the performance of extensive procedures to reduce that risk to an acceptable level. The risk cannot be eliminated entirely, not least because of the potential for human error.

Paragraphs 6 and 7 of the same standard highlight the difficulty in detecting some frauds. They note that the risk of not detecting a material misstatement resulting from fraud is higher because fraud may involve sophisticated and carefully organised schemes concealing it, such as forgery, deliberate failure to record transactions, and intentional misrepresentations made to auditors. Collusion in the concealment of fraud is common. Furthermore, in many cases, determining what is and what is not a fraud is a matter of judgement that only the courts can decide. The dividing line between an aggressive accounting policy and fraudulent financial reporting is rarely clear and often only emerges over time as a situation deteriorates. It is invariably with the benefit of hindsight that headline writers claim that frauds were 'hiding in plain sight'.

UK auditing standards

Detailed requirements and guidance in the UK's extensive corpus of auditing standards cover the conduct of a financial statement audit. UK auditing standards issued by the FRC are based on those issued by the international standard-setter, the International Auditing and Assurance Standards Board (IAASB) and are therefore aligned with standards that are now widely adopted globally. These standards have detailed requirements for auditors to:

- comply with legal, ethical and quality control requirements;
- exercise professional scepticism and professional judgement;
- perform a risk assessment to determine the risk of material misstatement in the financial statements whether caused by fraud or error;
- understand and evaluate internal controls;
- perform tests of controls and substantive procedures;
- obtain audit evidence to support the audit opinion by means of observation, enquiry, inspection and analytical procedures;
- document their work; and
- form an opinion on the financial statements on the basis of the audit work and report their opinion in a loosely prescribed format.

Auditors cannot realistically perform an effective audit without the active co-operation of directors and many levels of management and the audit process almost always results in changes to the draft financial statements prepared by directors. All significant matters are discussed with the audit committee and some of them are described in the audit report under the heading of 'key audit matters'.

Company law has long required directors to provide auditors with such 'information and explanations' that auditors deem necessary for the purposes of the audit. In 2005, company law was changed to make providing auditors with false or misleading information (in a material particular), a criminal offence, carrying a two-year prison sentence. To date, no prosecutions have been made under this section.

6. AUDITORS REPORT VARIOUS MATTERS ABOUT THE AUDIT TO THE AUDIT COMMITTEE

Discussions between audit committees and auditors cover the intended audit approach, the risk assessment, significant audit findings, especially in judgemental areas, and areas of significant control weakness, for example. Starting with the many matters discussed with the audit committee, auditors determine which of those are of 'most significance' to the audit of the financial statements in the current period. These matters are then described publicly in the auditor's report to shareholders as 'key audit matters'. This type of 'extended' auditor reporting was pioneered in the UK and has been taken up by standard-setters globally, including in the USA. Investors have generally welcomed this development but some are asking for more graduated reporting, including more public disclosure of matters discussed by auditors with audit committees. Importantly, investors also believe that the quality of audit committee reports to shareholders within the annual report can and should be improved significantly.

7. AUDITORS REPORT ON THE FINANCIAL STATEMENTS TO SHAREHOLDERS

The main elements of audit reports on the financial statements of UK companies with full main market listings currently consist of:

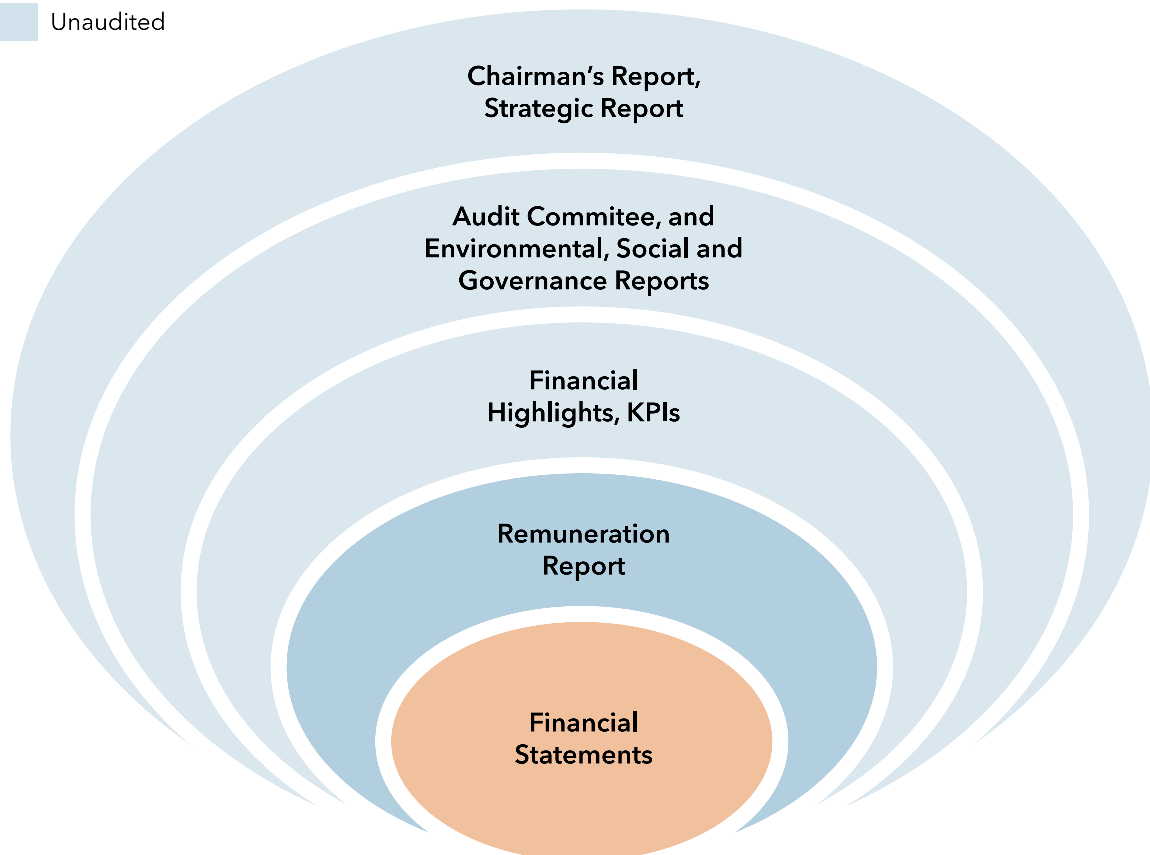
- a binary, 'pass/fail' 'true and fair' opinion, as required by company law;
- a more discursive free form element: 'key audit matters'; and
- a variety of other matters (summarised below).

'Key audit matters' are matters reported to the audit committee and of 'most significance' to the current audit.

What is not well understood is the fact that much of the financial information in the annual report is unaudited.

The Annual Report

The annual report as a whole should be Fair, Balanced and Understandable



Should the scope of the audit be extended?

Debates continue about:

- the extent to which the scope of the audit can be extended to take in some or all of the other information in the annual report, particularly critical information such as KPIs which are currently unaudited, and other matters such as the effectiveness of internal control, as currently required in the USA;
- the desirability and feasibility of providing assurance on the entire annual report; and
- the length and complexity of annual reports.

While it is possible for auditors to qualify their true and fair opinion if they are uncertain about a material matter, or if they disagree, such qualified audit reports are rare for UK companies with full main market listings.

Investors value the long-established, albeit fairly inflexible 'true and fair' opinion but they want more. This led to the development of auditor reporting on 'key audit matters' relatively recently. This more subjective and flexible area is still developing and there is a debate about the need for and feasibility of more 'graduated reporting'.

AUDITOR REPORTING ON OTHER MATTERS

Auditors are required to 'read' all of the 'other' information that appears in the annual report as well as the financial statements, and to deal with any actual or apparent inconsistencies between the financial statements and the other information, and any 'misleading' information. This is not the same as auditing the other information though, which require a great deal more work. Company law, the UK Code and the continuing obligations of listing require auditors to report:

- on or about their various responsibilities with regard to:
  - the strategic, directors' and remuneration reports;
  - statements by directors about the entity's viability, their assessment of principal risks, and whether the annual report as whole is 'fair, balanced and understandable'.
- if the statement describing the work of the audit committee does not appropriately cover matters communicated by auditors to the committee;
- if the directors' statement relating to the company's compliance with the UK Code does not properly disclose a departure from the Code; and
- if they have not received all the information and explanations they required for their audit, if adequate accounting records had not been kept or if the financial statements do not agree with the underlying records.

In short, auditors are variously required to audit, review, read or otherwise deal with specific parts of the annual report in various different ways. Financial statements, together with the auditor's report thereon, are sent to shareholders. Directors must place the financial statements on public record by filing them with Companies House and the Stock Exchange.

Auditors also have a narrow range of responsibilities to report directly to a number of regulatory bodies about, for example, suspected money laundering.

The regulatory framework and the sanctions regime: what happens when things go wrong?

The purpose of the regulatory framework is to encourage confidence in publicly available financial information through high quality accounting and auditing standards and the effective regulation of companies, directors and auditors. Regulation should also provide an environment in which when companies fail, they do so in an orderly manner, with minimum disruption and loss to all concerned.

In many respects, the UK regulatory framework achieves those goals. Levels of confidence in UK financial reporting, and in the integrity of the UK's capital markets remain high. While it is important to reduce the number of high profile corporate failures as far as possible, and their impact, it will never be possible to eliminate the risk of failure altogether.

The regulatory framework surrounding financial reporting, like any regulatory framework, cannot force anyone to do or to refrain from doing anything. It sets out what directors, auditors and others are required to do, and refrain from doing, and what will happen when those requirements are not met. The framework itself is not perfect, and one of the objectives of the existing inquiries into audit is to establish what can be done to improve the regulatory framework.

Ultimately, the responsibility for financial reporting in the UK is underpinned by Government, which lays down the legislative framework. Company law deals with the rights and duties of both directors and auditors, and sanctions for non-compliance. Company law delegates some responsibilities for the:

- regulation of audits and auditors; and
- requirements governing the preparation of financial statements and other information that appears in the annual report

to bodies established by the Secretary of State such as the FRC.

Is standard-setting sufficiently independent?

Until the early 1990s, the profession was self-regulating and professional accountancy bodies used to perform many of the functions now undertaken by the FRC, such as auditing and accounting standard-setting. The FRC is formally independent of the profession, but it has been suggested in recent reviews that it needs to be more independent.

The professional accountancy bodies retain a role in regulating their members, who comprise directors and accountants employed by companies, as well as auditors. In cases of misconduct, both the FRC and the professional accountancy bodies have the right to take enforcement action, including fines, exclusion and other sanctions. Broadly speaking, the FRC deals with auditors and directors of public interest entities (PIEs), including listed companies and large private companies. It delegates the operation of some of its other responsibilities, such as the regulation of auditors of non-PIEs, to the professional accountancy bodies. Those bodies continue to issue non-mandatory guidance on auditing and accounting issues, and mandatory guidance on ethical issues with which all of their members, whether in business or in practice, must comply.

The FRC currently has responsibility for the regulation of actuaries, as well as accountants and auditors. It also operates the UK's corporate governance system, principally through the UK Code. It implements accounting, auditing and ethical standards, monitors the annual reports of listed, large private and other PIEs, and inspects the auditors of those entities. It challenges companies where it has concerns about their accounts.

The UK Code applies to companies and other incorporated entities on a 'comply or explain' basis.

The FRC's Stewardship Code encourages active engagement between institutional investors, including pension funds, insurance companies, investment trusts and other collective investment vehicles, and the companies they invest in. It was developed partly to enable the voices of smaller investors represented by institutional investors to be heard, but also to deal with a perceived laissez-faire approach among institutional investors to investee companies. It too adopts a 'comply or explain' approach. Its seven principles deal with the need for investors to deal with:

- conflicts of interest;
- monitor investee companies;
- establish guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
- be willing to act collectively with other investors where appropriate;
- have a clear policy on voting;
- be transparent about all of these activities; and
- disclose their policy on how they will discharge their stewardship responsibilities.

Are the UK's codes effective?

The 'comply or explain' basis of the UK Code has been called into question, as has the effectiveness of the Stewardship Code.

The FRC sets audit quality targets for the performance of auditors, and reports publicly on the achievement of those targets, and on its other activities.

Directors, including non-executive directors on the main board and audit committee members, must prepare a company's financial statements and other information in accordance with:

- UK company law;
- The continuing obligations of the Financial Conduct Authority (FCA), i.e. the Listing Rules and the Disclosure Guidance and Transparency Rules (DTRs), with additional requirements for companies with premium listings, such as a requirement for such companies to act with 'integrity' towards existing and future holders of its shares: and
- EU-adopted International Financial Reporting Standards (IFRS).

Directors must also comply with, or explain why they have not complied with, the UK Code. Companies with a premium listing cannot opt out of the preparation of a viability statement on going concern issues under the UK Code by explaining why they have not prepared one, because the continuing obligations of the FCA mandate the preparation of such a statement.

Non-compliance with company law, the continuing obligations of listing or IFRS can be sanctioned variously by the FRC, the Stock Exchange, the courts and the professional accountancy bodies where their members are involved.

The FRC can request or, through the courts, demand restatements of financial statements, although to date it has never had to resort to the courts. It can impose fines and sanctions on directors who are members of professional bodies, but not, currently, other directors. The Stock Exchange can suspend trading in a company's shares, among other things. Applications can be brought to disqualify directors who are 'unfit', as a result of trading whilst insolvent, for example.

Auditors must comply with:

- The relevant sections of UK company law;
- UK auditing standards issued by the FRC;
- Certain requirements under the Listing Rules; and
- Ethical requirements and audit regulations issued by the FRC and the professional bodies.

Audit firms are inspected and sanctioned by the FRC and the professional bodies.

Is the UK's sanctions regime effective?

The sanctions available to the FRC in the UK are considerably greater than those available to sanction auditors in the USA. There remain questions however about how effective these sanctions are. Recent inquiries have focused on whether the sanctions for directors and auditors are appropriate and enforceable, and on the different treatment of misconduct on the part of directors and senior management who are members of professional bodies, and those who are not.

The ICAEW Audit and Assurance Faculty is the professional and public interest voice of audit and assurance matters for ICAEW and is a leading authority in its field. Internationally recognised as a source of expertise, the Faculty is responsible for submissions to regulators and standard setters and provides a range of resources to professionals. It also offers practical assistance in dealing with common audit and assurance problems.

The faculty is producing a series of succinct, high-level thought leadership essays on themes that are relevant to the debate on the future of audit. They are designed to inform the various inquiries relevant to audit and regulation, and to improve the understanding of these by boards, investors, politicians, policymakers and others. These are available at icaew.com/futureofaudit

For more information on the faculty, the current work programmes and how to get involved, visit icaew.com/audit

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ICAEW
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA
UK

T +44 (0)20 7920 8100
E generalenquiries@icaew.com
icaew.com

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