Future of Audit – Sir Donald Brydon CBE

Speech at ICAEW Audit & Assurance Faculty Conference

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Introduction

I am delighted to be here today to address this inaugural audit conference of the ICAEW's Audit and Assurance Faculty. The conference title ['Reflect, Reform, Refocus'] certainly chimes with the Review I have been undertaking this year. I have had the opportunity to *reflect* on a multitude of arguments about audit *reform*, and I am now *refocusing* in order to deliver a report to Government, as previously indicated, by the end of this year.

Before going further, it may be useful to address any 'expectation gap' regarding this speech. My aim today is to highlight the wealth of responses, views and ideas that have been presented to me since my Call for Views launched in April. I hope this will be of interest to you. You will understand, at the same time, that I cannot give a preview of the recommendations I will be making in my report. That report was commissioned by Government and you will appreciate that it is to the BEIS Secretary of State that I must present my recommendations when the time comes.

I am acutely aware that Audit is very much in the headlines and I am making good progress.

Call for Views – overview

Whatever my Review's recommendations may be, I would like thank all the organisations and individuals who have taken the time to contribute their thoughts, insights and suggestions. Some several times. I was pleased to receive 120 submissions to the Call for Views, comprising over two and a half thousand pages, from a very wide range of stakeholders. This included responses from the preparers of accounts, investors, audit committees, audit firms, think tanks, academia, professional and trade bodies and members of the public. Indeed, I received another thoughtful and original academic paper only last week. I also had the benefit of hearing directly from people across the country at well over 100 meetings and roundtables.

A number of those people are in this room today. I have been impressed by the constructive and positive way you have engaged. I have also been assisted by both an Advisory Board and an Auditors Advisory Group, where I have been able to learn from very experienced users and auditors.

I will be publishing the responses, subject to any stated concerns over confidentiality. I will not therefore go into any great numerical detail today about the range of opinion across each of the sixty questions asked in the Call for Views. Indeed, a statistical count would not be meaningful as many single responses from professional or trade bodies spoke for many members.

But I would observe that the over-whelming message given by almost every respondent, and every person I have spoken to in the course of the Review, is that audit matters greatly. The sheer scale of the response says so.

This matters because a company's independent external auditor occupies a unique and influential position in our society and economy. Lots of people have things to say about the running of any major company, for good or bad. But only the auditor combines an independent viewpoint with unparalleled access to the internal workings of the company. The auditor has virtually unlimited opportunity, should he or she wish, and the right, to interrogate the company's directors, management, employees, systems, processes and information.

This right of access to people and information, enshrined in Section 499 of the Companies Act, reflects the considerable importance and value that society places on the audit. The auditor's opinion therefore counts, or it should count, for a great deal.

I will not rehearse here the criticisms of audit that have been expressed clearly by others, including the BEIS Select Committee. The question is, how can we address the clear concerns that audit is not currently living up to its perceived importance.

<u>Mind the Gap</u>

Well, first we need to diagnose the problem. And in this respect, I have been helpfully presented with all kinds of gap analysis in the responses and comments I have received.

For many, there is the expectation gap – a perceived mismatch between what audit actually is and what people think it is. For others, there is the delivery gap – in which audit is not seen as delivering what it is already meant to be doing. And between those two points, I have been urged to consider various other kinds of gap, including the knowledge gap, the quality gap, the education gap and even the evolution gap.

I am not sure that this obsession with gaps gets us very far.

I also have little patience with the rather tendentious point of view that everything would be OK if the media, Parliamentarians and the general public were simply better educated on what audit does, and what it does not do. The challenge, and the opportunity to raise standards, is surely greater than that. What is wanted is better audit.

Instead, I see part of the aims of my Review as being <u>both</u> to consider how the quality of the existing audit product might be improved, <u>and</u> to explore whether and how audit should be defined in terms of its scope. Above all, and here I will let slip a view, I want to consider how audit can become a more informative process and product whilst not losing its compliance aspect.

I can say that there were very few responses to my Review which saw no need for change. Taken as a whole, about two thirds of respondents were strongly of the view that audit could do a lot better. And most of the remainder were open to some kind of change while cautioning against possible unintended consequences.

<u>The users of audit</u>

This rough split of opinion was reflected in comments over whether the reporting duty on auditors might be reframed to reflect better the interests of other users, in addition to the shareholders. A clear majority of respondents variously cited employees, suppliers, customers, regulators and even the public in general as relevant users of the audit. One organisation in this camp said that the current focus on shareholders "no longer reflects social and economic reality."

There was rather less consensus, however, on how this could best be achieved in practice.

Some thought that auditors could simply be directed to keep in mind the interests of other users of the audited financial statements. Others were more radical and called for company law to be amended to explicitly recognise the interests of other users in addition to the shareholder.

Against such ideas, there were concerns that a formal widening of auditors' responsibilities beyond shareholders, to include other stakeholders, could result in a fragmented, incoherent audit opinion that struggled to serve competing interests, while opening up auditors to wider liability risks. As one contributor to the Review stated, "If you try to please everybody, you risk pleasing nobody."

Clearly any reform in this area would need to be very carefully thought through to retain clarity and consistency in the audit process and report. I also recognise that shareholders, as the company's providers of capital, have a particular interest in how their capital is being managed and put to use.

At the same time, I think it is unhelpful to exaggerate the different perspectives on audit across various categories of user. In the words of another respondent to the Review, a former company director as it happens, the users of an audit are quite simply "all who rely on the company's stability and financial well-being at least twelve months hence." I would hope that we could all agree that is a good starting point.

<u>The scope and purpose of audit</u>

This brings me then to the scope and purpose of audit, which is fundamental to any recommendations to improve the quality of the audit process and product. I am pleased that the Review received a great deal of comment and suggestions in this area.

For some, the existing objective of audit is ambitious enough; namely, to provide an independent opinion that the company's financial statements provide a true and fair view of its financial position and performance.

But others who responded saw this as not going nearly far enough. There were calls for a higher degree of assurance to be provided by the auditor on the front end of the annual report, including reporting on risks and corporate governance.

A number of respondents flagged specific elements of company reporting which might benefit from a greater level of assurance being provided by the auditor.

For example, I have been asked whether auditors could assess directors' new obligations to report on how they are meeting their duty under Section 172 of the Companies Act to have regard to employee, customer and supplier interests, as well as the impact of directors' decision-making on the long term. In passing, I note the publicity surrounding the recent US Business Round Table Statement about the purpose of companies being to serve a wide range of stakeholders. Section 172 arguably got there some time ago.

I have also been asked whether the audit should be expanded to cover company disclosures around cyber security and climate change, given the increasing risks to companies of failing to address such issues.

Beyond such specific suggestions, some submissions to the Review called for a complete rethink of the purpose of audit. In the words of one respondent, the audit should "assume a more visibly social purpose and responsibility". For this, and similarly minded respondents, the purpose of audit should be to serve the public interest by, essentially, assessing the contribution of the company to society.

Now, I am not saying that I necessarily share this view. And I have stated before that my job in conducting this Review is not to redesign Western capitalism. But I do think it is important to note that many people and organisations have expressed to the Review their frustrations with what they see as, essentially, a narrow, backward looking and increasingly rules-obsessed approach to audit.

This is not to say that rules are unimportant. They matter greatly, for reasons of consistency, fairness and clarity. But the goal of providing assurance over the financial and economic standing of our major companies requires more than just the following of prescriptive standards and the completion of files.

Good and experienced auditors already demonstrate this, when they exercise judgment, scepticism and challenge over the course of their audit. Effective auditors do this even when it makes for difficult conversations with company management. Yet not all auditors are seen as effective; is this just a question of professional training or a more fundamental question about the professional structure within which they sit?

Whatever the answer, my Review is considering how existing good practice in audit could be built on and applied more widely and consistently.

In this regard, I would highlight one particular comment made to me during the course of the Review that has resonated. This compared the audit to a high jump, in which auditors have little incentive to do more than the minimum required to 'clear the bar'. I repeat that there is a hunger for audit to be informative and not just evidencing compliance.

The role of the audit committee

So where might that extra incentive come from? Is it a question of resource? Some respondents think so and have suggested that audit fees have not kept pace with the complexity and demands of the audit of major global companies.

Alongside this concern is a view expressed by some respondents that audit committees could be doing more to reinforce the role of the auditor during the audit process, and to facilitate an audit process which truly invokes sceptical judgments..

In the words of one professional body, from North America:

"Audit Committees bear responsibility for seeing audit as a commodity only, one which must be contracted and delivered to meet minimum regulatory requirements at the cheapest price, rather than an opportunity to strengthen the company's financial and other reporting and so increase confidence of investors and others."

Now, I am unconvinced that this is a fair characterisation of all audit committees in the UK. I have had some excellent engagement with Audit Committee chairs and members during the Review which has highlighted a range of good practice but not all are perfect.

I do believe that in seeking to improve the impact and quality of audit, we must look not just to auditors, but to audit committees, Boards and management too. Nonetheless, many of the submissions from auditors and their associations begin with pinning all primary responsibility on directors. There may be truth in this, but it would have shown more understanding of public perceptions of audit if their first step in this debate had been to discuss how they can make audit better.

I have said before that it is not, however, auditors that cause companies to fail; that is the result of actions by directors. And I am a little troubled by the current mood that reaches for a shotgun aimed at auditors every time there is a corporate problem. I am mindful that audit needs to be an attractive profession that attracts the brightest and best who can have confidence that good professional work will not be misdescribed at moments of stress.

Lest this is taken as in any way defensive, let me repeat what I said earlier. What is needed is better audit.

The role of shareholders

For some respondents, part of the answer also lies with a greater engagement by shareholders with audit.

Most shareholders I met said they place considerable value on the audit. However, there was less agreement over what role shareholders might play in driving up audit quality.

For some investors, it is enough to know that the audit had been carried out and an unmodified auditor opinion given. This point of view sees the main job of audit as essentially keeping the management on their toes and checking for any material misstatement. The underlying detail is regarded as of less importance or interest.

For other investors who responded to the Review, including retail investor representatives, shareholders could do more, or should be enabled to do more, to shape and influence the audit itself, as well as scrutinise its outcomes.

Company law does of course already provide a number of powers and rights to shareholders in respect of the audit, beyond the general right to receive the annual audit report. These include a mechanism for shareholders to call out formally any concerns over the audit, the right to be notified of any material concerns relating to an auditor resignation and an ultimate power to remove an auditor from office if enough shareholders propose it.

For some respondents, these legal provisions are mainly a back-stop – if I may use that term – to be used *in extremis.* For others, they present an opportunity for shareholders, if they wish, to be more engaged and involved in audit than they arguably are at present.

There is also expressed concern with IFRS. The evolution of IFRS is beyond the scope of my Review but it does impact on the vexed question of the capital maintenance regime where I hope I can indicate possible ways of reducing shareholder anxiety. This is one area where my Review has an overlap with the Kingman Review. I note also that BEIS is taking forward recommendations in this area from the BEIS Select Committee.

The responses to my questions on capital maintenance could not be said to have provided a consensus. However, they did help further inform my understanding of the debate, including the question of how companies might better demonstrate the affordability of the distributions they choose to make.

<u>Overlaps with Sir John Kingman's and CMA Reviews</u>

Let me turn now to some other issues where there is a degree of overlap between my Review, and some of the recommendations coming from Sir John Kingman's review of the Financial Reporting Council, and the CMA review of the audit market.

The overlaps with Sir John's report are mainly around internal controls, going concern and the viability statement, on which my Call for Views asked a number of questions.

On internal controls, the responses to my Review provided a mixed view. For some, a full-scale importation of Sarbanes Oxley is the answer, including full auditor assurance on a directors' attestation that the company's financial reporting controls are effective.

Others suggested building on existing measures in law and the UK Corporate Governance Code, which already require some degree of reporting on internal controls, both financial and non-financial.

Some sought a middle-way by calling for a more proportionate British version of SOX (or 'SOX lite') in the UK, although very few sought to explain exactly what this might mean in practice.

On going concern and longer-term viability reporting, most respondents thought that there was ample room to improve the current requirements.

It was argued that the current going concern assessment sets the bar too high for directors having to disclose any 'material uncertainties' relating to a company's ability to continue as a going concern. And that strengthening related requirements for auditors will not address this underlying weakness.

The current viability statement was seen by most as not meeting the purpose which informed its introduction to the UK Corporate Governance Code. Those critics saw it as being not so much a serious analysis of a company's future viability, but instead a piece of boilerplate supported by high level budget and cash flow forecasts over a typically three year period. This was, of course, the view reached by Kingman as well.

BEIS has stated its intention to consult further on these issues. Any recommendations I make will therefore inform that process.

Regarding the CMA's recommendations on audit, the most eye catching is probably that regarding joint audits. This has generated a lot of comment, and BEIS has recently finished a consultation on this and the other CMA recommendations.

I recognise that there are arguments for and against joint audits improving overall audit quality. However, for the avoidance of doubt, my report will not be opining on the merits of joint audit. The proposals primarily relate to competition in the audit market, and my Review has enough to consider without venturing into audit competition as well.

Conclusion

I have provided here today a brief overview of the many comments and views expressed to me during my Review. I have not touched in these remarks on fraud, technology, culture and some of the other issues covered in the Call for Views, but I certainly received useful responses in these areas too. As I have said, all the responses will be published, subject to any confidentiality concerns.

It is important that the proportionality of any recommendations for change I make is carefully considered. For example, to what extent could or should any new drivers of audit quality also apply to the audits of companies which are not Public Interest Entities? In this respect, I note that there are a number of delegates here today from firms who audit companies outside the FTSE. I would encourage you to share any thoughts around proportionality with the excellent members of my Review Secretariat who are also here today.

That would certainly be welcome when I think of the single question in the Call for Views that succeeded in unifying almost every respondent. This question asked whether, as we seek to improve audit quality, we might also – in the interests of proportionality – drop anything from the existing scope of audit. I asked the question since many wise heads have advised me that I must not recommend imposing yet more controls or obligations on business.

Rather to my surprise, virtually no respondent had anything to say on this. So if anyone does have any thoughts about what could sensibly be dropped from the current scope of audit, now is the time to tell me.

So in sum I am seeking for audit to become more informative and not just a compliance checking function and one which helps to maintain and grow trust in business as a whole.

Thank you.