ICAEW Audit and Assurance Faculty Speech

Sir Donald Brydon

14th February 2020

1.

I am grateful for this opportunity to speak to you today about the report I presented to Government last December.

It was a daunting task to attempt a thorough review of the quality and effectiveness of audit and I would like to thank all those who assisted me in this task, - many in the room today. Especial thanks go the ICAEW whose initial work prompted the review in its current form.

Before I began the work, I was advised by one highly experienced individual that one should always know at the outset of any review what its final conclusions are going to be. I did not. What I did know was:

(1) there was considerable dissatisfaction with audit;

(2) that there had been very limited progress since Macfarlane in 1992;

and

(3) that I was sure audits needed to be more informative.

As the report says I consulted widely, read two and a half thousand pages of responses to my call for views and debated extensively. I found surprising ignorance about what audit is, closed minds in many quarters about what it could be and a significant communication challenge. Indeed, the report begins with the words "language matters": this is a reflection of the extent to which audit has become estranged from its users by the arcane precision of much of its language. Auditors need to break free of the bubble in which they communicate.

The report covers a wide range of subjects reflecting the reality that there is no single, simple answer to improving audit quality and effectiveness; and equally, there is no single stakeholder group in the audit process who should shoulder all the responsibility for doing so.

I am delighted by the way in which the report has been received. The acknowledgement that it is comprehensive and consistent is particularly satisfying. The length of the report is also a reflection of the breadth and high quality of thought and argument presented to me during the review - from business, audit firms, professional bodies, academia, shareholders, civil society and many members of the public.

The report makes many recommendations of relevance to a range of stakeholder groups, including audit firms, audited entities, the audit regulator, shareholders and, of course, government.

But, you know, we do not have to wait for others for many of the recommendations to be put into action. For too long auditors have been defensive and incremental in their thinking; now is a moment to seize. Why should not senior auditors get together and design a profession for themselves, why should shareholders not demand the extensions of assurance proposed in the report, why should directors not voluntarily share risk profiles in the way proposed. I pick just three points; there are many others which need neither legislation nor regulation to be enacted. What is needed are the Sparticuses of audit who will stand forward and say "I'll do it".

But I am getting ahead of myself. I will not attempt to describe and explain every single recommendation today. I will instead highlight the main proposals under some key themes, which I hope will be helpful.

I would like to emphasise that this report is not a shopping list of disparate suggestions. Its core philosophy needs to be embraced as a whole if its proposals are to be understood and implemented effectively. It deserves to be read in its entirety.

Let me also clarify that the bulk of the recommendations in the report are aimed at improving the audits of Public Interest Entities.

I am content for the Government and ARGA to take a final view on the scope of company coverage of particular recommendations. That will clearly include taking account of whatever new definition of Public Interest Entity BEIS might arrive at, in response to Sir John Kingman's recommendation that the PIE definition be reviewed.

2.

So why was this review necessary? What is the problem with the audit product and process today that needs fixing?

Well the traditional answer is that it comes down to the so-called 'expectation gap' between what audit currently delivers, and what many think it should deliver.

Others point to the audit regulator repeatedly finding in recent years that a quarter of audits of Public Interest Entities are below an acceptable standard.

Then there is the strong criticism of auditors by Parliament and others following recent high profile corporate failures.

All of these factors undoubtedly played a part in the Government's decision to commission a review of audit quality and effectiveness, and I have certainly been mindful of these concerns in carrying out my review.

At the same time, I believe the challenge is more fundamental than this, and that the opportunity to enhance confidence through the audit environment is correspondingly greater.

As I say in the report, I am not sure that focusing on expectation or other gaps gets us very far. I do not agree with those who say that the main problem with audit today is that people have unreasonable expectations of it.

But nor do I believe that audit alone can respond to societal attitudes to corporate risk and challenge, or that individual corporate failures should necessarily drive changes to audit across all companies. The main responsibility for a company's success or otherwise must remain, of course, firmly with its directors. Good audit cannot substitute for failing boards.

What I do believe, however, is that audit is currently falling short, for various reasons, of satisfactorily informing the user of the audit. This was the central message I took from the written submissions and other contributions to the Review, and it provides, in some ways, a unifying theme for my report. After all, what all stakeholders want to know is: is this company being honestly run and is it likely to have a future.

Of course, audit reports as they currently stand do provide information, and the amount of information provided has grown in recent years with the arrival of the extended audit report and the highlighting of key audit matters.

But providing information and being informative are not necessarily the same thing.

Information is not informative if it is not interesting or useful. Information that only verifies that a company has complied with the necessary accounting standards is not particularly interesting or useful.

That is not to dismiss the role of audit in assessing and verifying that the financial statements have been prepared in accordance with generally accepted rules. That is clearly important but it does not go far enough.

As I said in October:

"The auditor occupies a unique role 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 the right and virtually unlimited opportunity, should he or she wish, 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."

The core aim of my Report is therefore to encourage and enable a more informative audit report – that is to say, a report which provides interesting and relevant information. In doing so, it seeks to elevate the role of auditor to a level that goes significantly beyond that of compliance checker.

3.

So, how can this be achieved? Well, before anything else, it is my strong belief that auditing needs a unifying purpose and set of principles which define audit as a profession in its own right.

Currently, audit consists of a series of duties, underpinned by standards. These are important, but they do not ensure the delivery of desired information.

The auditor exists fundamentally to help enable shareholders and other users of company reporting form a view on whether the audited company deserves to be a recipient of their confidence. To ask just two questions:

Can these accounts be taken to represent the genuine financial performance, position and short term prospects of the audited company?

Can other information provided be trusted as reliable and is it formed as the result of robust processes?

Holistic and meaningful answers to such questions are essential in a world where estimation and judgment in financial and other corporate reporting is ever increasing.

There is a clear (and widely acknowledged) need for the auditor to step back and think about the overall credibility of the information presented to them, as well as checking compliance.

I therefore propose in the Report the adoption of an over-arching purpose of audit, to help determine whether confidence in a company, its directors and the information they communicate is deserved.

I further propose that this new purpose of audit be enshrined in the Companies Act, if possible, as something to which the auditor should have regard in carrying out their duties.

Whether enshrined in law or not, I have recommended that this new audit purpose should inform all kinds of corporate auditing; that is, it should cover the existing statutory audit of the financial statements, and also the auditing of any other information produced by companies, whether now or in the future.

I have made this recommendation because I believe that all independent auditing of corporate information serves a public interest in promoting the integrity of corporate reporting, and therefore must share the same purpose.

This might include, for example, the auditing of companies' cyber risks, or their disclosures in relation to managing the risks of climate change, both of which are likely to become ever more important to users in judging the current position and future prospects of a business.

For this same reason, I believe that we need to establish, as a matter of priority, a new audit profession, to serve the public interest in corporate auditing whatever the specific subject of an audit.

It is not enough for the auditor to be an extension of the accounting or any other profession. The importance of what they do demands a recognition, a professional responsibility and a set of principles by which their behaviour is guided that are wholly centred on the purpose of audit.

I propose a set of principles for a new audit profession in my report

They introduce a number of clear professional responsibilities

For example, they include an obligation on the auditor to act in the public interest and to have regard to the interests of other users of the audit report in addition to those of the shareholders. In a society as complex as ours, to imagine that interests can be defined in the narrowest possible way, as many have sought to do, is to fly in the face of the information age.

There are also obligations for auditors to provide appropriate challenge to a company's management, while looking for signs of over-optimism and judgmental bias.

And there is an obligation to set out all information necessary for user understanding of the auditor's opinion.

The report proposes that the successor body to the Financial Reporting Council - the Audit, Reporting and Governance Authority (ARGA) – be given responsibility for ensuring the establishment of the new audit profession based on these principles, and for being its statutory supervisory body.

I hope and expect that a new professional body will emerge to represent corporate auditors and to uphold their professional standards. I see no reason why existing professional bodies should not play a leading role here too.

And as ARGA is itself being established to increase confidence in the regulation and monitoring of audit and company reporting, I can think of no better organisation to oversee the establishment an audit profession whose purpose is to scrutinise corporate information.

For the same reason, the report recommends that ARGA be tasked with developing a new framework for all auditing of corporate information, to further underpin a new audit profession. And even as we wait for the legislation to create ARGA, the FRC with its new leadership can legitimately encourage and corral leaders to rise to the challenges presented here.

4.

A stand-alone audit profession with a clear sense of purpose will be better equipped and emboldened to produce a more informative audit report to the company's shareholders and other users.

Alongside this, my report makes a number of specific recommendations to make the statutory audit report more meaningful and useful, while, importantly, retaining its binary opinion.

First, it proposes a much greater emphasis on the auditor providing information to shareholders, creditors, lenders and other users of accounts that is useful to the decisions they take regarding their ongoing interest in a company.

As part of this, I have recommended that existing audit standards be reviewed to facilitate inclusion of original information in the audit report, that is information beyond that disclosed by the directors, where the auditor considers that such information is likely to be of material interest to the users of the audit report.

As I say in the report, auditors would invite the company to disclose such information in the first place. I also suggest that regulators have a role in considering the disclosure of such information in relation to banks and other systemically important companies, taking account of the public interest.

In a similar vein, I have also proposed the highlighting of material inconsistencies between audited information and that contained in investor presentations or RNS Statements to the market. Here investors could make the auditing of APMs for example happen now, without waiting for others. If they don't, I can only conclude that, for all their fine sentiments, they do not really care.

I recommend that the audit report provides further information on the auditor's assessment of elements of the financial statements that rely heavily on management estimation and judgment. This would include the valuation of goodwill and valuation of future revenues.

I also recommend that any material difference of view between the auditor and management regarding any such valuations be highlighted and explained in both the audit report and the audit committee chair's statement in the annual report. These explanations should also state how the difference of view was resolved.

It is already the case, of course, that good auditors are ready to challenge management on an unduly optimistic, even aggressive, use of estimates and judgment. But this rarely sees the light of day. It would further increase confidence and transparency in audit if both the auditor and the audit committee were given responsibility for reporting on how any material differences of view arising during the audit process were reconciled.

I recognise there are concerns that this could hamper the frankness of discussions between management, auditor and audit committee in future. But to remind you, auditors will be operating under a set of immutable principles which would not permit such coyness. This is a good example of how this holistic approach needs a complete change in mindset.

A good audit should involve robust discussion between auditor and management where necessary. It should be of more concern if there is a lack of evidence of appropriate auditor challenge having taken place.

I also propose greater continuity between audit reports from year to year. For example, if a key audit matter from last year does not feature this year, the audit report should note this and tell us why it is no longer a key audit matter. I believe that it will be helpful and even reassuring to users to be presented with an audit report that compares and contrasts with the previous year's report.

My report also includes a number of other recommendations for making the audit report more informative, and adding a section to the audit report about how the auditor has responded to external signals regarding the company.

I also propose a new section in the audit report regarding fraud, about which I will say more later.

5.

In addition to these specific recommendations covering the audit report, I have proposed that the government replace the phrase 'true and fair' in the Companies Act. Let me explain why.

There is no statutory definition of 'true and fair', and over the course of the review I have come across various different interpretations of it.

For some, it means truth, in the sense of the auditor being satisfied that the company's accounts are 100% free from error. How can estimates of the future be true in any sense understood by a normal person?

For others, it has the more prosaic meaning of the accounts having been 'truly prepared'; that is, done in the right way to a high standard.

Neither of these definitions are of much use.

How can the audit pronounce on the absolute truth of a set of accounts? Its core role today is to provide reasonable assurance that the accounts are free from material misstatement.

What does 'truly prepared' add when the auditor already has separate obligations to check that the accounts have been prepared in accordance with the relevant standards and law?

I therefore think that 'true and fair' should be replaced with a more meaningful term. I have proposed the phrase "presents fairly, in all material respects" which is already used elsewhere in the world.

I believe this would improve users' understanding of the audit opinion and the level of confidence it provides.

The concept of 'fair presentation' is already well embedded in IFRS and UK GAAP, and International Auditing Standards deem the use of 'true and fair' to effectively mean the same thing.

The so-called 'true and fair override' would continue as a 'presents fairly' override, but would be reinvigorated by linking it to auditors' obligation to be faithful to the overarching Principles of Corporate Auditing.

6.

All the recommendations outlined so far have focused primarily on the auditor and the specifics of the audit report. But for the audit process and product to really improve in quality and effectiveness, I believe we also have to consider the roles played by the users and the audited entity.

To begin with the users, the primary user group is of course the company's shareholders, as recorded as its members on the company's share register. That is a matter of UK company law, which requires the auditor to prepare their report for the company's members.

In practice, these shareholders are mostly asset managers, custodians of the capital of pension fund members and savers at the end of typically long investment chains.

I believe there is an opportunity for these shareholders to engage, and to be engaged, more systematically in the audit process than is currently the case. For too long, audit has been a (largely) producer led and producer shaped product. The balance needs to swing back to the consumer, and my report makes a number of recommendations aimed at facilitating this.

I propose that shareholders be formally invited by the Audit Committee each year to propose any areas of emphasis they wish the auditor to include in that year's audit plan.

To support this, I recommend that the directors' annual Risk Report be published alongside the Audit Committee's invitation to shareholders. In this way, shareholders will have a grasp of the type and scale of the current risks facing the company before they make any requests regarding the next audit plan.

Under this proposal, the Audit Committee would not be bound to accept every shareholder request, but would need to state which requests it had accepted or rejected, and why.

In addition to this, I have called in the report for a new audit users' review board to be established, comprising a range of audit users, including institutional and retail shareholder representatives, the Audit Committee Chairs Independent Forum, the 100 Group and other users. This new body should be independent of auditors, who may wish to set up their own separate body.

To further facilitate shareholder scrutiny of the audit process, I have recommended that there be a standing item on audit at the company's AGM, to enable questioning of the Audit Committee Chair and the auditor. I have also set out proposals for significantly increased communication to shareholders covering the reasons for any auditor resignation or dismissal.

Further, the report recommends that audit committees publish a rolling three year Audit and Assurance Policy, which would be subject to an advisory shareholder vote at the AGM.

The purpose of the Audit and Assurance Policy would be to draw together in one place the company's approach over the following three years to obtaining assurance, both external and internal, over its corporate reporting and risk management.

It should go beyond the financial statements and could potentially cover, for example, the way it deals with and reports on risks in a wide range of areas. That might include cyber and other infrastructure security, and climate change risk.

Let me be clear here that my aim with this recommendation is not to add carelessly to companies' already considerable reporting burden.   Many companies are already doing this kind of reporting in their own way, including utilities and natural resource companies where a high degree of assurance is already required in many areas beyond the financial statements.

An Audit and Assurance Policy would therefore not necessarily require companies to do things they currently do not.   But it would provide them with an opportunity to demonstrate more systematically and clearly to their shareholders the role that audit and assurance plays in their particular business.

Taken as a whole, these and other recommendations in the report would give shareholders far greater scope, if they wish, to engage with and influence the audit and assurance of the companies on which they depend to provide long-term returns on clients' savings. "If it wishes" is an important caveat; it will be for shareholders in the first instance to determine the cost/benefit of such steps. That is the route to proportionality.

7.

Shareholders are not the only users of audit, however, nor the only group which relies upon the auditor doing their job well. Employees, customers, suppliers and society at large all have a strong interest in the audits of our major companies functioning at a high level of quality.

My report therefore makes several recommendations to help audit better serve this wider public and stakeholder interest.

These include a recommendation that the recently introduced directors' reporting duty covering section 172 of the Companies Act be subject to audit.   This reporting duty covers how the directors have had regard to employee, customer, supplier and other interests in pursuing the success of the company. I believe the quality of such reporting would benefit from the auditor reporting whether the section 172 report corresponds with the auditor's knowledge of the company and its processes gained in the course of the audit.

With regard to employees specifically, I have recommended that companies provide an opportunity for employees to raise any issues around risks and assurance. The company would be required to respond to the workforce on how it had considered any issues raised.

With regard to suppliers, I am mindful of persisting concerns over companies' payment practices. The most recent Government analysis from June 2019 found that 97% of suppliers experienced late payments from business customers, while only 11% thought matters have improved in recent years.

I recognise that companies are providing greater transparency on their payment policies and track record, but this generally does not feature in annual reports, nor is it subject to any form of audit.

I have therefore recommended that directors report to shareholders on their company's payment policies and performance and that this be subject to some level of audit.

I also considered during the review the extent to which the public interest in our major companies and their reporting could be better considered and assured. Many companies are already taking active steps to demonstrate the purpose of their business, and the values that drive it, that serve a public interest goal interlinked with the imperative to make a profit and provide a return on investment.

I believe it would be of value to all users of company reporting if our Public Interest Entities were obliged to prepare an annual Public Interest Statement. This statement would not be an exhaustive list of every legal duty that a company complies with but, rather, an explanation of how the directors believe their business serves a public interest, comprising both legal obligations and the fulfilling of other perceived social, economic and environmental responsibilities.

I have also recommended that the Public Interest Statement be subject to audit.

As with the Audit and Assurance Policy, I do not see this as necessarily adding significantly to companies' reporting obligations. It would be a chance for companies to demonstrate more coherently, and credibly, how they perceive their own public interest and how they believe they have met that interest.

8.

Another issue I have been conscious of in my review are the many calls, following recent corporate failures, for more to be done to identify and act on warning signs which threaten the viability of major companies.

This is not a straightforward issue, and I do not believe that sweeping reforms must necessarily be made in response to individual company collapses. Nor do I believe that the statutory auditor, or any other independent assurer, bears central responsibility for averting a corporate failure.

As I have said several times before, that responsibility lies clearly with the directors of the company.

I do believe, however, that there is an opportunity for major companies to provide a more systematic and transparent explanation, from year to year, on how they are seeking to ensure their ongoing resilience, in the short, medium and long term.

I have therefore proposed in my report the introduction of a Resilience Statement by Public Interest Entities. This statement would essentially incorporate and build on the existing Going Concern and Viability Statements.

It would set out how the company identifies and seeks to mitigate risks to the company's resilience over a 1 to 2 year, 5 year and longer term period.

The short term assessment would essentially follow the Going Concern statement, with enhanced transparency such as the disclosure of material uncertainties that exist before any mitigating action. This would be subject to audit in the same way as the Going Concern statement currently is.

The medium term component of the Resilience Statement would be based on a strengthened Viability Statement, which I suggest should include reverse stress testing, drawing on models used by the PRA. It would be for the directors to articulate in their Audit and Assurance Policy the extent to which they seek independent assurance of this work.

Finally, the long-term resilience statement would set out perceived existential threats facing the company's business model, whether from climate change or other sources. This would not be subject to any independent assurance, unless seen as desirable by the company or its shareholders.

I have also recommended that there be an over-arching obligation on the auditor to report to the directors any concerns they have about the company's viability that do not feature in the Resilience Statement.

Should the auditor believe that any such concerns have not been sufficiently addressed by the company, my report recommends that the auditor escalate them to ARGA or other appropriate regulator.

9.

Every major company will have its own particular resilience challenges. But there are some common risks facing all companies of course. One of these is fraud, or material fraud to be precise, whether carried out knowingly by a company's management or by a rogue employee or group of employees.

Material fraud on a sufficient scale can bring any company down. Given this, and given the considerable debate generated recently about the role of the auditor in relation to fraud, my report proposes a package of measures in this area.

First, I have recommended that ARGA amend the relevant auditing standard to make clear that the auditor is obliged to endeavour to detect material fraud in all reasonable ways. To help discharge this obligation, the report calls for training in forensic accounting and fraud awareness to be part of an auditor's formal training, qualification and ongoing learning.

Second, I propose that the directors of the audited entity report each year on the actions they have taken to prevent and detect any material fraud.

Third, I recommend that the audit report include a new section in which the auditor both comments on the directors' fraud statement, and states what independent steps the auditor has taken to assess relevant controls and endeavour to detect any material fraud.

Alongside these recommendations, I have proposed that ARGA maintains an open access case study register of corporate frauds, from which auditors can learn.

I also propose that a new independent panel be established to assess, in any case of a material fraud coming to light that had not been detected by the auditor, whether the auditor was at fault. This panel would have the powers to impose sanctions and remedial action if auditor negligence was determined.

Taken as a whole, it is my hope that these recommendations will bring an increased focus and energy by companies and auditors to preventing and seeking out material fraud.

10.

Now, you will of course be aware that my review followed on from Sir John Kingman's review of the audit regulator and the CMA's review of the audit market.

In focusing on audit quality and effectiveness, my review has largely avoided overlap with these two preceding pieces of work. However, there were some points of common interest, as I state in my report.

In particular, Sir John's recommendation that serious consideration be given to strengthening the UK's framework on internal controls.

I support Sir John's recommendation and have offered suggestions in my report as to how the Government might take it forward. In particular, I have suggested that the CEO and CFO of listed companies should make an attestation to the board of directors on the effectiveness of the company's internal controls over financial reporting.

In the spirit of the UK's unitary board model, the board as a whole would then confirm to the shareholders that it has received such an attestation.

I do not believe that such attestations should automatically be subject to audit. But whereas SOX limits audits of the internal controls statement to a sub-set of larger companies, my proposal is that audits should only be required in cases where there has been a failure of relevant controls, or persistent material weaknesses. In this way I believe we can achieve a proportionate step forward.

It is now for BEIS to decide how it wishes to take this forward.

11.

BEIS is also taking forward work on how the existing capital maintenance framework in UK company law might be further clarified or strengthened. This is in response to recommendations from the BEIS Select Committee's 'Future of Audit' report, and also an earlier BEIS consultation on 'Insolvency and Corporate Governance'.

I had a number of passionate representations and suggestions on the issue of capital maintenance during my review, including through my Advisory Board and Auditors Advisory Group.

It is a complicated issue, evidenced by the existing ICAEW guidance on capital maintenance running to over 170 pages. Fundamentally, however, it is a matter of greater assurance being sought about the affordability of company's distributions.

I therefore offer in my report a suggestion to BEIS that companies, when proposing a dividend, be required to state that the distribution in no way threatens the existence of the company over the short to medium term.

In doing so, I propose that companies confirm that the proposed distribution is consistent with the new Resilience Statement and is within known distributable reserves.

I also suggest that, where a proposed dividend is deemed of a similar size to the company's distributable reserves, these distributable reserves should be disclosed and subject to audit.

This may not answer every concern by every stakeholder engaged on this issue. But I believe it strikes a reasonable balance between placing greater onus on companies to take care over the affordability of dividends, and the need not to impose disproportionate costs on business.

As I have said, these are not formal recommendations, but suggestions to BEIS to inform the work it had already begun in this area prior my review.

12.

Time today prevents me from setting out a number of other recommendations that I hope will also add value to audit and assurance in future. These include proposals around the use of technology in audit, the audit fee setting process, auditor remuneration and culture.

I would be happy to discuss the rationale behind any of these other recommendations as part of the question and answer session that will shortly follow.

For now, to conclude this overview of my report, I would like to make some final observations.

First, as I say in the report, audit in the UK is not broken, but it has lost its way. Audit has adopted an increasingly liability-averse and compliance-driven mindset that does not serve adequately the user and wider public interest.

Importantly, it also does not make auditing the most attractive of professions to younger people. It is my sincere hope that the proposals set out in my report will help audit to become more ambitious and interesting, and in so doing continue to attract – and hang on to – the brightest and the best.

Second, the recommendations I have presented are not intended to punish or undermine auditors or any other stakeholder group. In fact, many of the proposals aim to highlight the existing good work that many auditors, audit committees and management do each year in the course of the audit.

Third, while a number of recommendations in my report can be taken forward quickly, some would require new primary legislation or the full establishment of the new Audit, Reporting and Governance Authority. It is my sincere hope that, regardless of how the Government may respond to individual recommendations, parliamentary time should be found as soon as possible to deliver the full audit reform package now on the table.

Let me finish, finally, by saying again how encouraged I was to receive such a wide range and depth of engagement with my review, across the world of business, professional advisers, academia and wider society. As I have said, many of those responses and ideas came from people in this room today. I thank you all.

I would also thank in particular the members of my Advisory Board and auditors Advisory Group, who gave very generously of their time and counsel.

As I say in the report, the time for audit reviews is now over; so too is the time for open-form consultation. It is time for action from all those with a stake in the success of our economy.

So, my challenge to you is – who is going to be Spartacus?   Thank you.

END