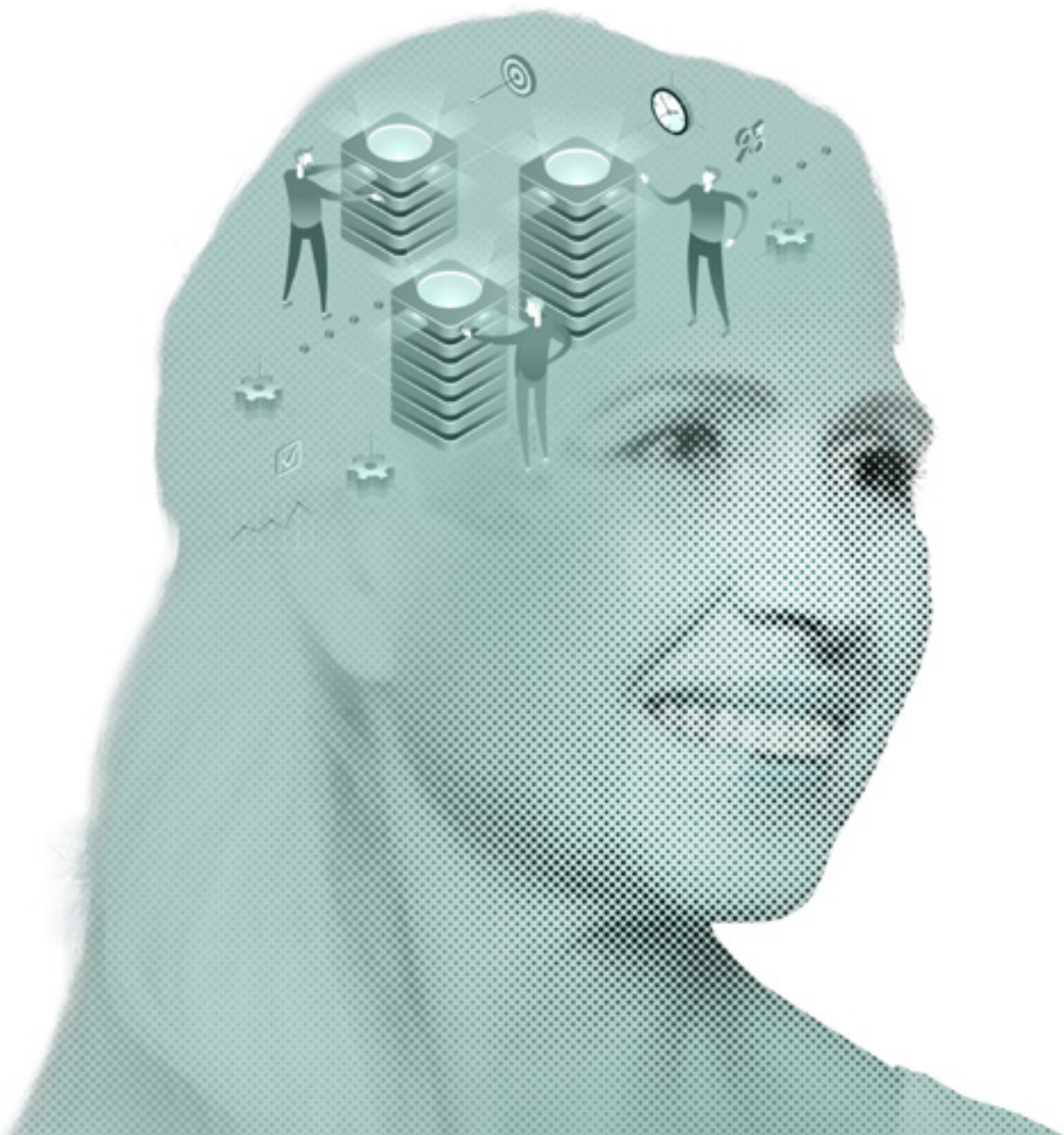


User-Driven Assurance: fresh thinking





Audit is currently undergoing an unprecedented level of public scrutiny. The expectations of investors and other stakeholders - including employees, customers, suppliers and pension-holders - have increased in recent years, and the purpose, scope and practice of audit need to keep pace.

ICAEW's Audit and Assurance Faculty is developing a series of thought leadership essays that consider issues directly or indirectly relevant to the international debate about the future of audit. This series is intended to help directors, audit committees, shareholders, politicians, journalists and policymakers understand the key issues, and it will, among other things, help to inform the development and implementation of recommendations in the UK regarding audit, its regulation and the market for audit services.

The faculty has published a number of papers already, which are available to all at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit). Further papers will be issued in the coming months. If you have views on any of them, or experiences to share, we would very much like to hear from you. Please email your comments to Nigel.Sleigh-Johnson@icaew.com

In June 2019, ICAEW responded to the call for views from Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit. A number of our thought leadership essays, including this one, will be used to highlight and develop the ideas presented in our submission.¹

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A new vision for assurance

USER-DRIVEN ASSURANCE

At the launch in April 2019 of the call for views from Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit Sir Donald stated:

'The voice of the ultimate user has been curiously muted; yet in the rest of the world the consumer drives the evolution of product features.'

We agree. It is important to address this problem and to energise engagement with the audit consumer. To this end we recommend the application of a three 'pillar' model of what we call 'User-Driven Assurance;' a fresh way of thinking about assurance, directed in its first phase by the needs of the primary user - the shareholders. We advocate an enhancement of the part played by shareholders in the commissioning of assurance, alongside a more proactive role for audit committees. Assurance of virtually any area of corporate activity is possible, but decisions need to be taken about what's most important to the business, and shareholders should assume a shared responsibility for those decisions.

Our model would comprise a range of assurance engagements and could involve a variety of assurance providers. While this innovative approach would require significant time and effort to develop and make fully operational, we believe that urgent action to address public concerns is needed now, and that progress can be made by building on the solid foundations already in place to support each of the three pillars. It could be an effective way of better meeting the information needs of all stakeholders and contributing towards fully and finally closing the so-called 'expectation gap.'

The starting point for this essay is the current debate on audit in the UK, and the UK financial reporting system, and we include a section on 'Developing the model in the UK'. However, we anticipate that the ideas set out will also be of interest in many other jurisdictions and that the basic principles we articulate could be developed and applied universally.

THE EXPECTATION GAP

The expectation gap in audit is not new. The 1992 paper by the former UK Auditing Practices Board *The Future Development of Auditing* refers to a 'gap between the role expected of auditors and that performed by them today'. Most of the issues which are the subject of Sir Donald's Review are also considered in that paper. ICAEW has urged those involved in Sir Donald's Review to think differently, and to embrace fundamental reform rather than incremental change.

The expectation gap has changed considerably over the years and will continue to do so; raise the standards for auditors, raise the demands of stakeholders. Our model of User-Driven Assurance can evolve and keep pace by building creative solutions into each pillar to meet emerging expectations. This is an opportunity to tackle the key challenges in a coherent, comprehensive and conclusive fashion, which will help to restore public trust in the financial reporting system and underpin confidence in business.

A performance gap, which has also been referred to as a 'delivery' gap,² also exists. This is the gap between auditors' existing responsibilities in law and auditing standards and their current discharging of those responsibilities. The performance gap is evidenced by audit monitoring reports by regulators.³ It is critical to address this gap too, and ICAEW recognises its role as a professional body in providing support and advice to its members to this end.⁴

This essay focusses on what *auditors* can do to close the expectation gap rather than on the role of the other players in the financial reporting system⁵, including directors, audit committees and shareholders. But we recognise that to achieve meaningful reform, all players have to embrace change. Our strong impression is that auditors are ready to rise to the challenge.



The three pillars

PILLAR 1

Improvements to the statutory audit

In October 2019 Sir Donald Brydon told ICAEW's Audit and Assurance Faculty conference that 'audit matters greatly' and that auditors occupy 'a unique and influential position in our society and economy.' He also stated that 'what is needed is a better audit.'

ICAEW is in agreement with these statements and recognises that audit needs to become more informative; that the most important issue is the perception and reality of audit quality. It is right to question the value of audit, and to measure the performance of auditors against the highest standards of professionalism⁶. But there is a risk that a focus in audit monitoring on compliance rather than the exercise of judgement may drive dysfunctional behaviour rather than address the real issues. The Audit and Assurance Faculty plans to explore and comment on the topic of audit quality in the coming months.

The first pillar of User-Driven Assurance is therefore an improved version of the statutory audit, with a renewed focus on avoiding disorderly failure and protecting against fraud to improve audit quality. We identify three priority areas for enhancement:

- strengthened internal control responsibilities of directors and auditors, using lessons learnt from implementing SOX in the US;
- directors and auditors applying insights to the foundations of going concern and viability taken from experience with other prospective financial information; and
- auditors becoming more expert in recognising the early warning signs of fraudulent financial reporting.

Auditors already play an important role in these three areas and have a significant impact on corporate behaviour, but there are still things that can be done to address expectation gaps and improve audit quality. Separate Audit and Assurance Faculty essays in this series prepare the profession for change by contributing fresh thinking on these three priority areas. This will provide a basis for a better-informed debate about audit reform and a platform for gathering information on current practice.

WHAT IS AN AUDIT?

ICAEW's Audit and Assurance Faculty background paper *What auditors do: the scope of audit* explains that, essentially, an audit involves three elements:

- a substantial risk assessment: auditors build up a detailed understanding of the business to enable them to assess the risk that the financial statements as a whole might be materially misstated, and the risk that the individual elements within the financial statements might be materially misstated. The greater the risk, the better the audit evidence will need to be;
- evidence-gathering in response to the risk assessment, intended to reduce the risk that there will still be a material misstatement, even after the audit, to an acceptable level. A great deal of evidence-gathering is about challenging management and corroborating explanations, ie, not taking explanations at face value, even if they appear to be plausible; and
- the audit opinion reported to shareholders, based on the evidence obtained.

Further information on the current scope of audit is available in this background paper.

The 1905 publication *A History of Accounting and Accountants*⁷ states: 'The origin of auditing goes back to times scarcely less remote than that of accounting... Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.' We consider that this fundamental purpose of auditing remains unchanged. Audit was developed in response to agency risks because of the principal: agent relationship that exists between shareholders, as the principals, and directors, as their agents. Auditors provide an independent check on the agents for the principals, which addresses the need for trust and confidence between them. Audit therefore plays a fundamental stewardship role. But change is needed to ensure that audit meets the needs of modern society.

The 2019 paper by John Coffee *Why Do Auditors Fail? What Might Work? What Won't?*⁸ describes auditors as 'gatekeepers' who pledge reputational capital that they have developed over many decades and many customers to give credibility to their opinions. This is an important insight. If audit firms are 'reputational intermediaries', whose most important asset is their reputation, this should provide shareholders with the confidence they need to trust in the audit process.

PILLAR 2

Enhanced use of assurance by regulators and other sector-focused bodies

The second pillar of User-Driven Assurance is the use by regulators and other sector-focused bodies of a range of assurance engagements other than audit. The underlying subject matter of these assurance engagements includes financial and non-financial information and information on systems and processes, and can also cover future-oriented information.

Critically, this second pillar builds on the International Framework for Assurance Engagements published by the International Auditing and Assurance Standards Board (IAASB), which provides a point of reference for those involved with assurance engagements. The IAASB has also developed assurance standards, including International Standard on Assurance Engagements (ISAE) 3000 (Revised), Assurance Engagements Other Than Audits or Reviews of Historical Financial Information. The framework and standards can be used to design and underpin new assurance engagements.

WHAT IS AN ASSURANCE ENGAGEMENT?

The International Framework for Assurance Engagements covers quality control within firms and compliance with ethical principles, including independence requirements. It defines an assurance engagement as an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users about the outcome of the measurement of an underlying subject matter against criteria. In an audit, which is one example of an assurance engagement, the financial statements (the outcome) result from measuring a company's financial position, financial performance and cash flows (the underlying subject matter) by applying a financial reporting framework (the criteria).

An assurance engagement needs to have an appropriate underlying subject matter and suitable criteria. Practitioners need to employ professional scepticism and professional judgement to obtain sufficient appropriate evidence to form their conclusion. The conclusion provides 'reasonable assurance' (a conclusion in a positive form) or 'limited assurance' (a conclusion in a negative form). Practitioners then express that conclusion in a written assurance report. An auditor, for example, forms an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, and expresses that opinion in an independent auditor's report.

Further information is available on ICAEW's assurance webpages at [icaew.com/assurance](https://www.icaew.com/assurance).

Such assurance engagements may be required or commissioned by government departments, regulatory bodies and other third parties, including trade and licensing bodies operating in relation to particular business sectors. The importance of such engagements to the smooth functioning of economies should not be lost in the international debate about audit reform.

We set out below a case study illustrating the effective use of Pillar 2 assurance, drawn from practice in the UK.

UK CASE STUDY: FINANCIAL POSITION AND PROSPECTS PROCEDURES



Directors of a company that is seeking to list on a UK market are required to have established procedures that provide a reasonable basis for them to make proper judgements on an ongoing basis as to the financial position and prospects (FPP) of the applicant and its group.

A generally accepted interpretation of the directors' obligations in connection with the specific regulatory requirement in relation to FPP procedures is that the directors must have established procedures that enable them to be informed on a regular basis about:

- the financial position of the applicant and its group, including assets and liabilities, profits and losses;
- projected profitability, cash flows and funding requirements based on realistic assumptions about the internal and external factors that might reasonably be expected to have a material impact on the business; and
- any changes in the above.

ICAEW has developed guidance⁹ for:

- directors of companies preparing for an Initial Public Offering (IPO), explaining how they can demonstrate that they have established FPP procedures to address relevant objectives; and
- reporting accountants undertaking an assurance engagement to address relevant objectives and providing an assurance report in relation to FPP procedures established by directors.

The general approach is consistent with ISAE 3000 (Revised); the guidance includes objectives (the criteria) with which to evaluate FPP procedures (the underlying subject matter), and the reporting accountant's opinion is then expressed in an assurance report.

PILLAR 3

Empowerment of shareholders to require the commissioning of assurance

We propose a third pillar of User-Driven Assurance: empowerment of shareholders through new voting rights, alongside a more proactive role for audit committees in this area. Shareholders would be enabled in specified circumstances to require the commissioning of bespoke assurance engagements that are tailored to the specific situation of the company. This builds on the proven approach of the statutory audit and assurance engagements required or commissioned by regulators and other sector-focused bodies, as well as the International Framework for Assurance Engagements and assurance standards such as ISAE 3000 (Revised).

The way a business generates value over the long term, ie, its business model, the sustainability of that model, and its principal risks, is of central importance to its shareholders¹⁰. This means that this third pillar would be a key component of the drive to ensure that governance, reporting and assurance meet the needs not only of shareholders but of wider stakeholders too. In time, consideration might be given to extending the model more formally to amplify the voices of other stakeholders.

Examples of areas where such assurance engagements might be undertaken include:

- alternative performance measures (APMs);
- policies and practices in relation to carbon emissions;¹¹
- cyber and data security issues;
- the value and resilience of the order book and other off balance sheet items;
- supplier payment policies;
- distributable reserves; and
- diversity issues.

The notion of 'reputational intermediaries' referenced by John Coffee also underpins the expansion of niche providers of wider assurance services requiring particular specialist skills and experience. The new model would ring-fence the core statutory audit, but drive increasing opportunities for innovation in other assurance engagements, providing opportunities for both small and medium-sized audit firms and other providers to develop and utilise more effectively assurance specialisms beyond statutory audit. It might also, among other things:

- assist audit firms to retain the brightest and best, given the opportunity to be involved in a variety of assurance assignments, including those with a high perceived societal value;
- necessitate the development of new skills for auditors to conduct this range of assurance assignments, including re-evaluating the involvement of specialists and experts;
- provide a platform for the delivery of more bespoke assurance in relation to the growing number of off balance sheet items; and
- facilitate the provision of more relevant and valued assurance services to the increasing number of companies not subject to statutory audit.

We set out below a case study illustrating the possible use of Pillar 3 assurance, drawn from practice in the UK.



UK CASE STUDY: BANKING REGULATORY RATIOS

Prudential regulatory ratios are key measures of the strength and resilience of banks and building societies of interest to investors, creditors, regulators, and other stakeholders. Capital, leverage and liquidity ratios and risk-weighted assets (RWA) calculations are complex. Banks and building societies need to use data from a range of sources, including their risk management, credit and financial reporting systems and need to apply a variety of judgements to these data. Designing a control system for this is similarly complex.

It is important for banks and their stakeholders to have confidence in the controls, processes and governance surrounding the production of regulatory ratios and related information. The regulatory focus on stress testing and public transparency of capital ratios has taken on an important role in the market.

ICAEW guidance¹² in this area does not create a requirement for assurance. It simply provides a framework that firms can choose to adopt when undertaking such assurance activity. It is intended to help both those commissioning and those providing assurance, in scoping and performing an engagement.

THE ROLE OF AUDIT COMMITTEES

We agree with Wesley Bricker, former SEC Chief Accountant, who recently emphasised the critical role played by audit committees 'in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting (ICFR), the quality of financial reporting, and the quality of audits performed on behalf of investors.'¹³ Audit committees, positioned as they are between shareholders, management and auditors, will play a central part in this new model.

We recognise that the best audit committees already engage effectively with shareholders. However, there is scope for audit committees to assume greater responsibility for both understanding and meeting the assurance needs of shareholders. Shareholders would then exercise their new voting rights as, in effect, a backstop in situations where unresolved concerns exist about the scope and timing of planned assurance initiatives. Audit committees will therefore need to communicate their assurance planning with shareholders,¹⁴ and, to do so, will need to undertake discussions with both management and auditors. New approaches, including the exploitation of technology, may be needed to facilitate engagement between audit committees and shareholders; annual meetings in their current format may not be suitable vehicles for this engagement.

Audit committees may need a new mechanism to help deal with shareholder requests for assurance. Multiple calls for assurance might be received, and they might of course differ or conflict, or even be vexatious. Such requests might also be co-ordinated across a particular business sector, for example one or more investor groups may request assurance on reporting on climate impacts from all major oil and gas companies in their portfolios.

Audit committees can act now and address the need to enhance the way they engage with shareholders to better understand and meet their assurance needs, without waiting for a formal empowerment of shareholders.

Developing the model in the UK

This section of our paper considers in general terms what developing this model in the UK might involve and what can be done now, without the need for new legislation. A similar exercise could be undertaken for other jurisdictions around the world. Where changes to the law are needed, they should define very clearly the purpose and nature of the core statutory audit but not stymie flexibility regarding the provision of other assurance engagements. The first pillar, the core statutory audit, would be the most defined and regulated, and the third pillar would be the least defined and regulated.

PILLAR 1

Improvements to the statutory audit

Implementing changes to Pillar 1 may involve changes to auditor behaviour, auditing standards and company law, and therefore some of these changes can be implemented more quickly than others. We believe such changes present an opportunity for the UK to show global leadership, as it did with the introduction of the extended audit report, in developing solutions to issues such as how to avoid disorderly failure and protect against fraud which are also under the spotlight in other jurisdictions around the world. We encourage the UK regulator and Government to consider what changes to regulatory and legislative requirements would best bring about these improvements. We have stressed the need to prioritise these most important areas of audit reform, which we believe will have the greatest impact on audit quality.

ICAEW also recognises its own role in equipping its members to make behavioural changes, as well as in contributing to the development of policy. In *Internal control effectiveness: who needs to know?*¹⁵ we suggest ways of clarifying and streamlining the existing UK requirements using lessons learnt from the US. We are now reflecting on comments on this essay and using them to develop our thinking in this area. We also plan to publish *Future of Audit* thought leadership essays on going concern and viability, and fraudulent financial reporting.

PILLAR 2

Enhanced use of assurance by regulators and other sector-focused bodies

We believe that regulators and other sector-focused bodies should be encouraged to take their responsibility for understanding the existing assurance provided by the statutory audit even more seriously and should routinely consider the need for further assurance to enhance the confidence of stakeholders in information relevant to that sector.

Enhancing Pillar 2 may involve changes to regulatory requirements. ICAEW plays a key role in working with regulators and other sector-focused bodies to design new assurance engagements. Identification of the users of the assurance report and its purpose are, in our experience, crucial to the design of engagements. Detailed consideration of the nature and level of the assurance required, timescales, cost and liability can then follow in order to define the scope of the work.

PILLAR 3

Empowerment of shareholders to require the commissioning of assurance

Existing UK legislation and guidance provides a useful basis for developing Pillar 3. Section 172 of the Companies Act 2006 requires directors to promote the success of the company for the benefit of its shareholders, and in doing so, to have regard to a range of other interests - including those of its employees, customers and suppliers, as well as the impact of directors' decision-making on the long term. New regulations effective for December 2019 year ends require larger companies to publish an annual statement on how s.172 has been implemented, together with additional disclosures on employee and stakeholder engagement.¹⁶ Business also faces increasing pressure to improve climate-related disclosures. The updated UK Stewardship Code defines stewardship as 'the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'¹⁷

Taken together, these and other developments provide the backdrop to our proposals on Pillar 3. We anticipate that lowering the barriers to investor intervention, through the exercise of the proposed new voting rights, coupled with the focus by policymakers and others on this important aspect of directors' responsibilities, will help to ensure that these wider concerns are properly addressed and encourage investors to play their full part in ensuring that the business 'does the right thing'.

The full and consistent implementation of Pillar 3 will involve some further changes to regulatory and legislative requirements. For example, shareholders' requests for assurance that meet specified thresholds and other criteria provided for in law may then trigger responsibilities for audit committees to commission additional assurance. Those commissioning assurance will need a clear understanding of the different types of assurance and assurance provider available in the market: the publication *A buyer's guide to assurance on non-financial information*, developed jointly by ICAEW's Audit and Assurance Faculty and the World Business Council for Sustainable Development (WBCSD), should be of assistance to audit committees and others in this regard.

We anticipate that shareholder empowerment, once tested and proven, will be formally extended in time in the UK to encompass wider stakeholders. But we caution against taking this step at the outset. Simply engaging with shareholders in the way we suggest might initially prove highly challenging. Extending the new model to wider stakeholders is likely to require substantial further debate and consultation, learning from early experience of the new approach to assurance. It may as a result delay the start of the much-needed reform process for some considerable time. Shareholders should be empowered now to engage with the long-term challenges faced by business, to the benefit of wider stakeholders and society as a whole.

What next?

This paper presents a vision for change in the UK, through a mix of voluntary action, regulation and new legislation. We also encourage interested parties around the world to explore what can be done in their own jurisdictions. Energised engagement with and by shareholders will be critical, along with a more active role for audit committees in determining the need for wider assurance. Indeed, all stakeholders will need to come together to consider specific ways of enabling and promoting understanding of this new vision for the future of assurance. ICAEW is keen to work with interested parties in this endeavour.

ICAEW is also ready to work with such parties to develop further the concepts and practices underpinning User-Driven Assurance. This essay represents our latest thinking on this topic, but we recognise that the business and regulatory environment is changing rapidly, and expect our ideas to continue to evolve in response to emerging issues and new developments.



We invite you to share your comments with us.

What are your thoughts on our proposals for actively engaging with the audit consumer and other users?

What other measures do you envisage would help to achieve this?

End notes

- ¹ ICAEW representation 64/19 *Independent Review into the Quality and Effectiveness of Audit*, ICAEW, 12 June 2019.
- ² The Business, Energy and Industrial Strategy Committee's *The Future of Audit* report references a delivery gap.
- ³ For example, ICAEW's Professional Standards publication *Inspect the results, Audit Monitoring 2019*.
- ⁴ For example, ICAEW's Audit and Assurance Faculty publication, *Improving audit quality using root cause analysis*, covers the essential questions of: What? Why? How? Who? and When? and includes a list of illustrative potential root causes.
- ⁵ For further information on the roles of the players in the financial reporting system refer to ICAEW's Audit and Assurance Faculty background paper, *Financial reporting: who does what?*
- ⁶ In the UK, for example, the Financial Reporting Council (FRC) has oversight of the regulation of statutory auditors: <https://www.frc.org.uk/auditors/professional-oversight/oversight-of-audit>.
- ⁷ Richard Brown (ed.), *A History of Accounting and Accountants*, T.T. and E.C. Jack, 1905, page 75.
- ⁸ This paper was published in *Accounting and Business Research* Volume 49, 2019 - Issue 5: International Accounting Policy Forum.
- ⁹ ICAEW Technical Release Guidance on financial position and prospects procedures (TECH 14/14 CFF).
- ¹⁰ EY's research into UK investors *Turning the tide to greater corporate accountability*, mentions the paramount importance of long-term business strategy and planning to investors.
- ¹¹ For further information, refer to ICAEW's climate hub at [icaew.com/climate](https://www.icaew.com/climate).
- ¹² ICAEW Technical Release Guidance on banking regulatory ratios (TECH 03/17 FSF).
- ¹³ University of Tennessee's C. Warren Neel Corporate Governance Center, 24 March 2017.
- ¹⁴ One way for audit committees to both understand and meet the assurance needs of shareholders, as well as communicate their assurance planning with them, could be by using an assurance map.
- ¹⁵ Our published *Future of Audit* thought leadership essays are available at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit).
- ¹⁶ New corporate governance reporting requirements in *The Companies (Miscellaneous Reporting) Regulations 2018*.
- ¹⁷ The UK Stewardship Code 2020 published by the Financial Reporting Council (FRC).

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](https://www.icaew.com/futureofaudit)

For more information on the faculty, the current work programmes and how to get involved, visit [icaew.com/audit](https://www.icaew.com/audit). For information on individual or corporate membership of the faculty, open to all, contact louise.thornton@icaew.com

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