



## INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Issued 12 June 2019

ICAEW welcomes the opportunity to respond to the Call for Views published on 10 April 2019 by the Independent Review into the quality and effectiveness of audit led by Sir Donald Brydon, a copy of which is available from this [link](#).

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 152,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and to apply the highest professional, technical and ethical standards.

Audit is currently undergoing an unprecedented level of scrutiny, and in recent months two other external reviews of the sector have made significant progress. The report of the Independent Review led by Sir John Kingman of the operation of the Financial Reporting Council (FRC) was published in December 2018, and the current three-month public consultation on its recommendations closed on 11 June 2019. The Competition and Markets Authority (CMA) completed its market study of statutory audit services and issued its final recommendations on 18 April 2019. We expect these will be subject to further consultation in the near future. Meanwhile, public and parliamentary interest remains high, as demonstrated by the decision of the Business, Energy & Industrial Strategy Parliamentary Select Committee (the BEIS Committee) to conduct its own inquiry into the future of audit earlier this year.

ICAEW had argued for some time that the natural and necessary complement to the work of the Independent Review of the FRC and the CMA should be a fundamental and independent examination of the role of audit itself, together with a review of corporate reporting. The expectations of investors and other stakeholders – such as employees, customers, suppliers and pension-holders – have rightly increased in recent years, and the purpose, scope and practice of audit need to keep pace. Sir Donald's Independent Review is therefore timely and has our full support. That said, we accept the analysis of the BEIS Committee that the audit sector currently shows evidence not just of an 'expectation gap' but a 'delivery gap' as well.

ICAEW feels strongly that early and urgent action to address public concerns regarding audit - alongside wider issues of corporate governance and management accountability – is vital to maintaining confidence in business. It therefore makes sense for the Government to get the process of reform under way, and to achieve as much as possible even in advance of any new legislation. Chartered accountants acknowledge this as a watershed moment for their profession and are ready to be willing partners in change. We look forward to working with all parties to produce effective measures which will improve quality and increase choice in the market, while ensuring that audit meets the future needs of the British economy and wider society.

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## MAJOR POINTS

### A NEW VISION FOR ASSURANCE

1. The so-called ‘expectation gap’ in audit is not new: it has developed over many years and previous attempts to address it have tended to be gradual rather than fundamental – and have generally achieved little. As long ago as 1992, *The Future Development of Auditing*, a paper published by the Auditing Practices Board, mentioned the ‘*gap between the role expected of auditors and that performed by them today*’. Most of the issues which are the subject of Sir Donald Brydon’s Independent Review (the Review) were also considered in detail in that paper. ICAEW urges this Review to think differently, and to embrace generational reform rather than incremental change. This is an opportunity to tackle the key challenges in a coherent, comprehensive and conclusive fashion which will help to restore trust in audit.
2. At the launch of his Call for Views Sir Donald commented: ‘*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*’. In direct response to that we recommend consideration of a radical new three pillar model of User-Driven Assurance, one directed by the needs of the primary user - the shareholders. This would comprise a range of assurance outputs, demanded and delivered as and when appropriate, and could involve multiple providers. Such an innovative and transformative approach would require significant effort to develop and implement but could be an effective way of meeting the needs of all users – and finally and fully closing the expectation gap.
3. We propose that the first pillar in User-Driven Assurance should be an improved version of the statutory audit product for shareholders, with a renewed focus on avoiding disorderly failure, fresh thinking on fraud, better audit reporting and championing proportionality to address the delivery gap. The second pillar would be provided by a range of other assurance engagements – as now. Such engagements are widely required or commissioned by government departments, regulatory bodies and other third parties, and include skilled person reviews (Section 166 and Section 166A reviews) for the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and the Bank of England. ICAEW plays a leading role in developing guidance for these important assurance engagements, including the guidance on skilled person reviews.
4. User-Driven Assurance builds on the IAASB’s assurance framework available from **IFAC**, which provides a frame of reference for those involved with assurance engagements. The IAASB has also developed standards such as ISAE 3000 on assurance engagements. This framework and these standards can be used to design assurance engagements, and, in our experience, the key to designing such engagements is to identify clearly who the users of the report are, and the purpose for which they want the assurance. 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.
5. Building on this proven approach (of the statutory audit and other defined assurance engagements for regulators and other bodies), we propose a third pillar: a significant empowerment of shareholders through new voting rights, enabling them to require the commissioning of assurance on a flexible and discretionary basis. It relies on improved communication between all parties including the directors, audit committees and auditors to engage with shareholders and understand and meet their needs. Given the importance

to shareholders of how the business generates value in the long term and consideration of the public interest, we are confident this User-Driven Assurance would be of significant value to other users. Section 172 of the Companies Act 2006 is relevant here. That 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, suppliers, the community and the environment. Coupled with the recent focus by policy makers on the Section 172 requirement and calls for the new regulator to continue to encourage directors to focus on this important aspect of their responsibilities, we anticipate that the exercise of the new voting rights will help address these wider interests.

6. Developing this User-Driven Assurance may require the exploitation of new technology and revision of the liability regime. In addition, there may need to be changes to UK law, which should define rigorously the purpose and nature of the core statutory audit but remain flexible regarding the other assurance engagements. It should empower shareholders to drive assurance. There may also be changes that can be achieved via changes to regulation rather than law.
7. ICAEW is ready to work with the Review to develop further the concept of User-Driven Assurance on these lines and is well-placed to facilitate the extensive discussion and collaboration between wider stakeholders that would be necessary to realise it fully and introduce it, including consideration of the operational aspects of the proposals.
8. In the context of this User-Driven Assurance, the 2019 paper by John Coffee (Adolf A. Berle Professor of Law and Director of the Centre on Corporate Governance at Columbia Law School) *Why Do Auditors Fail? What Might Work? What Won't?* has particular relevance and resonance. This paper was commissioned by ICAEW and presented at our Information for Better Markets 2018 conference, with a response from Michael Izza, ICAEW CEO. The paper was published in *Accounting and Business Research* Volume 49, 2019 - Issue 5: International Accounting Policy Forum, and is available [here](#). The paper describes auditors as 'gatekeepers' who pledge reputational capital that they have developed over many decades and many clients 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.
9. An audit is not – and should not be thought of as – an insurance policy against corporate failure, dependent for its effectiveness on punitive sanctions and the financial resilience of major audit firms. ICAEW recommends strengthening the 'gatekeeper' ethos because – unlike an insurance model – we believe this has the potential to encourage and facilitate entry into the audit market. Casting audit firms as 'reputational intermediaries' would support the development of niche providers with particular assurance specialisms, which would be further encouraged by the implementation of the kind of User-Driven Assurance set out above.
10. John Coffee's paper also mentions empowering shareholders by giving them greater ability to select and remove auditors as a means of strengthening their role as 'gatekeepers'. The Review may wish to consider this and other ways of deepening and widening the active engagement of shareholders with the business.

## A BETTER CORE PRODUCT

11. ICAEW believes that the core audit product for shareholders, the statutory audit, remains essential, but it must be improved to address the delivery gap. In our answers to the Review's specific questions (see below) we make several suggestions for change to statutory audit, the most important of which refer to:
- Avoiding disorderly failure;
  - Fresh thinking on fraud;
  - Better audit reporting;
  - Championing proportionality.
12. Starting with **avoiding disorderly failure**. Sir John Kingman believes that more could be done to '*avoid unnecessary and avoidable causes of major corporate failure*' and assigns much of the responsibility for this to the new regulator. We prioritise below the actions that companies, auditors and regulators should take to achieve this in relation to internal control, viability reporting and capital maintenance.
13. First, *internal control responsibilities of directors and auditors can and should be strengthened*.
- Kingman explores the potential for the introduction of a requirement similar to the Sarbanes-Oxley Act's Section 404 in the UK. The evidence suggests that despite significant problems in the early years, Section 404 resulted in an overall strengthening of internal control, and long-overdue maintenance of internal controls by companies. In the US, the COSO framework on which Section 404 is based provides appropriate criteria against which internal controls over financial reporting can be evaluated. Section 302 is also important and, in essence, makes the CEO and CFO directly responsible to the Securities and Exchange Commission (SEC) for the accuracy and fairness of the financial reports they are required to make, including the financial statements.
  - A robust framework, with clearly defined responsibilities and accountabilities for directors and auditors can and should be developed and implemented in the UK. ICAEW recommends that consideration should be given to the development of a UK framework based on the current duty under the Companies Act for companies to maintain adequate accounting records, and the current framework used by companies floating on (among other markets) the London Stock Exchange in fulfilling their regulatory obligation to establish procedures that '*provide a reasonable basis for them to make proper judgements on an ongoing basis about the company's financial position and prospects*'. The framework used by accountants reporting on compliance with this obligation is set out in ICAEW guidance<sup>1</sup>. This obligation is ongoing, and while few if any entities refresh their understanding of these responsibilities on a regular basis or seek recurring assurance on them, they could and should be required to do so.
  - The new regulator might be tasked with studying the development of a UK framework for internal controls over financial reporting based on these. Such a framework should not detract from the more flexible approach to internal control

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<sup>1</sup> ICAEW TECH 14/14CFF *Guidance on financial position and prospects procedures*.

more broadly, as currently set out in the FRC *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (September 2014). The new regulator could also be given powers to supplement directors' accountabilities and responsibilities under the Companies Act, enabling it to bring effective action.

- Our ideas for improving internal control responsibilities for directors and auditors are discussed in more detail below in paragraphs 86 to 97.
14. Second, *viability reporting should be improved, and a new assurance requirement introduced.*
- At present, as Kingman notes, many viability statements fail to provide useful intelligence and, in some cases, have failed to highlight impending distress. However, the concept of viability is crucial. Investors want a 'better indication that companies are looking at the longer term'. At the heart of this is more robust and more focused risk reporting on the business model. We need to examine how such risk reporting can be improved to provide a clear indication of the principal factors that could reasonably be considered to affect viability.
  - Our ideas for improving viability reporting and introducing a new assurance requirement are discussed in more detail below in paragraphs 103 to 114.
15. Third, *capital maintenance must be revisited.*
- Enforcement of the statutory capital maintenance regime and the impact of IFRS on capital maintenance have been criticised by some active investors and by the BEIS Committee, which recommended that the current regime be strengthened through disclosure of distributable reserves, an explicit auditor responsibility and the introduction of a solvency test for distributions. These are sensible initiatives; ICAEW has been calling for investigation of the merits of a solvency system for some time. That is a simpler system and consideration of its advantages should be accelerated.
  - Nonetheless, these are arguably not the main issues. The key concern is with levels of capitalisation themselves. No capital maintenance regime can be successful where capital levels are inadequate to withstand reasonable levels of stress. Non-financial corporates do not have the same public interest profile as banks and do not benefit from implicit and explicit state guarantees and so a full prudential regime is inappropriate. Therefore, the root causes of concerns about capital adequacy will need to be addressed in new ways. A frank debate should be held on the level of capital shareholders want to support a business.
  - In the coming months we will consider the development of proposals for reform, for submission to government.
  - Our comments on this matter are discussed in more detail below in paragraphs 154 to 164.
16. Turning to **fresh thinking on fraud**, the public expects auditors to detect material fraud and ICAEW and other professional and regulatory bodies need to support them robustly in their duties. But this is not enough. We need fresh thinking to recognise how and when fraudulent reporting occurs and equip management, boards and auditors to address this. There should be greater recognition of the conditions and pressures surrounding the exercise of judgement, how appropriate judgements can be supported and the point at



which previously reasonable judgements risk tipping over to being unreasonable and ultimately fraudulent as the situation changes. Once a direction of travel has been established it can be hard to reverse, particularly if business conditions worsen; a slippery slope down which, at some point, management behaviour slides over the line into what is later assessed to be fraud.

17. ICAEW accepts that it has a responsibility to equip its members to recognise the warning signs and to protect against these situations. Our thoughts on these issues are discussed in more detail below in paragraphs 180 to 193.
18. Whistleblowing also has an important role to play and more could be done to ensure that channels that enable or require whistleblowers to share their concerns with the new regulator are effective in encouraging these individuals to come forward. That requires careful definition of who may have a duty to blow the whistle and how such a duty is framed, while ensuring that a duty to report does not discourage voluntary disclosure. It is important that whistleblowers are confident that reports will receive attention from the new regulator and that confidentiality is respected as appropriate<sup>2</sup>.
19. Next, **better audit reporting**. Extended audit reports have increased the value of the audit, but we can go further. Auditors have already experimented with ‘graduated’ auditor findings, including commentary on positions adopted by companies. In addition to presenting a binary opinion and drawing attention to key audit matters, auditors can present graduated auditor findings that describe judgements as, for example, cautious, balanced or optimistic.
20. Graduated auditor findings can cover a wide range of disclosures, including commentary on, for example, which accounting estimates auditors believe are more risky, or those they consider to be at the more ‘aggressive’ end of the spectrum, on the overall degree of conservatism displayed in the preparation of the financial statements, or on the level of subjectivity involved in determining a valuation. We need to consider the comparability of such reports. Allied to this is the possibility of conveying some sense of the variation in the levels of assurance auditors are able to gather in different audit areas.
21. We understand that companies have not embraced this style of reporting universally or enthusiastically and it is important to understand the reasons for this. We stand ready to support the Review with an urgent exploration of ways of improving audit reporting, along with other communication between auditors and users, and how it might bring benefits to users, particularly in relation to key areas such as fraud discussed above.
22. Our comments on audit reporting and other aspects of auditor communication are discussed in more detail below in paragraphs 134 to 147 and 168 to 179.
23. Finally, **championing proportionality**. Robust regulation is crucial for Public Interest Entities where ownership and management are separate. Conversely, in a small owner-managed business, enabling appropriate professional support is likely to be more relevant to survival and success than increasing compliance obligations. Regulation should reflect the size and risks of the audited entity. In championing proportionality, we would emphasise:
  - The need to recognise that risks and incentives are very different for smaller and less complex entities – at this stage most of the measures proposed are intended to target Public Interest Entities. However, owner-managed businesses, which

<sup>2</sup> ICAEW’s report [How whistleblowing helps companies](#) explores this in more detail.



comprise the vast majority of businesses in the UK, do not typically have the agency conflicts that are present in Public Interest Entities with separate ownership and management. Such entities may not be willing or able to engage external consultants but may benefit greatly from the advice and support that can be offered by their auditor as a trusted business advisor.

- The significance of the IAASB's consultation on the audits of less complex entities – our Audit and Assurance Faculty is currently developing a response to this consultation paper. We expect responses to this consultation to influence the debate on the future of audit for such entities in the UK and internationally.
- The importance of not over-burdening the new regulator – the Independent Review of the FRC, the CMA and this Review, taken together, comprise a far-reaching programme of reform. The focus should be on building on the existing regulatory tools as far as possible, not reinventing the wheel, and, as discussed below, on a rigorous assessment of priorities.

## BETTER REGULATION PRINCIPLES

24. In considering the above, we stress the importance of applying Better Regulation principles. A rigorous impact assessment for the package of reforms - including the work of Sir John Kingman's Independent Review of the FRC and the CMA market study – taken together is essential. This has not been carried out yet and the government's own Better Regulation Framework suggests it should be. The overall cost of the package to business is likely to be very significant and it is essential that the expected benefits that justify this are carefully identified. To ensure that the final package of reforms is effective and delivers what is expected of it, it is essential that there is a comprehensive consultation with stakeholders once the detail of the measures and the results of impact assessments have been established.
25. To be clear, the problems we have witnessed with audit are in many cases simple failures of conduct or quality. They demand a simple but robust reaction that focuses on the core objectives of audit and avoids being distracted by less effective measures of peripheral impact. There are important actions to be taken to enhance and strengthen regulation for both auditors and directors. But the sheer scale of the proposed reforms and the work required to ensure that they are properly framed and assessed therefore means that there needs to be a rigorous upfront assessment of priorities. Without this, legislators and regulators will not have the capacity to do a proper job and public expectations of meaningful change will not be delivered.

## THE ROLE OF THE PROFESSIONAL BODY IN REFORM

26. We recognise in making suggestions for the future of audit and assurance the importance of our own role and responsibilities as a major professional body, and the potential for us to do more, starting with explaining better to those with an interest in audit and the audit profession what we and our members do. ICAEW determines the qualification and CPD requirements applicable to its membership, regulates and disciplines its members, encourages the development of an appropriate culture within member firms and provides members with appropriate guidance and advice. We also seek to influence the development of thinking and policy in the wider public interest. The most relevant aspects of our role are:

- Equipping members to meet both current and new public expectations;
  - Encouraging and contributing to the policy debate;
  - Developing new thinking.
27. Starting with **equipping members to meet both current and new public expectations**, we recognise that changes arising from the reform of audit will place new demands on ICAEW members. More specifically, the Review asks what audit needs to deliver to meet public expectations. With any extension of audit's scope, we need to ensure those doing it can deliver what the public expects to a high professional and ethical standard.
  28. Although auditors are well equipped to provide this additional assurance (and we explain above how this can be achieved) we do not take it for granted that this will be their exclusive professional preserve. In deciding who should provide new services and how they are provided, we can expect policy makers to focus on ensuring that there is a sound basis for confidence in the quality of those services. We recognise that we need to demonstrate that our qualification and CPD requirements can adapt to meet these new demands, and that we provide members with appropriate advice and guidance on technical and ethical issues and developments.
  29. With regard to **encouraging and contributing to the policy debate**, ICAEW is responding in detail to each of the audit-related reviews. We are closely engaged with the Review process, including through the involvement of Michael Izza, ICAEW CEO, in a personal capacity, on the Auditors' Advisory Group, and continue to stand ready to support its work in any way. We welcome the involvement of Sir Donald in ICAEW's Audit and Assurance Faculty's annual conference in October 2019.
  30. In determining the way ahead, we will continue to consult extensively with our members and ICAEW working groups and committees. We will also continue to engage closely with academics, for example via our participation in sessions on the Future of Audit at the BAFA (British Accounting and Finance Association) conference in May 2019.
  31. The debate about the future of audit will continue following the conclusion of this Call for Views, which has a short duration and is limited in scope, with, for example, further consultation expected on changing technologies and international aspects. ICAEW will continue to be active in encouraging discussion in coming months and will continue to share insights which may be of relevance to the debate.
  32. One key area we intend to focus on, largely absent from this Call for Views, is the attractiveness of the profession – that is, the degree to which firms can recruit and retain the best people – and assuring the quality of future professionals. The ICAEW 'AuditFutures' project *Time to Think* aims to work with young people to rethink the social role and purpose of the profession, and to explore fresh ideas for the future development of auditors<sup>3</sup>.
  33. The scope of the AuditFutures programme is currently being adapted to ensure that it contributes in the best possible way to addressing current and future concerns about audit and the audit profession.
  34. Importantly, we will also in due course facilitate discussion and the sharing of experience around the implementation and consequences of the changes brought about by the

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<sup>3</sup> Other projects in this programme include *Ethos: A guiding compass for the future professional* (introducing the new concept of ethos and emphasising the significance of character, qualities and purpose as necessary in guiding the work of our members), and *Future professional: the journey*, (which calls for broader professional education).

current reform process. We anticipate that the Audit Quality Forum (AQF) will play a major role. The AQF, hosted by ICAEW and supported by the FRC, ICAEW and BEIS, has encouraged open and constructive debate among stakeholders about how to improve audit quality over the past 15 years, and we see that role as being highly relevant in the coming years.

35. Finally, on **developing new thinking** ICAEW also plays a key role here, working closely with academics and others. In particular, the Audit and Assurance Faculty is currently producing a series of succinct thought leadership essays that consider a range of issues directly or indirectly relevant to the debate. The essays and related events are intended to help directors, politicians and policy makers understand the key issues and will, among other things, help to inform the various reviews currently in progress.
36. The Faculty has very recently published two background papers to support the thought leadership essays. *Financial reporting: who does what?* 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. *What auditors do: the scope of audit* explains what auditors do, why audits are necessary and their current limitations, and what auditors do and don't audit. Further papers will be issued in the coming months.
37. ICAEW also has a catalogue of existing policy and thought leadership reports, including many of direct relevance to the current debate about the future of audit<sup>4</sup>. These reports include several proposals for action which the Review may wish to consider. ICAEW has issued a number of other publications of relevance to the current debate<sup>5</sup>.
38. The AQF, referred to above, has also produced a series of **influential papers exploring how to improve audit quality**, many of which may be of relevance to the debate. Copies of all these reports have been delivered to the Review team.

## UK GLOBAL LEADERSHIP

39. While we fully acknowledge the significance and impact of recent corporate failures, and acknowledge the need for fundamental change, it is important to recognise that the UK audit sector operates to rigorous professional and technical standards and is recognised internationally as high calibre. Alongside the work of the Independent Review of the FRC and the CMA, this Review provides the opportunity for the UK to show global leadership in developing solutions to issues under consideration in many other major jurisdictions around the world. We should not hesitate to do this.

<sup>4</sup> For example, the ICAEW Audit and Assurance Faculty has published:

- *The start of a conversation* (July 2017), which examines lessons learned from the extension of auditor reporting;
- *The use of data analytics by external auditors* (March 2016), which explores the use of new technology by auditors;
- *Scepticism: The practitioners' take* (June 2018), which gives auditors a voice on the importance of challenge; and
- *Improving audit quality using root cause analysis* (October 2016), guidance on using root cause analysis to identify the underlying key causes behind audit quality review findings.

<sup>5</sup> Relevant ICAEW publications include:

- The Financial Reporting Faculty thought leadership report *What's next for corporate reporting: time to decide?* This sets out key policy questions that need to be addressed before a step change in the quality of corporate reporting can be made.
- The Financial Services Faculty guidance TECH 03/17/FSF *Assurance on banking regulatory ratios*.
- The Corporate Finance Faculty guidance TECH 14/14CFF *Guidance on financial position and prospects procedures*.
- The Corporate Finance Faculty Exposure Draft, updated guidance on Prospective Financial Information: *Consultation on guidance for preparers of prospective financial information*.

40. Particularly in the light of the likely exit of the UK from the European Union, we also highlight the importance of this country maintaining a fair, open, welcoming economy for inward investment: robust audit and corporate reporting are a key part of this, but it must not be at disproportionate cost. We should be careful to ensure that the package of measures supports and strengthens the audit profession in the UK and does not impede its international competitiveness as a key export sector.

## ANSWERS TO SPECIFIC QUESTIONS

### CHAPTER 1: DEFINITIONS OF AUDIT AND ITS USERS

**Question 1: For whose benefit should audit be conducted? How is it of value to users?**

**Question 2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?**

#### **The fundamental value of audit**

41. Audit is and should be conducted for the benefit of the shareholders. Its core value to users is the provision of an independent opinion on the truth and fairness of the financial statements prepared by the directors – a clear purpose, long enshrined in UK law and replicated in many other jurisdictions. The independent opinion provided does and should enhance the confidence of shareholders in using financial statements to assess the stewardship of directors and their management of the business.
42. The statutory audit also requires auditors to assess and address any potential threats to their independence. One thing we can start to change now is the view of who is the ultimate client. We need to reinforce the point that it is not the company being audited. And we could start this cultural shift by ceasing to refer to them as 'the audit client'. We are all guilty of this – but the company is not the client, its shareholders are.
43. Audit was developed in response to agency risks because of the principal: agent relationship existing between the shareholders, as the principals, and the directors, as their agents. Audit provides an independent check on the agents for the principals, which addresses the need for trust and confidence between the shareholders and the directors. Audit therefore plays a fundamental stewardship role.
44. In *A History of Accounting and Accountants*, it is stated:
 

*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.*

Richard Brown (ed.), *A History of Accounting and Accountants*, T.T. and E.C. Jack, 1905, page 75.

We consider that this fundamental purpose of auditing remains unchanged.
45. Corporate reporting and audit are mandatory for certain entities because it is in the public interest. We recognise the need to reflect that public interest in considering how audit is of value to users. Users may include potential investors, employees, customers, suppliers and wider society, and the needs of users may, of course, differ and conflict. We therefore recognise that the current corporate reporting and audit model may not meet the needs of all users.

#### **A new vision for assurance**

46. At the launch of his Call for Views Sir Donald commented: *'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'*. In direct response to that we recommend consideration of a radical new three pillar model of User-Driven Assurance, one directed by the needs of the primary user - the shareholders. This would comprise a range of assurance outputs, demanded and delivered as and when appropriate, and could involve multiple providers. Such an innovative and transformative approach would require significant effort to develop and

implement but could be an effective way of meeting the needs of all users – and finally and fully closing the expectation gap.

47. We propose that the first pillar in User-Driven Assurance should be an improved version of the statutory audit product for shareholders, with a renewed focus on avoiding disorderly failure, fresh thinking on fraud, better audit reporting and championing proportionality to address the delivery gap. The second pillar would be provided by a range of other assurance engagements – as now. Such engagements are widely required or commissioned by government departments, regulatory bodies and other third parties, and include skilled person reviews (Section 166 and Section 166A reviews) for the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and the Bank of England. ICAEW plays a leading role in developing guidance for these important assurance engagements, including the guidance on skilled person reviews.
48. User-Driven Assurance builds on the IAASB's assurance framework available from **IFAC**, which provides a frame of reference for those involved with assurance engagements. The IAASB has also developed standards such as ISAE 3000 on assurance engagements. This framework and these standards can be used to design assurance engagements, and, in our experience, the key to designing such engagements is to identify clearly who the users of the report are, and the purpose for which they want the assurance. 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.
49. Building on this proven approach (of the statutory audit and other defined assurance engagements for regulators and other bodies), we propose a third pillar: a significant empowerment of shareholders through new voting rights, enabling them to require the commissioning of assurance on a flexible and discretionary basis. It relies on improved communication between all parties including the directors, audit committees and auditors to engage with shareholders and understand and meet their needs. Given the importance to shareholders of how the business generates value in the long term and consideration of the public interest, we are confident this User-Driven Assurance would be of significant value to other users. Section 172 of the Companies Act 2006 is relevant here. That 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, suppliers, the community and the environment. Coupled with the recent focus by policy makers on the Section 172 requirement and calls for the new regulator to continue to encourage directors to focus on this important aspect of their responsibilities, we anticipate that the exercise of the new voting rights will help address these wider interests.
50. Developing this User-Driven Assurance may require the exploitation of new technology and revision of the liability regime. In addition, there may need to be changes to UK law, which should define rigorously the purpose and nature of the core statutory audit but remain flexible regarding the other assurance engagements. It should empower shareholders to drive assurance. There may also be changes that can be achieved via changes to regulation rather than law.
51. ICAEW is ready to work with the Review to develop further the concept of User-Driven Assurance on these lines and is well-placed to facilitate the extensive discussion and collaboration between wider stakeholders that would be necessary to realise it fully and introduce it, including consideration of the operational aspects of the proposals.



52. In the context of this User-Driven Assurance, the 2019 paper by John Coffee (Adolf A. Berle Professor of Law and Director of the Centre on Corporate Governance at Columbia Law School) *Why Do Auditors Fail? What Might Work? What Won't?* has particular relevance and resonance. This paper was commissioned by ICAEW and presented at our Information for Better Markets 2018 conference, with a response from Michael Izza, ICAEW CEO. The paper was published in *Accounting and Business Research* Volume 49, 2019 - Issue 5: International Accounting Policy Forum and is available [here](#). The paper describes auditors as 'gatekeepers' who pledge a reputational capital that they have developed over many decades and many clients 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.
53. An audit is not – and should not be thought of as – an insurance policy against corporate failure, dependent for its effectiveness on punitive sanctions and the financial resilience of major audit firms. ICAEW recommends strengthening the 'gatekeeper' ethos because – unlike an insurance model – we believe this has the potential to encourage and facilitate entry into the audit market. Casting audit firms as 'reputational intermediaries' would support the development of niche providers with particular assurance specialisms, which would be further encouraged by the implementation of the kind of User-Driven Assurance set out above.
54. John Coffee's paper also mentions empowering shareholders by giving them greater ability to select and remove auditors as a means of strengthening their role as 'gatekeepers'. The Review may wish to consider this and other ways of deepening and widening the active engagement of shareholders with the business.

### ***A better core product***

55. ICAEW believes that the core audit product for shareholders, the statutory audit, remains essential, but it must be improved to address the delivery gap. In our answers to the Review's specific questions (see below) we make several suggestions for change to statutory audit, the most important of which refer to:
- Avoiding disorderly failure;
  - Fresh thinking on fraud;
  - Better audit reporting;
  - Championing proportionality.

These suggestions are considered further above in our Major Points section.

### ***Question 3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?***

56. UK law already provides clarity regarding the current purpose of an audit, and for whom it is conducted. Under UK law, auditors are appointed by and report to the shareholders of the company. As confirmed by the *Caparo Industries v Dickman* case, auditors are directly accountable and hence owe a duty of care to the company's existing shareholders as a body. However, if changes are made to the current scope and purpose of audit, there may be a need for consequential changes to relevant UK law.
57. UK law also covers the responsibilities and accountability of directors, which need to be revisited, along with a consideration of the responsibilities and accountability of other players in the financial reporting system.



58. We support an increased emphasis on Section 501 of the Companies Act – the legislation that makes it a criminal offence to provide misleading information to auditors. Greater focus on this would reinforce the obligations of executives and directors to provide auditors with all the information they need. This legislation has been held by the Court of Appeal not to apply to companies under its present drafting. Consideration should be given to changing the legislation to allow prosecution of companies and conferring this power on the new regulatory body.
59. We do also envisage the need for changes to UK law, including to empower shareholders, to realise our new vision for assurance set out in our answers to Questions 1 and 2 above.

## CHAPTER 2: THE ‘EXPECTATION GAP’

### **Question 4: Do respondents consider there is an expectation gap?**

60. Yes. The so-called ‘expectation gap’ in audit is not new and has been researched extensively. As considered in ICAEW’s Audit Quality Forum paper on *Stakeholder expectations of audit*, there are multiple expectation gaps, and the gaps vary over time and by stakeholder.
61. The expectation gap has developed over many years and previous attempts to address it have tended to be gradual rather than fundamental – and have generally achieved little. As long ago as 1992, *The Future Development of Auditing*, a paper published by the Auditing Practices Board, mentioned the ‘*gap between the role expected of auditors and that performed by them today*’. Most of the issues which are the subject of the Review were also considered in detail in that paper. ICAEW urges this Review to think differently, and to embrace generational reform rather than incremental change. This is an opportunity to tackle the key challenges in a coherent, comprehensive and conclusive fashion which will help to restore trust in audit. As explained further in our Major Points section, we recommend consideration of a radical new three pillar model of User-Driven Assurance, one directed by the needs of the primary user - the shareholders. This would comprise a range of assurance outputs, demanded and delivered as and when appropriate, and could involve multiple providers.

### **Question 5: If so, how would respondents characterise that gap?**

62. The expectation gap is of serious concern. We broadly agree with its characterisation in this Review and believe that it is particularly evident in relation to a number of items considered elsewhere in this Call for Views, including disorderly failure and fraud.

### **Question 6: Is there also a significant ‘delivery’ or ‘quality’ gap between auditors’ existing responsibilities in law and auditing standards, and how those responsibilities are currently met?**

63. Yes. There is clearly a ‘delivery’ or ‘quality’ gap as referenced by the BEIS Committee and evidenced in audit monitoring reports by the FRC and professional bodies, including ICAEW. It is important to address this gap and one key way of doing so is our proposed improvements to the statutory audit, as considered further in our Major Points section, with a renewed focus on avoiding disorderly failure, fresh thinking on fraud, better audit reporting and championing proportionality. ICAEW’s Audit and Assurance Faculty provides support and guidance on audit quality including:

- Using root cause analysis to identify the underlying key causes behind audit quality review findings. Our 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.
  - *Quality control in the audit environment*, a guide which includes illustrative policies and procedures on seven key areas.
64. ICAEW's monitoring report is also designed to offer help and support to improve audit quality. In *Audit Monitoring 2019*, just published on our website, we include examples of good practice as well as case studies on areas to improve. In addition we have a series of webcasts on key topics to help firms get it right.
65. We also note the importance of the IAASB's current quality management consultations and consider the use by auditors of professional scepticism to be key to audit quality. The Audit and Assurance Faculty thought leadership report, *Scepticism: The practitioners' take*, gives auditors a voice on the importance of challenge and includes a number of calls for actions which the Review may wish to consider.
66. The quality gap may be subject to its own expectation gap, as there may be some confusion among the public regarding the meanings behind audit inspection findings. We suggest that, working with other regulators internationally, the new UK regulator explores ways of improving communication of the significance of audit findings, alongside considering ways of aligning such findings internationally and putting them into context as standards of quality may vary from country to country.

### CHAPTER 3: AUDIT AND WIDER ASSURANCE

#### **Question 7: What should be the role of audit within wider assurance?**

67. Audit is the first pillar in User-Driven Assurance, as explored further in our Major Points section, with the second and third pillars covering wider assurance. The distinction between audit and other assurance engagements is crucial to auditors but can be confusing for some users. Audit and assurance are words that are used differently in various contexts, which further complicates understanding.
68. As stated in our responses to the questions on the definitions of audit and its users, an audit is an independent opinion provided to the shareholders on the truth and fairness of the financial statements that are prepared by the directors. By contrast, in other assurance engagements both the users and the information can vary significantly, as can the level of assurance and liability. Key to scoping such other assurance engagements is engaging with users and understanding their needs.
69. Our Audit and Assurance Faculty has sought to clarify the meaning and comparative value of different types of assurance engagements, for example by providing [online resources](#). The Faculty is moreover working with the World Business Council for Sustainable Development (WBCSD) to co-produce a 'Buyers' guide to assurance', to be published later in 2019. The purpose of the publication is to address common misconceptions by explaining assurance in simple terms, as well as highlighting considerations for companies looking to engage an assurance practitioner.
70. We consider the question posed to be about the way different types of assurance engagements, including audit, fit together, which will also need to consider their

interaction with internal audit. It is this holistic view that will provide crucial insights for audited entities seeking to manage their business risks. The Faculty's online resources also include information on the 'lines of defence' and on mapping the different types of risk responses over them, as well as **resources** to support internal auditors.

**Question 8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?**

71. The overall 'reasonable' level of assurance that an audit provides is high but not absolute and cannot currently vary. However, the value of the audit to users may vary depending on the business sector in question and the nature of the entity's business risks. There may well be variation in what keeps auditors awake at night regarding the assurance obtained on entities in different business sectors and with different risk profiles. Auditing standards and methodologies already take this into account and it will be reflected in the work procedures performed by auditors. This is a simple function of risk being the inverse of assurance.
72. In the banking sector, for example, information about a bank's capital ratio and risk-weighted assets (banking regulatory ratios) is of particular importance to investors but is not required to be included in the financial statements. This arguably decreases the relative value of the audited financial statements for those investors. Our Financial Services Faculty created a framework for assurance on **banking regulatory ratios**, which can be used by auditors, other assurance providers and internal auditors to provide options to boards and investors seeking to fill this 'assurance gap'.
73. We recommend that the new regulator considers the value of developing specific auditing standards and / or guidance to support certain business sectors; the same basic auditing standards may also apply, including the same level of assurance, but with extra requirements for auditors' work and reporting for the business sector in question.
74. We note that User-Driven Assurance set out in our Major Points section above may include varying levels of assurance.

**Question 9: Are the existing boundaries between internal and external audit clear?**

75. Yes. We consider the existing boundaries between internal and external audit to be clear to key players, including internal and external auditors, directors and audit committees. However, they may not be clear to all users.
76. A key distinction between internal and external auditors is the independence requirements for external auditors. Investors have told us that such independence requirements are important to address any conflicts of interest, so that they have trust and confidence in the audit process, the financial statements and the directors.
77. Internal auditors have also flagged to us the work they perform in relation to areas such as culture, as discussed in our answer to Question 55. While we do not consider that extending the scope of audit to cover culture should be an immediate priority for this Review, we nonetheless recognise the importance of the work performed by internal auditors and continue to publish **resources** to support them.

**Question 10: To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?**

78. This is a topic worthy of further consideration. External auditors tell us that the limitations on the use of the work of internal auditors are restrictive and they rarely use evidence

obtained from this source in drawing conclusions. However, audited entities may wish for greater use of the work of internal auditors by external auditors to save cost and time.

79. Internal auditors tell us they have urged external auditors to make greater use of such evidence, while acknowledging the need for internal audit to change, calling for an extension of the *Financial Services Code*, published by the Chartered Institute of Internal Auditors, to other sectors. They have told us that there are factors which compromise, or have the potential to compromise, their objectivity. These include the control of their budget, and the remuneration, performance assessment, and hiring and firing, of heads of internal audit.
80. We note that the objectivity of internal audit would be enhanced by avoiding any reporting line that does not have accountability to non-executive directors.
81. Our internal audit panel is expecting in the coming weeks to publish a new report *Setting priorities to establish and expand internal audit* and we will share this with the Review team.

**Question 11: Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?**

82. A significant issue that would need to be addressed if the market were to be opened up, would be the level of understanding of accounting and auditing standards that are necessary to audit accounts. The suggestion to widen the provision of audit services to consultants and IT firms, greatly underestimates in our view the complexity and nature of large company audit. It is rare for material errors to arise from the processing of transactions. Rather, the principal risk areas are those that involve management judgement (such as valuation of work in progress or revenue recognition). It is hard to conceive that an alternative provider could form an opinion on financial statements without having the requisite professional expertise.
83. The legislation that governs who can be a registered auditor is derived from EU law and requires firms that conduct audits to be at least half-owned by qualified auditors, and such individuals to be members of Recognised Supervisory Bodies. When firms meet those criteria and are prepared to operate under the audit and ethical standards, they are given recognition. The legislation on who can be an auditor, and the professional standards set by the supervisory bodies, recognise that business are complex, accounting for them is complex, and a high degree of understanding of those accounts is required to be able to audit them.
84. While independence is of great importance when conducting an audit, the ownership requirements for entities providing audit services could become more principles based. We acknowledge, as this review does, that an audit is only of value if it is undertaken by individuals who are independent of the audited entity. However, as long as it were to remain possible to maintain the fundamental principles of professional ethical behaviour, both actual and perceived, and governance procedures of any audit provider prevented interference in the audit work, more innovative ownership structures for audit providers could be considered. Any change in this area would require a change in the legislation that governs registered auditor eligibility.
85. The fundamental principles referred to above are vital to the performance of work to a professional standard. They encompass not just objectivity and the related independence requirement, but integrity, professional competence and due care, confidentiality and

professional behaviour. In particular in this context, independence does not of itself result in professional competence.

## CHAPTER 4: THE SCOPE AND PURPOSE OF AUDIT

### *Risk and internal controls*

#### **Question 12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?**

*We assume in the light of the accompanying text that this question refers to the management of financial reporting risk and internal controls over financial reporting, rather than controls over and the management of broader operational and other risks to businesses. Risk management is one component of internal controls over financial reporting, and our references to internal controls over financial reporting below can be taken to cover both.*

86. Yes, directors should make a more explicit statement in respect of internal controls over financial reporting, and, yes, such a statement should be subject to audit, acknowledging that any new and robust reporting regime must be capable of standing the test of time and avoid the unnecessary cost and excess initially experienced in the US.
87. The responsibilities of directors and auditors relating to internal controls over financial reporting can and should be strengthened. Sarbanes-Oxley increased directors' responsibilities relating to the maintenance of internal controls and the preparation of company accounts in the early 2000s in the US and the evidence suggests that, despite significant problems in the early years, Section 404 resulted in an overall strengthening of internal control, and long-overdue maintenance of internal controls by companies. The improvement in the US arose primarily from changes made by directors and a focus on director accountability is therefore critical.
88. In the US, the COSO framework on which Section 404 is based is needed to provide appropriate criteria against which internal controls over financial reporting can be evaluated. The detailed requirements of the COSO framework for internal controls over financial reporting have been embedded in US corporate culture for decades, and while there are valuable lessons to be learned from Sarbanes-Oxley, it cannot and should not simply be transplanted to the UK. The COSO framework is designed to operate in a very different legal, economic and business environment. It is easy to underestimate these differences and they are beyond the scope of this response, but we would be happy to discuss them in more detail.
89. Section 302 is also important and, in essence, makes the CEO and CFO directly responsible to the Securities and Exchange Commission (SEC) for the accuracy and fairness of the financial reports they are required to make, including the financial statements.
90. A robust framework, with clearly defined responsibilities and accountabilities for directors and auditors can and should be developed and implemented in the UK. It needs to be balanced and proportionate in order to ensure that the UK retains its reputation as an attractive and stable place for international businesses to invest. Two options are worthy of further consideration in this context, namely the development of a UK framework based on:
  - (a) the current duty under the Companies Act for companies to maintain adequate accounting records. The importance of this requirement is not always appreciated.



Every company must keep accounting records that are sufficient to show and explain the company's transactions, to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and to enable the directors to ensure that any accounts required to be prepared comply with relevant requirements.

- (b) the current framework used by companies floating on (among other markets) the London Stock Exchange in fulfilling their regulatory obligation to establish procedures that *'provide a reasonable basis for them to make proper judgements on an ongoing basis about the company's financial position and prospects'*. The framework used by accountants reporting on compliance with this obligation is set out in ICAEW guidance Tech 14/14CFF *Guidance on financial position and prospects procedures*. This obligation is ongoing, and while few if any entities refresh their understanding of these responsibilities on a regular basis or seek recurring assurance on them, they could be required to do so.

The new regulator might be tasked with studying the development of a UK framework for internal controls over financial reporting based on these. Importantly, in both cases, some element of controls over forward looking information are covered. Such a framework should not detract from the more flexible approach to internal control more broadly, as currently set out in the FRC *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (September 2014). The new regulator could also be given powers to supplement directors' accountabilities and responsibilities under the Companies Act, enabling it to bring effective action.

91. Our Audit and Assurance Faculty is expecting to publish a thought leadership essay on this topic in the near future and will share this with the Review team.

**Question 13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?**

*In our answer to Question 12 above, we discuss the possibility of enhanced reporting by directors and auditors on internal controls over financial reporting. In answering this question, we deal with the current requirements of UK auditing standards relating to work on internal controls for the purposes of the financial statement audit.*

92. Auditors of listed companies invariably test internal controls over financial reporting in listed company audits to a certain degree to be able to reduce the reliance on substantive testing to a manageable level. They have no choice. Regardless of the option in auditing standards to take a substantive approach (one generally used for much smaller audits), it is not practical to run a large company, or perform a large audit, without reference to internal controls over financial reporting. We agree that more use could be made of 'key audit observations' in the audit report to cover internal controls over financial reporting, and note that the FRC has recently encouraged auditors to do so.
93. The UK auditing standard dealing with internal controls over financial reporting – ISA 315 on risk assessment – is currently being revised. It deals with the auditor's approach to understanding the design, implementation and testing of internal controls over financial reporting. The last major overhaul of that standard took place in 2003 and one of the principal objectives of the current revision is to reflect developments in technology. We believe that the changes now being considered will help auditors deal more effectively with internal controls over financial reporting.

94. This modernisation of requirements is not the only development in this area. New projects on audit evidence and group audits are underway and they too will consider some of the more complex aspects of the audit approach to internal controls over financial reporting, including the use of data analytics in controls testing, as well as the control and other implications of the use of shared service centres, and outsourcing issues.
95. The FRC and other audit regulators have made detailed observations on shortcomings in auditor approaches to internal controls over financial reporting in recent years. These shortcomings may be caused by implementation issues that auditors should continue to address within their methodologies. Auditing standards are being modernised in this area and we do not believe that further action is called for at this point. Auditors' responsibilities for assessing the effectiveness of an entity's system of internal control are indeed being extended and clarified through the revision to ISA 315.

**Question 14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?**

96. We believe that calls for auditors to report publicly on internal controls over financial reporting, and on other controls where relevant, are worthy of consideration. Using auditor reporting to audit committees as a starting point is just one possibility and other possible approaches should be considered.
97. We caution though against raising expectations excessively in this area. Investors should not be led to believe that public reporting on internal controls over financial reporting is a panacea: public reporting might be expected to improve or enhance the quality of internal controls over financial reporting directors implement, the work auditors perform on them and investor understanding, but none of these things is guaranteed. If auditors are required to report a binary pass/fail opinion on the effectiveness of internal controls over financial reporting, it seems highly likely that some directors will do whatever it takes to obtain a 'pass', but no more. If instead auditors are required to provide more nuanced views on more detailed aspects of internal controls over financial reporting, questions would inevitably arise about the auditors' overall view. If both were provided (a pass/fail opinion and more nuanced views) questions would arise about the extent to which the latter compromises the former.

**Going concern**

**Question 15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?**

98. We suggest in our Major Points section that the priority for this Review should be the viability statement, rather than the current regulatory framework for going concern, as explained in our answers below. This is important in relation to proportionality as the current regulatory framework for going concern applies to all companies whereas the viability statement does not. Nonetheless, we agree that further consideration should also be given to the current regulatory framework for going concern. This is a key example of an area where there is an expectation gap, and it is important to understand the current role auditors' play in relation to going concern.
99. While the reasons for high profile corporate failures tend to be complex, the 'truth and fairness' of the financial statements is rightly called into question. As discussed in more detail in our publication, *Financial reporting: who does what?*, 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 corporate collapses do not typically 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.

100. We are currently responding to the FRC's current going concern consultation, and we are making several suggestions for the FRC to consider, including the case for undertaking root cause analysis in relation to recent corporate failures. We agree that this is a topic which the Review should revisit after the FRC's consultation has concluded. We note that the FRC's consultation proposes changes to the auditing standard in isolation, while we believe that any proposed changes to the current regulatory framework (including international accounting standards) should be considered together.

***Question 16: Should there be greater transparency regarding identified 'events or conditions that may cast significant doubt on the entity's ability to continue as a going concern'?***

101. While we accord much greater weight to a reform of viability reporting, greater transparency regarding identified '*events or conditions that may cast significant doubt on the entity's ability to continue as a going concern*' may be worthy of further consideration.
102. The future performance of a company is inherently complex and difficult to predict due to the number of internal and external factors at play. Perhaps worthy of consideration is a move away in going concern disclosures from a binary assessment of whether or not there are material uncertainties towards directors providing more informative insights on, for example, 'close call' assessments – situations where potential events or conditions exist that directors conclude do not result in material uncertainty but nonetheless present some uncertainty that could threaten an entity's ability to continue as a going concern.

### ***Viability***

***Question 17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?***

103. No, if a separate new statement is envisaged, as we explain below. However, we think that reporting on viability is an area ripe for improvement, and first comment on this below.
104. The usefulness of current viability statements has been questioned by some commentators, including Kingman, who recommended either reforming the requirements to make the statements more useful, or removing them altogether. We strongly support the former approach. We acknowledge that predicting the future viability of a company is a complex and difficult exercise for management. However, as Kingman notes, many viability statements fail to provide useful intelligence and, in some cases, have failed to highlight impending distress, and we believe that directors could and should improve the disclosures in viability statements, providing more meaningful insights into the viability of the business and avoiding boilerplate language.

105. We agree with Recommendation 52 of Sir John Kingman's Review, that it would be helpful to carry out a review of viability statements with a view to finding ways to make them more useful and understandable. This should cover their scope and style: the concept of viability is crucial. At the heart of this is more robust and more focused risk reporting on the business model. We need to examine how such risk reporting can be improved to provide a clear indication of the principal factors that could reasonably be considered to affect viability.
106. In undertaking a review, reference should be made to the FRC's Financial Reporting Lab's November 2017 report, *Risk and Viability Reporting*, which usefully identified factors that might help enhance how companies talk about viability. The report suggested that investors want a *'better indication that companies are looking at the longer term'* and to *'explain how they consider longer term prospects'*. A review should also cover their frequency and timing: there might be a case for reporting more than once a year.
107. We also believe that the new regulator should focus on these statements as part of their Corporate Reporting Reviews and prioritise working with companies to improve their disclosures. The new regulator may also wish to consider the development of new guidance for directors in this area.
108. We agree with the Review that there is scope to improve the comments of directors on the sustainability of the entity's business model beyond that already provided in the viability statement. However, it is unclear to us whether one or two statements are being proposed by the question above, ie, a viability statement and a statement about the sustainability of the entity's business model or a single statement. Rather than introduce a new requirement, we suggest a better approach would be to carry out a broader review of the existing viability statement framework in order to improve, among other things, how directors report on their assessment of the long-term sustainability of the entity's business model. We are not convinced that introducing a sustainability statement on top of the existing requirement for a viability statement would be understood by users.
109. Whatever changes are made to the current viability report, dialogue by companies with investors will be key. This process should not be a one-off process, but a regular, iterative one, that re-assesses over time changes to investor appetite and interest, and involves removing information included in prior year statements that is no longer needed.

**Question 18: Should such a statement be subject to assurance?**

110. Yes, the viability statement should be subject to assurance as the second pillar of User-Driven Assurance. However, as we acknowledge above, predicting the future viability of a company is complex and difficult, and assuring such statements is, naturally, even more challenging. The longer the period being considered, the more difficult it is. Nonetheless, we think auditors should and would rise to the challenge of providing an agreed form of assurance and we would support such a change to the current regime.
111. The form of that assurance would be a key matter for discussion and investigation. Auditors might for example assess the process followed in preparing these statements and review them for reasonableness. There may be scope to provide positive comments on the extent of stress testing, reverse stress testing the linkage between the principal risks and uncertainties and the scenarios modelled. The need for new guidance for auditors on such reviews would be an important consideration.
112. A final decision on this matter will require careful consideration. A cost: benefit assessment is required, including consideration of other changes introduced by the

Review in relation to forward-looking information. The risks of proposed changes will also need to be addressed. For example, we have heard concerns that attempting to assure predictions of the future or the sustainability of a company's business model may result in a new expectation gap: investors and the public may view audit sign off as a guarantee that a company will succeed. This would not be a good outcome of the reform process.

**Question 19: Who might be capable of giving such assurance?**

113. Auditors would be capable of giving such assurance. We note that the work needed to assure these statements may be akin to that undertaken by reporting accountants when performing a working capital review. Auditors would be able to draw on existing skills and their knowledge of the entity and industry to provide such assurance, although as discussed in our Major Points section above, ICAEW recognises that we need to ensure our members can deliver what the public expects to a high professional and ethical standard and that we need to demonstrate that our qualification and CPD requirements can adapt to meet these new demands. We also recognise that the assurance opinions provided would have inherent limitations.
114. Our Audit and Assurance Faculty is expecting to publish a thought leadership essay on this topic in the near future and we will share this with the Review team.

**Unaudited information**

**Question 20: Is there a case for a more forward-looking audit? What would be the main benefits and risks?**

*We interpret this question as referring to unaudited information, including forward-looking information. International accounting standards already require significant consideration of forward-looking information.*

115. Yes. We believe that there is a strong case for a more forward-looking audit, assuming sufficient demand for it. Since the 2008 financial crisis, increased importance has been placed on disclosing information that explains how an organisation generates value in the long term.
116. In ICAEW Financial Reporting Faculty's 2017 thought leadership report, *What's next for corporate reporting: time to decide?*, we engaged with a diverse range of key stakeholder groups to build a consensus view on the future of corporate reporting. A common refrain in these conversations related specifically to this matter. Those we spoke to pointed to the increasing relevance of the 'front end' of the annual report to investors, as well as other users.
117. As discussed in more detail in *Financial reporting: who does what?*, what is not well understood is the fact that much of the information in the annual report is unaudited. This is a key part of the expectation gap. Before change is effected in this area however, there are a number of challenges that need to be addressed. In particular, non-financial reporting frameworks, such as on environmental, social and governance matters, are much less well developed and established than financial reporting frameworks, such as IFRS. Standardisation of such frameworks is necessary. Further, the systems, processes and controls of companies are still evolving in respect of non-financial information. Thus, it may be useful for changes to be made initially to relevant frameworks and company processes before the role of the auditor is expanded.

118. We also recognise that forward-looking information can be highly subjective and difficult to assure. There may therefore be a need to vary the level of assurance and to communicate clearly the work done and its limitations, for example by including disclosures in the audit report, as discussed elsewhere in this submission. One option worth exploring for some assurance work is testing the process of preparing the information rather than the information itself.
119. ICAEW has been a pioneer in establishing principles for the preparation of forward-looking information. In 2003 we published a framework for preparing prospective financial information (PFI) that is subject to UK capital markets regulation. *Prospective Financial Information: Guidance for UK Directors* (the 2003 guidance) was warmly welcomed by regulators and businesses as it helped meet the information needs of users. Since then, the 2003 guidance has become embedded in the preparation of PFI in a regulated capital markets context.
120. In December 2018, ICAEW published *Consultation on guidance for preparers of prospective financial information*, an exposure draft of new guidance for preparers of PFI. The exposure draft updates the 2003 guidance and includes general guidance for preparing any PFI, including, on a proportionate basis, any unpublished PFI. In addition, it includes application notes for preparing specific types of PFI in certain regulated capital markets transactions – statements of sufficiency of working capital, profit forecasts, and synergy and stand-alone cost saving statements.
121. As stated in *FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (September 2014), Section 463 of the Companies Act provides that directors are liable to compensate the company if the company suffers any loss as the result of any untrue or misleading statement in (or any omission from) the Strategic Report, the Directors' Remuneration Report or the Directors' Report. The extent of the liability is limited: directors are only liable to the company. Further, directors are only liable to the company if they knew that the statements were untrue or misleading or if they knew that the omission was a dishonest concealment of a material fact. This protection is sometimes known as 'safe harbour'. We would support consideration of a similar protection for auditors.
122. Our Audit and Assurance Faculty is currently developing a response to the IAASB's consultation on extended external reporting assurance and is expecting to publish a thought leadership essay on this topic in the near future and we will share with the Review team.

***Question 21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?***

123. Yes. Assurance over financial and non-financial information outside the financial statements would enhance its reliability and therefore may be of benefit to investors, as well as other users. We recognise that the value of such assurance to users may vary depending on the business sector and entity in question but believe there is a strong case for assurance over such information. User-Driven Assurance plays a key role here in understanding and meeting such needs of users.

***Question 22: If so, what information might usefully be subject to audit or another form of assurance and why?***

124. The market needs to decide what information might usefully be subject to audit or another form of assurance and we suggest a mechanism for achieving this is via User-Driven Assurance, which involves understanding and meeting the needs of users. That said, we believe that the annual report remains a key form of communication for investors. Our thought leadership report *What's next for corporate reporting: time to decide?* states: *'The annual report remains the cornerstone of the corporate reporting process, underpinning investor trust and confidence...the confirmatory role of the annual report seems likely to remain very important in the medium-term at least. It pulls together the information that is made public at various times during the reporting year. Investors can therefore have more confidence in this information, knowing that they will be able to confirm later on that it is reflected in the annual reporting and audited financial statements.'*
125. We therefore believe that information in the annual report would usefully be subject to assurance. Such assurance might initially be restricted to certain KPIs and non-financial metrics and the development of a framework may be necessary to provide assurance of forward-looking information, but ICAEW has already undertaken considerable work in this area. An example in the banking sector is information about a bank's capital ratio and risk-weighted assets (banking regulatory ratios), which is of particular importance to investors. Our Financial Services Faculty created a framework for assurance on **banking regulatory ratios**, which can be used by auditors, other assurance providers and internal auditors.
126. We note that investors access information from a wide range of sources, including preliminary announcements, press releases, quarterly updates, investor presentations and company websites. While it may not always be practicable to assure all such information, we support a future consideration of the needs for assurance over other public documents, including preliminary announcements. One option which may be worth exploring is separating the audit of the financial statements from the other work undertaken on the annual report and imposing separate reporting deadlines to facilitate the auditing of preliminary announcements.

## CHAPTER 5: AUDIT PRODUCT AND QUALITY

### **Question 23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?**

127. Yes. We broadly agree with the Review's analysis and consider that key to ensuring the value of audit is its quality.
128. There is clearly a 'quality' gap as evidenced in audit monitoring reports by the FRC and professional bodies, including ICAEW. It is important to address this gap and ICAEW's Audit and Assurance Faculty provides support and guidance on audit quality including:
- Using root cause analysis to identify the underlying key causes behind audit quality review findings. Our 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.
  - *Quality control in the audit environment*, a guide which includes illustrative policies and procedures on seven key areas.



129. ICAEW's monitoring report is also designed to offer help and support to improve audit quality. In *Audit Monitoring 2019*, just published on the website, we include examples of good practice as well as case studies on areas to improve. In addition we have a series of webcasts on key topics to help firms get it right.
130. We also note the importance of the IAASB's current quality management consultations and consider the use by auditors of professional scepticism to be key to audit quality. The Audit and Assurance Faculty thought leadership report, *Scepticism: The practitioners' take*, gives auditors a voice on the importance of challenge and includes a number of calls for actions which the Review may wish to consider.

**Question 24: Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgment?**

131. Yes. We have concerns that current FRC audit inspections adopt a rules-based rather than principles-based approach and note that such inspections may encourage a compliance rather than a challenge mind-set. We consider the use by auditors of professional scepticism to be key to audit quality, and, as discussed further in our answer to Question 56, below; that there may be a tension between the emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection and the desired focus on matters requiring the exercise of considered judgment. We need to ensure that audit inspection encourages the use of professional scepticism.
132. We note that the kind of audit inspections that encourage the use of professional scepticism are ones based on judgement calls and are more demanding than audit inspections that use a checklist mentality. However, we consider that this is what we should strive for in audit regulation. Within the UK regulatory framework for the last few years, ICAEW has trained its own reviewers to focus on key judgements and professional scepticism.
133. We are also concerned about the link between current FRC audit inspections and the attractiveness of the profession, as well as the link between current audit inspections and the development of future audit skills. Will a focus on compliance and checklists attract the best and brightest and will it indeed foster the skills necessary for their development? We discuss such 'people' issues in our Major Points section above.

**Binary nature of audit**

**Question 25: What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?**

134. In the past, audit reports conveyed very little sense of variation. The reporting by auditors of key audit matters (KAM), pioneered in the UK and now adopted globally, undoubtedly provides more colour and the study of these extended audit reports is worthwhile. They represent a genuine sea change and cover in detail areas in which audit effort was focused, why and how auditors approached those areas, and how auditors went about the audit more generally. More use can and should be made of these reports.
135. We noted in our recent publication *What auditors do: the scope of audit* that UK audit reports on listed, other public interest and some other entities must now include:
- KAM;
  - an explanation of how materiality was applied, including the materiality level used;

- information about the scope of the audit, including an explanation of how auditors addressed the KAM they identified.
136. The reporting of KAM is intended to facilitate discussion between auditors and audit committees, and between audit committees and investors. We strongly believe that there is more scope for audit committees and investors to engage more fully in these discussions, and for investors to make better use of KAM in their engagement with companies. We thus believe that better use could be made by investors of the information already provided to them by auditors.
137. But we think auditors can go further too. While we understand that investors value the binary audit opinion, and do not want to lose this, we consider that more graduated disclosure of auditor conclusions should be considered alongside the binary opinion. ‘Graduated’ auditor findings can cover a wide range of disclosures, including commentary on, for example, which accounting estimates auditors believe are more risky, or those they consider to be at the more ‘aggressive’ end of the spectrum, on the overall degree of conservatism displayed in the preparation of the financial statements, or on the level of subjectivity involved in determining a valuation. We need to consider the comparability of such reports. Allied to this is the possibility of conveying some sense of the variation in the levels of assurance auditors are able to gather in different audit areas.
138. We acknowledge the attempts by some firms of auditors to provide even more colour in their audit reports when this regime was first introduced, by means of commentary on positions adopted by companies. In addition to presenting a binary opinion and drawing attention to key audit matters, auditors can present graduated auditor findings that describe judgements as, for example, cautious, balanced or optimistic. We understand that companies have not embraced this style of reporting universally or enthusiastically and it is important to understand the reasons for this.
139. There are certainly challenges for policy makers to be aware of in this connection, which we note not as reasons for not exploring the reporting of more graduated auditor findings, but by way of caution. One significant problem arising from many examples of auditor commentary is the level of subjectivity involved, the likely level of challenge to auditors by management in some instances, and the extent to which auditors would be required to justify such commentary in an adversarial situation. These behavioural issues are important for policy makers: to impose a regime on unwilling companies and auditors is likely to drive excessive caution and boilerplate. Other issues are the extent to which more auditor reporting is likely to dilute the impact of and confidence in the overall audit opinion and that auditor reporting will also be by its nature judgemental. No matter how granular auditor reporting becomes, it will always represent a judgement, rather than the auditor being ‘right’ and management ‘wrong’.
140. In addition, while qualified audit reports on the financial statements of listed companies in the UK are rare, users may not ultimately distinguish between statements qualifying the audit opinion, and commentary or statements that do not. Auditor commentary in an area can be easily misread as a ‘mini’, ‘soft’ or ‘piecemeal’ opinion in that area. The more detailed commentary is provided, the less meaningful the overall opinion can appear to be – and the more investors may be tempted to give up on the detail and ask, instead, but ‘what is the overall view of the auditors’?
141. We stand ready to support the Review with an urgent exploration of ways of improving audit reporting, along with other communication between auditors and users, and how it



might bring benefits to users, particularly in relation to key areas such as fraud discussed elsewhere.

**Question 26: Could further narrative be disclosed alongside the opinion to provide more informative insights?**

142. We note in our answer above the possibility of auditors conveying some sense of the variation in the levels of assurance they are able to gather in different audit areas.
143. It is widely acknowledged that some areas in the financial statements are 'easier' to audit than others and that auditors obtain different levels of assurance in different audit areas when forming their overall opinion. For example, generally speaking, well-controlled areas (and companies) are generally easier to audit than those that are poorly controlled, and bank balances are generally easier to audit than provisions for legal claims. Ease of audit, and the level of assurance auditors can obtain, is affected by a number of interrelated factors including: the level of subjectivity involved in any given area; the quality of internal controls; and the availability of evidence from independent sources.
144. Providing narrative describing these issues, either in general terms or in specific audit areas, might provide insight into the audit without some of the drawbacks associated with the types of graduated auditor findings.

**Question 27: What would prevent such disclosures becoming boiler plated?**

145. In reality, little changes for some companies, year on year. Attempting to find slightly different wording in year 2, to avoid simply repeating what was said in year 1, is potentially misleading and counterproductive. Users might seek to interpret changes in wording when circumstances are unchanged and no difference is intended. Nevertheless, preventing the accretion of what appears to be boilerplate is a perennial problem.
146. It is important to acknowledge different types of boilerplate: where it arises from 'no change', it is not really boilerplate at all, but the fact that there is no change might be better flagged in some cases. Boilerplate arising from the convergence of wording or style on common issues within a particular sector or industry, or on the issues themselves, is another matter. The pressure to avoid divergence in such cases is real: what is so different about company X that requires a potentially alarming departure from industry practice?
147. Importantly, the FRC regularly reminds directors and auditors that all of their disclosures should be specific to the entity and not of a general nature. Recognising that changes of no great substance can accumulate almost unnoticed over the years to a point at which they do represent a real change is also important, as is a regular review of disclosures that have not changed for 3 years.

**Producer-led audit**

**Question 28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?**

148. We believe that our vision of User-Driven Assurance (set out in our response to Questions 1 and 2 above) would enable innovation and development for the benefit of users by empowering shareholders. User-Driven Assurance builds on the IAASB's assurance framework, which provides a frame of reference for those involved with assurance engagements. The IAASB has also developed standards such as ISAE 3000 on assurance engagements.

149. We recognise in any case the challenge of engaging users in standard setting and consider that an exploration by standard setters of new ways of improving such engagement, for example the use of surveys and events, may be worthwhile. We note that different approaches are taken by standard setters in different jurisdictions. The Review may wish to consider exploring this further and ICAEW would be happy to assist in this regard.
150. We believe however that it is essential that technically competent accounting professionals continue to be heavily involved in the drafting of standards, not only to ensure efficient development of high quality standards but also to assist with buy-in to the purpose and spirit of the standards and to ensure that the result is capable of practical application.
151. The debate about international standard setting led by the Monitoring Group is relevant here. International standard setting arrangements should result in standards which operate in the public interest. The standards need to command support from stakeholders and the standard setting processes must ensure that the standards are prepared within a transparent public interest framework that includes assessing: who the relevant public are; what they want and need; constraints to those wants and needs; how conflicting inputs are aggregated and balanced; and how this leads to the ultimate output.
152. The standard setting processes also need to be able to harness industry expertise to ensure that each standard is set to achieve the public interest objectives set for that standard in an effective, efficient and workable manner<sup>6</sup>.
153. Once arrangements have been established, it is necessary for them to be kept under review. But changes to processes should be made only where there are clearly better alternatives to the old arrangements, which would result in improvement in outcomes, substantial enough to outweigh any adverse consequences of the change. The procedure for changing the standard setting arrangements should be subject to the same transparent public interest framework as the standards setting process itself.

## CHAPTER 6: LEGAL RESPONSIBILITIES

**Question 29: What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?**

154. The relevant standard, ISA 250 (UK), sets out clearly the scope of the work required in determining whether the directors are complying with relevant laws and regulations. This is quite narrowly defined, distinguishing between matters which may materially affect the financial statements and other matters, but, in our view, broadly appropriate. However, the 2014 FRC audit quality thematic review, *Fraud risks and laws and regulations*, suggests that this is an area in which practice could improve, and our discussions with firms indicate there is still more to be done.
155. The role auditors play in determining whether directors are complying with relevant laws and regulations needs to be well understood and agreed by all relevant stakeholders. User-Driven Assurance, which enables the commissioning of assurance on a flexible and discretionary basis and relies on improved communication between directors, audit

<sup>6</sup> ICAEW's publication 'Acting in the Public Interest: A Framework for Analysis' considers this further.

committees and auditors to engage with shareholders and understand and meet their needs, is a mechanism for changing the role of auditors. Auditors must also be adequately supported to ensure that their work in this area is always of sufficient quality.

156. We refer briefly to the capital maintenance regime in our answers to Questions 30 and 31, below.

**Question 30: Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?**

157. Under Section 830 of the Companies Act 2006, profits available for distribution are calculated as accumulated realised profits less accumulated realised losses. Section 853(4) of the Act defines realised profits and realised losses as ‘such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses’. Although this section refers to realised profits, there is no requirement for the accounts to contain only such profits.
158. The profits in the relevant accounts are therefore a starting point and need to be analysed and adjusted in order to determine the amount of realised profit available for distribution.
159. We do, however, realise that there is an expectation gap here and that the statutory capital maintenance regime should be improved. We have previously raised concerns about the regime, including in our [response](#) last year to the BEIS consultation on Insolvency and Corporate Governance, and believe that government should review the effectiveness of the regime in protecting creditors.
160. Enforcement of the statutory capital maintenance regime and the impact of IFRS on capital maintenance have been criticised by some active investors and more recently by the BEIS Committee, which recommended that the current regime be strengthened through disclosure of distributable reserves, an explicit auditor responsibility and the introduction of a solvency test for distributions. These are sensible initiatives; ICAEW has been calling for investigation of the merits of a solvency system for some time. That is a simpler system and consideration of its advantages should be accelerated.
161. Nonetheless, these are arguably not the main issues. The key concern is with levels of capitalisation themselves. No capital maintenance regime can be successful where capital levels are inadequate to withstand reasonable levels of stress. Non-financial corporates do not have the same public interest profile as banks and do not benefit from implicit and explicit state guarantees and so a full prudential regime is inappropriate. Therefore, the root causes of concerns about capital adequacy will need to be addressed in new ways. A frank debate should be held on the level of capital shareholders want to support a business.
162. In the coming months we will consider the development of proposals for reform, for submission to government.

**Question 31: Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?**

163. Yes, we agree that this should be explored as a matter of urgency. Any change must result in clear and well-understood requirements that generate useful disclosures. Issues that will need further consideration include the current lack of a mechanism for the level of

distributable profits of groups of companies to be produced, and the impact on regulated entities, such as insurers and international reporting entities.

164. We anticipate developing suggestions on how best to take forward this and related proposals.

**Question 32: How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records? Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?**

165. There is scope for improving how directors and auditors discharge their obligations relating to whether reporting entities have kept adequate accounting records, but yes, the existing statutory requirements are effective in setting the bar for auditors at a high enough level.
166. Directors of UK legal entities are and should remain responsible for keeping adequate accounting records, and the courts are able to assess the relative degrees of responsibility in relation to any particular case. As it is never possible to simply produce financial statements ‘at the press of a button’ - except perhaps for very simple companies – the question of adequacy is whether, with reasonable time, the records allow compliant financial statements to be produced. That is a relatively low bar. As stated in our answer to Question 12, the new regulator could also be given powers to supplement directors’ accountabilities and responsibilities under the Companies Act, enabling it to bring effective action.
167. Our discussions with firms suggest that auditors’ reporting by exception to the shareholders on whether the entity has kept adequate accounting records is rare. Our discussions also indicate that further clarification or guidance on the existing statutory requirements may be useful, for directors initially, and then for auditors.

## CHAPTER 7: THE COMMUNICATION OF AUDIT FINDINGS

**Question 33: Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?**

168. Yes, there should be more open dialogue between auditors and users, including investors, which may help address the expectation gap. However, we stress the need for any new requirements to be proportionate, with a consideration of their application to and the needs of different types of audited entities. It is also important to consider liability issues and the extent to which these can be managed to enable auditors to engage informatively with users.
169. We support a requirement for auditors to present formally at all annual general meetings (AGMs) – including discussion of the extended audit report. Currently, auditors are not even required to attend. Although in practice many do, it is not unusual for an audit partner to spend their entire career without ever being asked a question at an AGM. Changing this would provide more information and greater transparency to shareholders and demonstrate that they – not management – are the client. This could be supplemented by the company’s internal audit function also presenting at the AGM on the work they have done in the course of the year. This would raise the profile of the internal assurance activities – around governance, risk-management and compliance, for example – which are often under-appreciated.

170. We note that lessons learnt from other jurisdictions may be relevant here, for example the Netherlands, as well as the public sector. The Review may wish to consider exploring these and we would be happy to assist in this regard.
171. Careful consideration should be given to the value of an annual assurance meeting, open to all stakeholders; any such meeting needs to be designed with the needs of such stakeholders in mind. It would also be worth exploring alternative ways of opening dialogue between auditors and users.
172. Opening dialogue between auditors and users may need change from other players in the financial reporting system, including investors and audit committees, as well as auditors. One way of improving dialogue between auditors and investors is improving audit reporting and, as discussed elsewhere in this submission, we believe that investors can and should make better use of the information already provided to them in extended audit reports.
173. Our new vision for assurance, set out in our answer to Questions 1 and 2, relies on an open dialogue between auditors and shareholders, with shareholders being empowered to drive assurance.

***Question 34: Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?***

174. This is worthy of further consideration, however, we have some practical concerns here.
175. In our discussions in developing this response, investors expressed support for improving transparency of the challenge between the three key players; auditors, audit committees and management, while auditors informed us that such challenge and tensions do exist. Most audited financial statements reflect adjustments to the numbers and/or the disclosures, which arise throughout the audit process. The audit process relies on ongoing communication between auditors, audit committees and management regarding such adjustments. Exploring a mechanism for filtering out routine communications and distilling the key ones would be important.
176. However, the practical challenges of making communication between auditors and audit committees transparent to users include the risk of inhibiting it.

***Question 35: Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?***

177. Yes, there should be enhancements to the extended audit report. However, we have concerns about an obligation to update on key audit matters featured in the previous audit report.
178. Communicating the reasons for no longer considering an issue a key audit matter (KAM) is worthy of consideration because the absence of an issue previously reported always gives rise to questions about what has changed. To explain what has changed helps tell a better story over time. However, two risks arise. The first is boilerplate; 'the issue is no longer a KAM because it no longer fits the definition'. The second is a slow accretion in the number of KAMs reported if it becomes clear that it is easier for auditors to repeat what they said in the prior year than explain what has changed. Such a trend might be exacerbated by the introduction of enhanced auditor reporting in the USA.
179. Reporting on 'Critical Audit Matters' (CAM) in the US is just beginning. By the autumn, we should have a good idea of what auditors are reporting. It is possible, given the different



environment, that the absolute number of CAMs reported for US companies will be, on average, more than those reported in Europe, particularly as the system settles. Despite the extensive and detailed work by the FRC on the nature and number of KAMs reported in the UK, US practice may influence practice in the UK.

## CHAPTER 8: FRAUD

**Question 36: Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?**

180. There is an inconsistency between some users' expectations of the auditors' role in fraud detection and the requirements in UK law and auditing standards, and yes, improvements are needed in the way that auditors discharge their responsibilities for detecting material fraud, as explained below.
181. It is important to understand the current role auditors play in detecting fraud. In particular, that UK auditing standards acknowledge (in ISA 240, paragraph 5) that *'owing to the inherent limitations of an audit undertaken in accordance with current practice, 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'*.
182. This is a long-established and important principle. As discussed in more detail in our publication, *Financial reporting: who does what?*, auditing is not the same as fraud detection. At present, 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. The audit opinion is an expert opinion, based on assessed risk and the performance of extensive procedures to reduce that risk to an acceptable level. Furthermore, fraud can arise from a variety of illegal acts, not all of which affect the financial statements or make them materially misstated – these acts would be outside the scope of a financial statement audit.
183. Paragraphs 6 and 7 of the auditing 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 also 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.
184. One way of addressing the expectation gap may be for auditors to disclose further narrative, including of the audit procedures designed and performed to detect fraud, in the audit report. The 2014 FRC audit quality thematic review, *Fraud risk and law and regulations*, suggests that this is an area in which practice could improve, and our discussions with firms indicate there is still more to be done.
185. The public expects auditors to detect material fraud and ICAEW and other professional and regulatory bodies need to support them robustly in their duties. But this is not enough.

We need fresh thinking to recognise how and when fraudulent reporting occurs and equip management and auditors to address this. There should be greater recognition of the conditions and pressures surrounding the exercise of judgement, how appropriate judgements can be supported and the point at which reasonable judgements risk tipping over to being unreasonable and ultimately fraudulent as the situation changes. Once a direction of travel has been established it can be hard to reverse, particularly if business conditions worsen; a slippery slope down which, at some point, management behaviour slides over the line into what is later assessed to be fraud.

186. ICAEW accepts that it has a responsibility equip its members to recognise the warning signs and to protect against these situations.
187. The auditors' role in the detection of fraud is an area our Audit and Assurance Faculty is currently exploring and on which we may comment further in the coming months.
188. We also note the responsibilities of other players in the financial reporting system, including directors, for the prevention and detection of fraud. This is the subject of a joint project by our Audit and Assurance Faculty and the Fraud Advisory Panel, which will conclude soon. The project will review and clarify the roles and responsibilities of different internal and external stakeholders in the prevention and detection of corporate fraud. It will identify and examine how new tools, techniques and ways of working are creating new opportunities and challenges for auditors (internal and external), and how these might add value to tackling corporate fraud in the future. Some of the areas that will be examined include the use of artificial intelligence and big data, and more effective collaboration to make the most out of the opportunities that new technology offers.
189. We will keep the Review informed of developments in this space.
190. Whistleblowing also has an important role to play and more could be done to ensure that channels that enable or require whistleblowers to share their concerns with the new regulator are effective in encouraging these individuals to come forward. That requires careful definition of who may have a duty to blow the whistle and how such a duty is framed, while ensuring that a duty to report does not discourage voluntary disclosure. It is important that whistleblowers are confident that reports will receive attention from the new regulator and that confidentiality is respected as appropriate<sup>7</sup>.

***Question 37: Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?***

191. Yes. We consider the use by auditors of professional scepticism to be key to fraud detection and note the existing requirements in the standards for auditors to maintain professional scepticism throughout the audit. Also important is audit regulation and, in our answer to Question 24, above, we note concerns that current audit inspections may not help auditors to exercise professional scepticism.

***Question 38: Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?***

192. Yes, it may well be possible. However, our discussions in developing this response have not convinced us of the value of devising such a test.

***Question 39: Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?***

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<sup>7</sup> ICAEW's report [How whistleblowing helps companies](#) explores this in more detail.



193. No. However, the current responsibilities of directors and auditors relating to internal controls over financial reporting, including risk management, can and should be strengthened, and we note that such internal controls over financial reporting would include those designed to prevent and detect fraud.

## CHAPTER 9: AUDITOR LIABILITY

### ***Question 40: Is the audit profession's willingness to embrace change constrained by their exposure to litigation?***

194. Yes. The liability of auditors is a critical issue in any discussion about encouraging wider participation in the audit market or potential change to the scope of audit. It does, inevitably, affect the appetite of audit firms for undertaking some forms of assurance. It might reasonably be expected that anyone's willingness to embrace change will be influenced by the extent to which that change is likely to increase their risk, particularly to litigation.
195. Auditors are currently exposed to litigation risk, as are other services providers. In particular, the law of contract/negligence applies, as illustrated by the AssetCo case. Auditors are also subject to professional standards and associated sanctions, the means by which poor conduct can be addressed regardless of whether loss has been caused. Not all advisors are subject to equivalent regimes, and, notably, neither are directors.
196. It will be important to consider these factors when assessing proposed changes to the scope of auditors' work, and accordingly we discuss some of the underlying issues in some detail below. To be clear, however, we do not think that liability issues should impede discussion about how audit and wider assurance should evolve as the level of liability can be varied for particular assurance engagements.

### ***The class of people who could sue auditors***

197. At present auditors provide an audit report for a defined purpose to specified persons, in the case of a company to the shareholders, and are liable to them. This is consistent with the position under the Companies Act, where directors' general duties are to the company itself and it is the company (ie, the shareholders or, in the case of insolvency, the liquidator) that can pursue remedies against them. This remains the case notwithstanding the Companies Act requirement for directors to have regard to the interests of other specified categories of persons.
198. The success of policies that amend the scope of audit will depend on how the risk of persons other than shareholders bringing claims is assessed and addressed. For as long as the purpose of audit is to provide comfort to shareholders regarding matters within the scope of directors' responsibilities, it would seem inequitable for auditors to be liable to a wider class of potential litigant than the directors. The so-called Bannerman clause in audit reports supports that position.
199. While, in principle, other professionals providing reports might also face the risk of claims from persons other than those to whom the report is addressed, the risk is perhaps particularly real for auditors, given the subject matter of the report (ie, the financial statements), that auditors are seen to have 'deep pockets' and that they are required to have insurance.

### ***Limitation of liability***

200. Many advisors limit their liability by contract and seek to reduce risk of exposure to third parties, for instance by obtaining indemnities or restricting use/publication of their advice or including notices such as the Bannerman clause. However, as noted by the Review, the ability of auditors to limit their liability is constrained by the requirements of the Companies Act and the operation of the market. This is a relevant matter when contemplating widening the scope of statutory audit, perhaps in relation to forward-looking information. It does not, however, impact on other assurance engagements not covered by statute. It could also be considered whether other checks and balances might be effective in achieving the same results as unlimited liability.

### ***Joint and several liability***

201. The Review notes correctly that principles of contributory negligence apply in determining an auditor's liability. For example, in the AssetCo case, the responsibility for losses was apportioned between the auditor and others, including the directors. However, there is another principle of law that is of concern to auditors, namely that any person liable to another, whether in tort, contract, breach of trust or otherwise, may recover a contribution from any other person liable in respect of the same damage, regardless of the basis of the latter's liability (Sections 1(1) and 6(1) of the Civil Liability (Contribution) Act 1978). This exposes auditors to the risk of being liable to pay amounts owed to a claimant by others, because, for instance, they have become insolvent or are otherwise unable to pay the amounts in question.

202. We continue to call for reform of the law in this respect, so that auditors would only be responsible for an amount proportionate to their responsibility for the loss in question. In theory, this might concern anyone who ends up being jointly and severally liable, but it is a particular concern for auditors as an attractive target for litigation. This is an important disincentive to potential new entrants to the PIE audit market.

203. It is possible to reduce the impact of joint and several liability through contract, but auditors are constrained from doing so, as noted above. While it seems possible that companies might agree to limitation agreements that result in proportionate (but still uncapped) liability, we understand this has happened rarely if at all in practice. This may affect the willingness of auditors to support change to the statutory audit where that change would increase their exposure.

204. An audit is not - and should not be thought of - as an insurance policy. The fact that auditors are required to have insurance should not mean that they are regarded as in some way insuring the company against risk of breach of their responsibilities by directors. In explaining what audit means and in determining its scope, it is important that fault-based liability is maintained and it is generally understood that losses may arise that cannot be recovered from auditors even if ostensibly within the scope of an audit.

### ***Question 41: If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?***

205. We are not aware of evidence supporting a direct link between liability and audit quality. Auditors will consider the risks in taking on an engagement and pricing it. However, these sorts of risk may deter those who would otherwise be qualified to do so from entering the market. Reducing the risks might therefore increase choice, and so arguably quality.

206. User-Driven Assurance, discussed in our Major Points section, would necessarily include consideration of liability issues.

**Question 42: Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?**

207. No. Liability inevitably impacts the appetite of auditors to undertake some forms of assurance. Increasing liability would likely serve to undermine efforts to widen participation in the audit market.
208. We do not believe that under the current model of audit it is reasonable for others to rely on a published auditor's report unless it is addressed to them. If others want to rely upon a report, the auditor should be given the opportunity to consider what risks may ensue (which may, or may not, have been contemplated at the time of the audit).

**Question 43: How might the quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?**

209. We are not aware of evidence supporting a direct link between liability and audit quality. The risk of reputational damage might be more significant here.
210. This and some of the preceding questions do not always seem to distinguish clearly between audit quality and the scope of the services in question. If an entity needs or wants some comfort over information not covered by the existing audit product, that would be different from audit and could be provided by a different assurance engagement, on such terms regarding liability as considered appropriate.
211. User-Driven Assurance, discussed in our Major Points section, would necessarily include consideration of liability issues. In practice, we see the extent of liability been subject to negotiation for particular assurance assignments.

**Question 44: To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?**

212. We are not aware of such issues but have not made specific enquiries of firms on this matter. We would be happy to do that on request.

## CHAPTER 10: OTHER ISSUES

### **Technology**

**Question 45: How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?**

213. New technology is used extensively in certain areas in many larger audits, but does not necessarily enable a higher level of assurance to be given. Its use is growing and is being explored by firms of all sizes. Larger firms continue to invest significantly in the application of new technologies, and while the use of drones in the audit of stock and the use of textual analysis software to review contracts both attract headlines, it is the use of data and analytics in risk assessment that represents the most important advance in recent years.
214. Significant time and cost is involved in recruiting appropriate teams with the relevant skillsets and integrating them technically and culturally with the audit practice; this includes developing the relevant platforms, persuading audited entities to trust audit firms

with large volumes of commercially sensitive data, developing secure interfaces with audited entities' systems, and scrubbing the data extracted. And all of that is before any analysis is performed.

215. The ability to analyse a full population of transactions should reduce or eliminate 'sampling risk' - the risk that a sample is unrepresentative of the population from which it is drawn - and provide better quality audit evidence. However, the sheer number of transactions analysed presents technical challenges and evidential uncertainties that do not exist when samples are taken.
216. While technology does not necessarily enable a higher level of assurance to be given, it does increase the value and the quality of audit. The way in which firms and regulators choose to embrace and apply new technologies also has a significant impact on the extent to which technology can and does improve audit. An example of technology enhancing the value of audit is in the use of analytics to perform routine audit procedures, enabling humans to focus on other tasks, exercising their skills in judgement and ethics.
217. In our publication, *Data Analytics for External Auditors*, we encourage auditing standard setters and regulators to embrace the value added to audit by data and analytics. If their approach acts as a drag on the use of data and analytics, the value of audit in general will be diminished and the statutory audit will be 'hollowed out' and marginalised, which is not in the public interest.
218. The IAASB decided not to address data and analytics in detail in its recent proposals for revisions to its standard on risk analysis. In our *response*, we noted our fear that this was a lost opportunity and we will be strongly encouraging the IAASB to address the issue in more detail in its upcoming audit evidence project. If it fails to do so, the ability of firms to use technology to its full potential and add value to audit will be compromised.
219. Our Audit and Assurance Faculty is expecting to publish a thought leadership essay on this topic in the near future and will share this with the Review team.

***Question 46: In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?***

220. Auditors have a good track record in the provision of assurance on a broader range of issues than is covered by the traditional audit, and new technology is important in enabling this. One example is the provision of assurance on KPIs being enabled by data analytics on the management information supporting these KPIs. New technology will also be important in the context of the new User-Driven Assurance model proposed in our Major Points section.
221. Our Tech Faculty is embarking on a project to explore how new technologies themselves are being assured – including assurance of algorithms, AI and blockchain. We will keep this Review informed of developments in this space.
222. Investment in new technology requires significant resources and is currently being made primarily by larger firms and specialist vendors. To improve the accessibility of new technology, we are also facilitating a working group exploring how to develop an industry-agreed standard for accessing business data. This will be open and available to all audit firms, technology providers and service developers.
223. The adoption of new technology may present its own challenges. Our AuditFutures programme, at a recent event held in partnership with the University of Edinburgh,

considered the ethical implications of adopting such new technology, and our Tech Faculty has built a [hub](#) to further consider these issues.

### **Proportionality**

#### **Question 47: Are there aspects of current audit procedures or output that are no longer necessary or desirable?**

224. Yes. The IAASB is the international standard setter upon whose standards UK auditing standards are based. Broadly, we support its work and the scope and quality of its standards. However, in many of our responses to both the IAASB and the FRC over the last two decades, we have noted with dismay the increasing length and complexity of standards and the lack of a mechanism for controlling it. It is likely that there are aspects of current audit procedures as determined by auditing standards that are no longer necessary or desirable.
225. The reluctance to do away with regulation once imposed is a widespread phenomenon, but a failure to deal with unchecked accretion leads to sclerosis, ossification and, ultimately, redundancy. Over-engineering in auditing standards will not maintain audit as the 'gold standard', but rather marginalise audits altogether. Our Audit and Assurance Faculty expects to produce a blueprint for improved standard setting in the coming months and will share this with the Review team.
226. We note that according to the Review, *'some have questioned whether all notes to the financial statements need to be audited.'* We believe that this view is misplaced and that we should be considering what more rather than what less auditors can do, including exploring the assurance of information outside the financial statements.

#### **Question 48: Given that a zero failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?**

*We interpret this question as referring to audit rather than corporate failure.*

227. We agree with this Review that a zero failure regime is not attainable and, further, we expect the costs of attempting to achieve it would significantly outweigh the benefits. Success should perhaps be measured by the extent to which trust in the profession endures despite the occurrence of events such as major corporate failures. In our Major Points section we reference the 2019 paper by John Coffee *Why Do Auditors Fail? What Might Work? What Won't?*, which describes auditors as 'gatekeepers' who pledge reputational capital that they have developed over many decades and many clients to give credibility to their opinions. The paper was published in *Accounting and Business Research* Volume 49, 2019 - Issue 5: International Accounting Policy Forum and is available [here](#). This is an important insight. If audit firms are 'reputational intermediaries', whose most important asset is their reputation, this should provide users with the confidence they need to trust in the audit process. We urge the Review to consider investigating trust levels in the profession, with a view to these being published alongside existing reports on audit monitoring.
228. Key to ensuring the value of audit is its quality. There is clearly a 'quality gap' as evidenced in audit monitoring reports by the FRC and professional bodies, including ICAEW. It is important to address this gap and our Audit and Assurance Faculty provides support and guidance on audit quality, including:



- Using root cause analysis to identify the underlying key causes behind audit quality review findings. Our 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.
  - *Quality control in the audit environment*, a guide which includes illustrative policies and procedures on seven key areas.
229. ICAEW's monitoring report is also designed to offer help and support to improve audit quality. In *Audit Monitoring 2019*, we include examples of good practice as well as case studies on areas to improve. In addition, we have a series of webcasts on key topics to help firms get it right.
230. We also note the importance of the IAASB's current quality management consultations and consider the use by auditors of professional scepticism to be key to audit quality. The Audit and Assurance Faculty thought leadership report, *Scepticism: The practitioners' take*, gives auditors a voice on the importance of challenge and includes a number of calls for action which the Review may wish to consider.
231. Finally, as noted in responses to other questions, there is a need to reconsider the scope and purpose of audit to improve its value. However, we would flag the need to also consider the impact of changes to the scope and purpose of audit on audit cost. In general terms, we stress the need to balance a consideration regarding the level of work, assurance, cost and liability in assessing changes to the scope and purpose of audit.

**Question 49: Does today's audit provide value for money?**

232. Yes. There is a competitive market for audit (including for FTSE 350 audits, although as we have indicated to the CMA, choice in that particular market should be enhanced). Information about audit fees is available, and this allows companies to gauge whether they may be paying their auditors too much or too little. The magazine 'Accountancy' publishes an annual survey of FTSE 250 audit fees and all medium and large companies publish their audit fees.
233. There is an expectation that those paying for audit will be keen to keep costs as low as possible. However, in the current climate we have seen that the reverse is often true. Particularly for companies in the public eye, there is pressure to ensure that auditors are being paid enough.
234. Nonetheless, the cost of audit also reflects the cost of compliance with regulation. Where regulation is effective in securing high audit quality, these costs deliver value to shareholders. However, where regulation is ineffective or disproportionate it does not. It is essential that a proper impact assessment is performed for the reform package.

**Question 50: How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?**

235. The market needs to decide and we suggest a mechanism for achieving this is via User-Driven Assurance, which involves understanding and meeting the needs of users.
236. We also stress the importance of applying Better Regulation principles, as considered in our Major Points section. A rigorous impact assessment for the package of reforms, including the work of the Independent Review of the FRC and the CMA, taken together is essential. This has not been carried out yet and the government's own Better Regulation Framework suggests it should be. The overall cost of the package to business is likely to



be very significant and it is essential that the expected benefits that justify this are carefully identified.

## Shareholders

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

237. The extended audit report can reveal a range of value-relevant information, particularly where it is not disclosed elsewhere. There is therefore advantage in analysts reading it, and comparative advantage for those analysts that do make use of it if others do not. The degree to which audit reports are read and used lends itself well to academic research, as does the usage of AI in the analysis of audit reports. In 2018 ICAEW commissioned Craig Lewis, Professor of Finance at Vanderbilt Law School and former Chief Economist and Director of the Division of Economic and Risk Analysis at the SEC) to present a lecture, *Fad or future? Automated analysis of financial text*. This presentation examined the ways in which textual analysis can provide new sources of information to investors and other stakeholder groups, as well as exploring opportunities for its use in the long term.
238. Another test would be whether audit reports do what they were originally intended to do, which is to provide a hook for discussions between audit committees and investors, and whether they prompt other communications.
239. Credit analysts within the ratings agencies are a significant source of information to debt markets. These analysts are required by their rating criteria to assess governance indicators, such as the integrity of accounting and audit, and can therefore be expected to consider audit reports, where relevant to this assessment.
240. Other information is also relevant to assessing the quality and integrity of audit. Making audit inspections reports easier to access may help, for example, as Sir John Kingman proposes for the new regulator.

### **Question 52: Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?**

241. Yes, in principle, although interaction between shareholders and auditors outside the AGM is limited by legal, practical and equitable considerations. We believe that auditors can and should play a more prominent role at the AGM. That would give an opportunity for real dialogue with shareholders. Work on shareholders' voting rights on the appointment of auditors and audit committees should also prompt these interactions.

### **Question 53: How could shareholders express to auditors their ex ante anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?**

242. Shareholders should be given a greater voice, for example audit committee chairs should be contactable, and companies could survey shareholders to seek their views. That would help identify shareholder concerns to support audit planning. Dialogue with auditors at the AGM and outside the AGM could also help.
243. Seeking shareholder approval for audit planning matters would be cumbersome and could distract from other more productive measures such as enhanced dialogue. We would not support a formal approval process.

**Question 54: What assurance do shareholders currently obtain other than from audit reports?**

244. Typically, assurance provided to shareholders is limited to the audit of the annual financial statements. Independent assurance is commonly provided over a range of additional statements, for example environmental, social and governance reporting or the current framework used by companies floating on, among other markets, the London Stock Exchange, which requires them to fulfil a regulatory obligation to establish procedures that ‘provide a reasonable basis for them to make proper judgements on an ongoing basis about the company’s financial position and prospects’.
245. The User-Driven Assurance model that we propose in our answer to Questions 1 and 2 envisages a broader range of assurance being made available to shareholders, which might encompass these matters and others. We suggest that this could go some way toward addressing the expectation gap.

**Culture****Question 55: In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?**

246. The culture of the audited entity is, of course, very important in relation to areas such as disorderly failure and fraud addressed elsewhere in this submission. It may be possible for auditors to report on the culture of the entity whose financial statements are being audited, with the development of a framework. However, we do not consider that this should be an immediate priority for this Review, although we note that proposals for improving audit reporting and other aspects of auditor communication may be relevant here.
247. External auditors are well-placed to understand the culture of the audited entity in conducting an audit of financial statements, which includes identifying and assessing the risks of material misstatement. In November 2015 an AQF debate looked at the importance of business culture and the challenges of getting it right. In her keynote speech, Baroness Neville-Rolfe, then parliamentary under-secretary of state for business, innovation and skills, explained how boards should be playing a central role in shaping the strategy and culture of a business. The event highlighted that audit has a role to play and that there was scope for auditors to do more. Auditors could go deeper and ‘get under the skin’ of an organisation by listening to the stories being told and looking at the indicators in the physical environment, understanding employees’ behaviours and intent, and communicating these understandings and their appropriateness, for example, in their extended audit reports.
248. Internal auditors have flagged to us the work they perform in relation to areas such as culture, and our practical guide, *How to audit culture*, outlines eight steps to follow to conduct a successful internal audit of culture under the following headings:
- Make the case for auditing culture
  - Gain the support of the board and audit committee
  - Pinpoint exactly what you want to assess
  - Take a risk-based approach
  - Be strategic about resourcing

- Tailor your approach to the organisation
- Be flexible
- Writing your report.

This practical guide may be the base of a framework to be used by internal auditors initially and then by external auditors, as the third pillar of User-Driven Assurance.

**Question 56: How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?**

249. Exercising, demonstrating and evidencing professional scepticism is not easy - it is after all an 'attitude of mind'. Regulators recognise that auditors who do in fact exercise professional scepticism appropriately may not always demonstrate it in their interactions with the audit team or the audited entity, that those who do manage to demonstrate it do not necessarily find it easy to evidence it in audit documentation, and that those who are adept at documentation for compliance purposes may be able to create an apparently acceptable veneer of documentary evidence covering a fairly superficial level of challenge.
250. ICAEW's recent publication *Scepticism: the practitioners' take* generated a high level of interest because it sought, through interviews with auditors, to understand how they have changed their approach to the issue in recent years. Of particular interest is how firms are attempting to deal with conscious and unconscious bias in audit, particularly under pressure.
251. There was a good consensus among those we interviewed for this publication on what needs to be done to enhance scepticism. We outline our key takeaways from the interviews in the next few paragraphs.
252. Structural changes are needed within the firms. Firms increasingly acknowledge that if their plans to exercise scepticism in higher risk areas are to survive contact with the first deadline, structural changes are needed to methodologies, working practices, training, recruitment and retention, to support and encourage scepticism in the field.
253. Auditors are not the only people who can or should exercise scepticism. Auditors and audit regulators are challenging other stakeholders in the wider financial reporting supply chain, particularly preparers, to practise what they preach by exercising scepticism themselves. Auditors are also challenging regulators to be more open about 'what good looks like'.
254. Scepticism is about quality, not quantity. Scepticism is about asking the right questions, not simply a lot of them, and about not accepting the first answer. It is also clearly about having the experience to recognise what can go wrong, and the structures in place to ensure that those without that experience – junior audit staff – learn to apply it from those who do.
255. Firms should not send out mixed messages. They should not encourage scepticism in the classroom but then discourage it in the field. Everyone involved, particularly junior staff, needs time to develop, exercise and enhance their sense of what might be wrong. For junior staff to learn from their own mistakes, budgets may need to accommodate the pursuit of 'unprofitable' lines of enquiry.
256. A requirement to seek out contrary evidence will not, of itself, enhance the exercise of scepticism. Very little evidence is genuinely 'contrary', much more is likely to be potentially 'inconsistent'. If auditors genuinely set out to challenge management when obtaining

audit evidence to support the audit opinion, a great deal of that sort of evidence is likely to appear. The language of 'robust challenge' is better and moves the onus to prove that the financial statements are right, towards management, which is as it should be. Auditing standards and professional ethics require auditors to exercise professional scepticism throughout the audit and in specific areas.

257. The IAASB is considering whether auditors should be required to seek out 'contrary' or 'conflicting' or 'inconsistent' audit evidence as well as corroborative evidence in its project on the audit evidence standard. Its preliminary deliberations are aligned with the views of those we interviewed: requiring auditors to seek out such evidence does not seem feasible, desirable or necessary within the current framework, not least because 'contrary' evidence is rare and hard to find.
258. To be sceptical, auditors need to manage the tension between the demands of independence and the need to understand the business in detail. Specialist knowledge and an intimate knowledge of a business may lead to groupthink, but without them auditors cannot mount an effective challenge to management. Asking 'stupid' questions in the absence of such knowledge has value, but it is limited.
259. Auditors need a bank of experience to enable them to react quickly in a changing environment. They also need to be able to step back and consider the bigger picture.
260. ICAEW's training films, *False Assurance* and *Without Question*, also have this issue as central themes.
261. No auditor sets out to be credulous or gullible, and scepticism cannot be addressed without also considering commercial pressures, quality, practice management, and independence issues. Audit firms are well aware of the need to continue to devote a meaningful level of resource to understanding their own internal dynamics in this area and we will continue to encourage them to do this and to work with them as they develop that understanding.

**Question 57: Should the basis of individual auditors' remuneration be made available to shareholders?**

262. Possibly. Audit fees are already disclosed for medium and large companies. Greater granularity might help provide greater insight on incentives and potential sources of conflict. Remuneration and financial incentives are used to try and encourage long-term thinking by executive directors. Extensive disclosure of executive remuneration, including details of long-term incentive plans, is included in annual reports for this reason. It is possible that the same tools could encourage the desired behaviours and thinking of individual auditors.
263. Nonetheless, we question whether financial statement disclosure is the most effective or efficient way of addressing these issues. Audit regulation has a lead role to play here and we assume that a similar objective is expected to be achieved through the publication of graduated audit inspection findings that Sir John Kingman envisages.

**Cost**

**Question 58: Do respondents view audit costs as generally too high, about right or insufficient?**

264. ICAEW has limited direct visibility of the profitability of audit. However, we consider the audit market to be competitive; in a competitive market costs would be expected to be

‘about right’. As we indicated to the CMA, choice in the market specifically for FTSE 350 audits needs to be enhanced and it is possible that changes to the market will affect fees.

265. Furthermore, costs are affected by regulation and by any actions taken to address the delivery gap. A rigorous impact assessment for the package of reforms, including the work of the Independent Review of the FRC and the CMA, taken together is essential, as considered further in our Major Points section.

**Question 59: Would users of financial statements wish more detail on the make-up of audit fees?**

266. Possibly. Users value comfort that the audit has been conducted to high quality and is unaffected by potential conflicts. Disclosures are one way in which this can be achieved, but it does not necessarily follow that incremental disclosures in the annual report are the optimal solution. Audit inspection has a key role to play here too.
267. The Companies Act 2006 requires medium and large companies to disclose audit fees. Large companies are additionally required to separately disclose fees paid to the auditor for other services; this additional disclosure is intended to provide an indication of the potential risk of a self-interest threat to the auditor’s independence due to a wish to secure or preserve non-audit services. For public-interest entities this risk has been significantly mitigated now that the audit directive prohibits most non-audit services and it might be questioned whether the current disclosure continues to provide relevant information on audit quality risks for these entities. However, it remains relevant for large companies that are not public-interest entities.
268. We note recent concerns that have been raised by investors, among others, around the amount and level of time spent on audits. Disclosure of audit fees already helps analysts assess whether the audit fee, and by extension the audit work performed, is proportionate in relation to the entity. Proportionality is affected by complexity as well as size, which complicates matters, but comparisons can be made. It could be asked whether greater granularity about work performed would be valuable; the audit fee is an imperfect proxy as work performed is also reflected, for example, in recovery rates, the mix of audit staff and expertise and different charge-out rates between firms. In the recent audit disciplinary findings on BHS Limited the FRC were critical of the amount of partner time that was spent on the audit.
269. Incremental disclosures might help address these concerns. We also note the possible usefulness of such information to management and audit committees, particularly information on different countries and business units, as well as the reasons for any overruns – although metrics for this purpose do not need to be included in public reporting.
270. Nonetheless, the review should consider carefully other alternatives. Kingman has recommended that the new regulator work toward publication of graduated audit quality inspection reports. Such an exercise should be expected to contribute to resolving these issues, perhaps more efficiently than through disclosure in financial statements.

**Question 60: Is the profitability of the audit function sufficient to sustain a high-quality audit industry?**

271. We expect high standards for all audits and the fees charged should be sufficient to achieve this. Shareholders benefit from high quality information and assurance over its reliability and the value of this benefit should be reflected in the audit market. Where quality and confidence are enhanced this value increases – supporting the audit effort

needed to achieve it. Similarly, there is also an opportunity to increase value where shareholders demand comfort over a broader range of metrics that are of importance to them.

272. Nonetheless, in reforming audit it does not necessarily follow that every measure will increase value to the same extent. Costs may be affected by reform. A rigorous impact assessment for the package of reforms, including the work of the Independent Review of the FRC and the CMA, taken together is essential, as considered further in our Major Points section.