Brydon Review

Independent Review into the Quality and Effectiveness of Audit

Call for Views

Response from the Investment Association

31 May 2019

EXECUTIVE SUMMARY

The Investment Association[1] (IA) welcomes Sir Donald Brydon undertaking this independent review into the quality and effectiveness of audit, and the opportunity to respond to the Call for Views. In preparing this submission, feedback was sought from the IA's members and from members of the Company Reporting and Auditing Group (CRAG). CRAG is the main UK grouping of institutional investors that specifically focuses on accounting and auditing issues. It provides input to the IA's responses.

In managing assets for both retail and institutional investors, the IA's members are major investors in listed companies. They rely on the quality and robustness of the audited information those companies report to the market when making investment decisions and holding company management and boards to account. High quality audits are vital to ensure the markets trust and have confidence in the information companies report.

In this context, the scope of the audit has remained largely unchanged since 1947 and has not kept pace with subsequent changes to the corporate reporting framework. Companies now have to exercise more judgement in preparing the financial statements and, in particular, determining the fair value of assets and the carrying value of intangibles. They also now report on their future viability and increasingly focus on narrative reporting, and significant environmental and social factors. Thus we consider it timely that the scope of audit should be revisited and welcome this Review. We set out below the IA's key observations on the issues raised in the Call for Views and in the attached Annex, our answers to the questions raised.

- Whilst we consider auditors largely seek to address the current scope of their responsibilities in law and auditing standards, their work is not always of sufficient quality. It is a particular concern that a continuing theme in the Financial Reporting Council's Audit Quality Review (AQR) reports is that auditor fail to demonstrate a lack of professional scepticism and challenge to management in relation to key judgements. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement. However, as noted by the AQR, auditors sometimes do not challenge management enough, and focus too much on gathering and accepting evidence to support management's assertions.

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[1] The IA champions UK investment management, a world leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively they manage £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. Forty per cent of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

This, combined with the recent high profile corporate failures and the fact in June 2018 the AQR noted falling audit inspection results means that for many investors their trust in audit has been undermined. Re-establishing that trust in the numbers companies report to the market is essential and should be a priority over extending the scope of audit or assurance (question 6). That said, there is a wide range of corporate reporting which currently falls outside the scope of the audit. Nor do the financial statements necessarily provide the only measures of a company's performance and there may be some benefit in exploring whether audit should cover the wider metrics investors consider important and become more forward looking.

- In the main, we consider the level of assurance an audit provides and the "true and fair" view tailored by reference to various Key Audit Matters should remain the same. However, the scope of what is covered could legitimately vary depending on the business sector in question, and the entity's business risks. Two sectors that we consider could benefit from additional scrutiny are banks and their capital ratios and risk weighted assets, and energy companies' reserves (see question 8). We also consider there should be better reporting and assurance on significant environmental and social issues – see below.

- Investors want to invest in well governed and controlled companies. Whilst on the whole companies risk reporting appears to be adequate, reporting on the review of the effectiveness of internal controls is largely boilerplate. We thus supported Sir John Kingman's recommendation 51 that there should be a consultation on introducing a framework in the UK whereby the directors, or the CEO and CFO, are required to set out in the annual report their assessment of the internal controls and make an explicit statement on whether they operated effectively in the period. Our initial views are that, similar to the UK Corporate Governance Code, this should address all material controls, including financial, operational and compliance controls.

  We also support auditors being required to form a view on that part of the statement that relates to the controls over financial reporting, as opposed to the wider internal controls, given their responsibilities for auditing the financial statements. This should be included in their audit report (questions 12 and 13).

- Non-GAAP financial measures are often presented in the financial statements, the narrative part of the annual report, and other corporate reports such as preliminary announcements and analyst/investor briefings. There are also non-financial measures and industry specific indicators, such as like for like sales in the retail sector. The combination of non-GAAP financial and non-financial measures, with the audited accounts conveys more than either dataset on its own. However, with the former unless they are in the financial statements, the figures will not have been subject to an audit.

Auditors should be required to look at both non-GAAP financial and non-financial measures presented in the annual report and accounts, the preliminary announcement of results and investor/analyst briefings. At a minimum, auditors should assure that for non-GAAP financial measures ESMA's Guidelines have been followed such that each measure is: defined with the basis of calculation clearly disclosed; clearly explained; reconciled to the nearest GAAP number; and presented consistently over time. For non-financial measures the auditor should assure that: they are defined with the basis of calculation clearly disclosed; an explanation is given as to why they are presented and are useful; and they are presented consistently over time (questions 21 and 22).

- Preliminary announcements of results tend to be produced days or weeks before the audited annual report and accounts and are the main driver of investment decisions. However, it is not always clear if, and to what extent, they have been audited. This needs to be addressed, clearly disclosed and the audit report issued at the same time (questions 21 and 22).

- In recent years the disclosure of significant environmental and social issues has become increasingly important to investors as they integrate these factors into the investment process. However, investors are dissatisfied with the quality and consistency of the information. The variety of reporting standards and frameworks around environmental and social issues can cause practical problems in assessing a company's approach to them and comparing reports between different companies and industries. The information is often inconsistent, not available or not verified. Also it is difficult for investors to determine what has been audited and what not, and understand what it meant by a reasonable or limited assurance. There needs to be more standardisation of the reporting frameworks and the level of assurance clearly explained and disclosed (questions 21 and 22).

- There are concerns when companies fail to maintain capital and pay unlawful dividends. Companies should be required to disclose distributable and non-distributable reserves in the audited financial statements. This disclosure will relate to the parent company accounts but should address any restrictions on dividends paid by subsidiaries to the parent and why. This would enhance investors' confidence in management's stewardship by demonstrating that dividends are not being proposed out of capital and clarify the headroom between the level of reserves and the proposed dividend. In this context, the IA's recent report on dividend payments also calls for companies to improve their transparency and publish a 'distribution policy' setting out their approach to paying dividends to shareholders (question 31).

We trust that the above and attached are self-explanatory but if you require any clarification of the points raised or wish to discuss any issues further then please contact Liz Murrall at liz.murrall@theia.org or on +44 (0) 207 269 4668.

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

The IA's answers to the detailed questions raised are set out below.

CHAPTER 1 – DEFINITIONS OF AUDIT AND ITS USERS

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

An audit should be conducted for the benefit of a company's existing and prospective shareholders, the institutional investors in companies. It is they that rely on the auditors' work, to whom the auditor reports and who ultimately bear the cost. In managing funds of behalf of both retail and institutional clients, institutional investors invest in listed companies and rely on the quality and robustness of the audited information those companies report to the market when making investment decisions, and holding company management and boards to account. High quality audits are vital to ensure they trust and have confidence in the information companies report.

We recognise that reporting and auditing is increasingly expected to meet the growing needs of wider stakeholders than just shareholders. In particular, audits also benefit the non-executive directors in that the auditor challenges management and holds it to account so that they can rely on the information management reports. Shareholders, as the providers of a company's risk capital and bearers of the residual risk, want audits to be high quality. We consider that other stakeholders' interests are aligned with this in that if shareholders' needs are satisfied, then we believe the needs of other external users are likely to be also. It is also unlikely that employees, suppliers and other stakeholders will scrutinise a company's audited accounts in the same way as shareholders.

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

As noted in ISA (UK) 200 currently the key purpose of an audit is to enhance the confidence of intended users in the financial statements. Since its core outputs were determined in 1947, the corporate reporting framework has changed dramatically and we consider it timely that the scope of audit should now be revisited. However, the role of audit still remains to enhance the degree of confidence users have in the corporate reports an entity issues and not necessarily in the entity itself.

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?

We set out in question 1 to whom we consider the audit is conducted and that its primary purpose is to ensure that existing and potential investors have confidence in the information that companies report. We note that the accounting framework sees the primary users of the financial statements as both the current and future shareholders, i.e. potential shareholders, whereas the Companies Act limits the obligation on the auditor to report to the current members. Whilst we note that there may be implications for auditors' liability, we consider it would be helpful if the accounting and audit framework were aligned such that both address existing and potential shareholders in that the framework for audit is currently too limited.

In the event the Review determines that the audit should look to the needs of other stakeholders and the wider public interest, there may be benefit in amending the law along the lines of Section 172 of the Companies Act 2006 relating to the responsibilities of directors which recognises the primacy of investors. Thus the law could clarify that the primary purpose of an audit is to ensure that existing and potential investors have confidence in the information that companies report to the market, and in doing so should have regard to the wider public interest.

CHAPTER 2 – THE 'EXPECTATION' GAP

4. Do respondents consider there is an expectation gap?
5. If so, how would respondents characterise that gap?

As noted in the Call for Views, the core output of the audit process has remained largely unchanged since 1947. Companies now have to exercise more judgement in preparing the financial statements and, in particular, determining the fair value of assets and the carrying value of intangibles – see question 6 below. They also now report on their future viability – see question 17 - and increasingly focus on narrative reporting, and significant environmental and social factors – see questions 21 and 22. The output of the audit process has not kept pace with these changes and we consider it timely that its scope should now be revisited and welcome this Review.

6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standard, and how those responsibilities are currently met?

The IA considers that the "delivery" or "quality" gap is distinct from the "expectation" gap. Thus whilst auditors largely seek to address the current scope of their responsibilities in law and auditing standards, their work is not always of sufficient quality. In particular, over time accounting standards have moved from historic cost to an approach based on fair value. Fair value accounting requires more judgement due to the difficulties in valuing and auditing certain assets and liabilities. In addition as the Call for Views notes "the valuation of goodwill and other intangible assets is another area where some argue that auditors have failed to challenge management and directors".

It is thus a concern that a continuing theme in the Financial Reporting Council's Audit Quality Review (AQR) reports is a lack of professional scepticism by auditors and challenge to management in relation to key judgements. Professional scepticism is vital when key areas of accounting and disclosure depend on management's judgement. However, as noted by the AQR, auditors sometimes do not challenge management enough and focus too much on gathering and accepting evidence to support management's assertions. Nor do we consider they look for market signals such as short selling, negative analyst notes or share price collapse that may indicate problems with the audited entity.

More recently there have been some high profile failures, both in the UK and internationally, which have had serious implications for companies, the people they employ, their suppliers and shareholders. Also, whilst in the past the AQR noted that its audit inspection results were improving, in June 2018 it indicated that "the Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council[2]".

For investors it is vital that audits are high quality and trusted. However, audit quality is difficult to observe and to an extent, users of audited company information have to trust that audit is high quality. For many, the trends noted above have undermined trust in audit and created a significant "quality" gap such that they consider measures are needed to re-establish it. Others, on the other hand, consider that on the whole in the UK audit quality is satisfactory and that recently introduced mechanisms should be given more time to take effect.

In this context, audit quality can be particularly impacted by a lack of independence and objectivity which can arise from:

- The way auditors are appointed and monitored.
- The limited competition and choice in the market.
- Non-audit services and the conflicts that result.

These are matters that the Competition and Markets Authority (CMA) looked at in its Study into the Audit Market. We responded separately to the CMA which has now issued its final report.

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

7. What should be the role of audit within assurance?

Audits are designed to give users confidence that the information companies report can be relied on and in so doing, the auditors are required to adhere to certain standards to ensure their independence and objectivity which are vital to providing a quality audit. Due to the standards expected, and the regulatory and enforcement framework around those standards, we consider audit should play an important role should its remit be widened to provide assurance on the wider corporate reporting framework.

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[2] The FRC highlighted that 73% of FTSE 350 audits reviewed in 2017/18 were categorised as requiring "no more than limited improvements" as compared to 81% in 2016/17.

In particular, companies will often now ask for a variety of reports to be assured such as those on diversity, and environmental and social matters. The level of assurance given can vary and it can be difficult for investors to determine what has been audited and what not, and understand what is meant by a reasonable or limited assurance. More clarity and consistency is needed when these wider assurances are given – see questions 21 and 22.

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?

The IA considers that the level of assurance an audit provides and the "true and fair" view tailored by reference to various Key Audit Matters should remain the same. However, we consider the scope of what is covered could legitimately vary depending on the business sector in question, and the nature of the entity's business risks. Two sectors that would benefit from additional scrutiny are banks and their capital ratios and risk weighted assets (RWAs), and energy companies' reserves.

Banks' capital ratios and RWAs are important to understanding a bank's strength and resilience but are currently not subject to any independent scrutiny. This was particularly highlighted after Metro Bank miscalculated the risk weightings for certain commercial property and buy-to-let loans, and announced it needed to increase its RWA by £900 million to £8.9 billion. Its shares subsequently fell 39% from £22.00 to £13.45 taking £800 million off the bank's value.

The calculation of capital ratios and RWAs is complex and brings together a large amount of information from disparate sources, requiring judgment and skill. The ICAEW created an assurance framework which helps give banks and their stakeholders more confidence in the figures. This is designed to be flexible so it can be used by both internal and external auditors. Although the framework has been used from time to time, it has not gained widespread traction among banks whose focus has been on implementing IFRS 9 and other regulatory changes.

Energy companies' reserves are another area where additional scrutiny would be welcome. In particular, Royal Dutch Shell was fined US$150 million in 2004 for overstating its energy reserves and misleading investors for five years. Differences in oil and gas reserve estimates and classification may result from errors or from the use of different methods, economic assumptions, or geological and engineering data. These differences may be resolved through a review of the supporting methodologies, assumptions and data, and would benefit from independent scrutiny.

That said, unless reporting on these matters is made a regulatory requirement, it would be difficult for auditors to carry out the assurance because of the additional costs and the current cap on non-audit services. As regards banks' capital ratios and RWA, the PRA is currently looking at the scope of assurance and where it asks for assurance (or not) and whether it is applied consistently. Currently, it requires insurers to have their solvency and financial condition reports (SFCRs) audited but not banks' Pillar 3 reports in that a larger proportion of banks' capital returns are based on audited accounts compared to the SFCRs. However, whilst banks' capital resources are based on audited numbers their capital requirements (derived from RWAs) are not, and we consider both the capital requirements and RWAs should be audited.

In addition to the above, we set out under questions 21 and 22 the increasing importance of companies reporting on significant environmental and social issues and the need for the reporting frameworks to become more standardised, and the level of assurance clearly explained and disclosed.

In this context, in terms of auditors having the available resources to audit such specialised areas we note that the Call for Views states that "the large firms' multi-disciplinary models mean that the required skill sets may often be available in-house[3]". It goes on to state that "alternative models for the conduct of large audits in the future could, perhaps, be envisaged. For example, a major consultancy or technology business might take the lead role while contracting-in specialist expertise that it does not have in-house[4]".

We highlight this is at odds with the CMA's final report which proposes that the Big Four audit firms should have an operational split and notes that this "will increase the focus on audit quality, with a reduction in the distracting interest in non-audit work; it will create transparency around audit practices, allowing the regulator to monitor their performance and resilience; it will give audit practices a place within the firms that compensates for their diminishing share of the firms' revenue, and reflects the public interest and concern; and it will give audit practices every possible incentive – short of a structural split – to bid competitively for more tenders, without trading off against possible non-audit revenues[5]".

Please see question 11 for investors' views on this.

9. Are the existing boundaries between internal and external audit clear?
10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

The IA notes that whilst the international auditing standard allows the internal auditor to provide direct assistance to the external auditor, the UK standard specifically prohibits this and requires certain procedures before indirect assistance can be given. We agree with this in that to produce a quality audit, auditors need to be independent from management, objective and free from bias and conflicts. We consider that ISA (UK) 610 sets the right bar in that whilst direct assistance is prohibited, the internal auditor can provide indirect assistance to the external auditor if it: has organisational status, and policies and procedures so that it is objective; is competent; and applies a systematic and disciplined approach, including quality control. It thus requires external audit to assess internal audit before the latter can assist.

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[3] Paragraph 37.
[4] Paragraph 38.
[5] Paragraph 58 of the CMA's report

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?

For investors audit quality is key and for an auditor to provide a quality audit, they consider that it is vital that it is independent of management so that it can challenge managements' assertions and judgements. Thus we do not consider that 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. Indeed, as we commented in our response to the CMA' s Update Paper: "investors support a wider ban on non-audit services such that the provision of non-audit services to audit clients in the FTSE 350 and/or large PIEs is prohibited. ……….Any restriction should be applied consistently across audit firms irrespective of whether they are Big Four or challenger firms. In addition, in the interests of efficiencies the auditor should still be allowed to provide certain audit-related services, such as reviewing preliminary announcements or auditing regulatory returns".

We highlighted that many investors are concerned about going further than this and requiring a full structural split and "audit-only" firms. The Big Four are international and often responsible for the audit of global companies. They need to remain connected to their international network to service global clients leaving questions over the non-audit services provided by that network. A quality audit also requires quality staff who can challenge and apply economic rationale. The seasonality of audits (the majority of companies have 31 December year ends) could impact the ability of an audit only firm to retain such staff. Thus investors' are more supportive of an operational separation as this is simpler and does not give rise to these same issues. However, it would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit without the issues that arise with a structural split.

We also have concerns that the dominance of the Big Four as auditors of FTSE 350 companies and the lack of choice an entity can have when it tenders its audit (audit firms can be precluded from participating if they provide prohibited non-audit services) can impact both quality and innovation. With such limited choice, investors question whether audit firms are really competing on quality issues and innovating sufficiently to improve quality. This is something that the CMA looked at in its review of the audit market.

CHAPTER 4 – THE SCOPE AND PURPOSE OF AUDIT

Risk and internal controls

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?

Currently, in accordance with the UK's Corporate Governance Code, directors of a premium listed company are required to: "monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls[6]".

The IA's members want to invest in well governed and controlled companies. Whilst on the whole companies risk reporting appears to be adequate, reporting on the review of the effectiveness of internal controls is largely boilerplate and we do not consider that existing requirements go far enough. We thus supported recommendation 51 in Sir John Kingman's report into his independent review of the Financial Reporting Council which stated: "BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of options for change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of company".

We consider that there are four key elements of the US framework that differ from that in the UK Corporate Governance Code in that the former:

- Requires an explicit statement by directors on the effectiveness of the company's internal controls over financial reporting.
- Requires an external assurance on the company's internal controls.
- Assumes personal liability by members of the Board.
- Focuses on internal controls over financial reporting as opposed to broader operational controls and risk management.

We would welcome a consultation on introducing a framework in the UK whereby the directors, or the CEO and CFO, are required to set out in the Annual Report their assessment of the risk management and all material internal controls, including financial, operational and compliance controls, and make an explicit statement on whether they operated effectively in the period. Requiring directors to be accountable for the operation of the controls will positively impact investors' views on their effectiveness. It is likely that there will be calls for a framework to be developed, similar to the COSO in the US, to assist with this.

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

We agree that if directors are to be required to make a statement on the effectiveness of the internal controls that auditors' responsibilities should be expanded so that they form a view on that statement. However, given the auditors' responsibilities for auditing the financial statements, we consider auditors should only be required to opine on the controls over financial reporting, as opposed to wider internal controls.

We understand that in the past the audit process comprised two parts: compliance testing of the control environment; and then based on that, substantive testing of balances/transactions. Thus in compliance testing evidence is gathered with the objective of testing an organisation's control procedures, e.g. verifying that certain controls have been applied over a database. Whereas in substantive testing, evidence

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[6] Provision 29

is gathered to evaluate the integrity of that data, e.g. verifying if the amount due to vendors is accurate.

We frequently meet with the major accounting firms and are aware that increasingly the firms' audit processes are becoming more substantive with the automated testing of data and moving away from a compliance testing of controls. Investors want to invest in well run and governed companies that have a sound control environment. We are concerned that the audit process is no longer looking at the control environment and would support the UK consulting on the introduction of a form of Sarbanes Oxley Section 404 reports that include auditors reporting publicly on their assessment of an entity's system of internal control over financial reporting[7].

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?

It would be valuable to shareholders if auditors were required to report their view publicly.

Going concern

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

Requirements for the assessment of going concern and related guidance are set out in accounting standards (IAS 1) and the UK Corporate Governance Code.

IAS 1 requires management to assess an entity's ability to continue as a going concern and if management has significant concerns then the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case a series of disclosures is required. In making the assessment, management must consider ALL information available about the future, which is at least but not limited to, twelve months from the end of the reporting period.

The UK Corporate Governance Code states: "in annual and half-yearly financial statements, the board should state whether it considers it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements[8]".

The related Guidance to the Code explains that in determining if there are material uncertainties directors consider: the magnitude and impact of uncertain future events or changes in conditions and the likelihood of occurrence; the availability and

[7] The Sarbanes-Oxley Act requires that the management of public companies assess the effectiveness of the internal control of issuers for financial reporting. Section 404(b) requires a publicly-held company's auditor to attest to, and report on, management's assessment of its internal controls.

[8] Provision 30.

effectiveness of actions the directors would take to avoid or reduce the impact or likelihood of the uncertain future events or changes in conditions; and whether the uncertain future events or conditions are unusual rather than occurring sufficiently regularly to make predictions about them with a high degree of confidence. It goes on to note that "uncertainties should not usually be considered material if the likelihood of that the company will not be able to continue to use the going concern basis of accounting is assessed to be remote, however significant the assessed potential impact[9]."

In conclusion, we do not consider that the current regulatory framework around going concern is "fit for purpose" in that it does not provide sufficient information to users and set out in question 16 how it should be enhanced.

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

We support greater transparency regarding "events and conditions that may cast significant doubt on the entity's ability to continue as a going concern" in that:

- The Guidance should be amended such that rather than directors' focus being on not disclosing remote events, there is a requirement to disclose possible events, including the failure of planned mitigation, which could have a significant impact.
- "Close calls" should be highlighted where significant judgement was needed to conclude that there was not a material uncertainty.

Viability statement

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

The IA agrees with Sir John Kingman[10] that viability statements are not performing an effective role and are largely boilerplate. We consider that these statements need to improve rather than directors being required to make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement. In this context, the IA issued Guidelines on Viability Statements in November 2016. These set out what investors would like to see in viability statements and expect companies, in summary, to:

- **Consider longer time horizons**. The majority of companies adopted a three year time frame with a few, such as major utilities and property companies, looking longer to five years. There should be more differentiation between companies and viability statements should address a longer timeframe than three or five years given the long-term nature of equity capital and directors' fiduciary duties.

[9] Paragraph 3.4

[10] Paragraph 3.21 of Sir John Kingman's' report into his independent review of the FRC

- **State clearly as to the why the period was chosen.** The FRC's Guidance states that in determining the length of the assessment period the factors to be considered include: the board's stewardship responsibilities; previous statements – particularly when raising capital; the nature of the business and its stage of development; and investment and planning periods. We consider directors should be clear as to why they have selected the particular timeframe and address wider factors, as set out in the FRC's Guidance, in determining the period. In particular, the specifics of the company's business and sector need to be considered, and not only its business cycle but its investment cycle as well.

- **Differentiate time horizons for prospects and viability**. A company may have different plans to cover short, medium and long-term horizons. The disclosures around prospects should address the long-term strategic plans and look longer than the period over which viability is assessed. Directors should separate their assessment of prospects from their assessment of viability. The former then gives them the opportunity to demonstrate that they have considered the future of the business over the long-term.

- **Sustainability of dividends.** Investors provide companies with equity or risk capital. The dividends received are an important return on that capital and investors would welcome the viability assessment addressing the sustainability of those dividends – see also question 31.

- **Stress testing.** Companies in the financial services sector are required to undertake stress testing, and we note that recently companies in other sectors have tended to undertake it as well. We would welcome this being extended to all companies and also reverse stress tests being undertaken. Each of the specific scenarios considered should be disclosed, together with the likely outcomes. The specific mitigating or remedial action taken should be transparent, together with an explanation of what could cause the risks to crystallise, the likely impact and how this could be mitigated or managed.

We would like to see these matters reported more widely than is currently the case.

18. Should such a statement be subject to assurance?
19. Who might be capable of giving such assurance?

Once the viability statements provide information that is helpful to investors then there is a case for requiring them to be subject to some form of assurance. In which instance, we consider that the statutory auditor would be best paced to give such assurance. Given that these are forward looking statements, we set out under question 40 the fact that directors have a safe harbour in the Companies Act for such statements and if auditors are to provide assurance on them then the safe harbour may need to be extended to them.

Unaudited information

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

THE IA'S ANSWERS TO THE DETAILED QUESTIONS RAISED

We believe there is a case for exploring whether the audit should be more forward focused. Currently, it is focused on the historical results and management's accountability for those results. However, investors, as the providers of a company's risk capital and bearers of the residual risk, want companies to report how they are creating, sustaining, and protecting value over the long term – see IA's Long Term Reporting Guidance.

We recognise that such forward –looking information may be highly subjective and difficult to assure. Thus the level of assurance may need to be varied. In which instance it will be important for the auditor to clearly communicate the work done and the level of assurance given. In this context, we set out in question 40, the fact that directors have a safe harbour for statements in certain reports whereas the auditors have no such safe harbour.

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 a benefit to users?
22. If so, what information might usefully be subject to audit or another form or assurance and why?

We set out in question 6 certain concerns investors have about the quality of the audit of the financial statements. It is essential that these concerns are addressed and trust re-established in the audit product. This should be a priority over extending the scope of audit or assurance. That said, there is a wide range of corporate reporting which falls outside the scope of the audit. Nor do the financial statements necessarily provide the only measures of a company's performance and there may be some benefit in exploring whether audit should cover the wider metrics investors consider important. Much of this reporting has developed in recent years and, regardless of the CMA and Kingman reviews, it is timely to consider what audit should be delivering and focus on those matters that influence investors' decisions. We set out below the main information that is currently unaudited or where the level of assurance is unclear, where investors would welcome some or better assurance.

- **Non-GAAP measures and KPIs**. Under IFRS management have to report additional information, non-GAAP financial measures, if the minimum line items required by IFRS are insufficient to enable investors to understand the financial position, financial performance and cash flows. Thus EBIT and EBITDA are often reported on the face of the Statement of Income and Expense, and revenue or operating income excludes certain expenses on the basis they are non-recurring. These measures can be helpful to investors and can convey changes to the business that are separate from those that may be considered unusual, infrequent or not representative of underlying trends. This can help in the analysis of future trends and if included in the financial statements then these measures are subject to an audit.

  There are also non-GAAP financial measures in the narrative part of the annual report and other corporate reports such as preliminary announcements of results and analyst/investor briefings, for example, return on capital employed or invested capital, as well as non-financial measures and industry specific indicators, such as like for like sales in the retail sector. The combination of non-GAAP financial and non-financial measures with the audited accounts conveys more than either dataset on its own. However, with the former:

- It is not always possible to see how they have been calculated.
- It is not clear whether they have been consistently calculated over time. Companies, even in the same industry, can use varying methods such that there is a lack of comparability.
- The subjectivity in how they are calculated make them prone to management bias. The adjustments can be opportunistic with business as usual items being treated as exceptional. Invariably non-GAAP financial measures paint a more favourable picture than GAAP.

We welcomed ESMA's guidelines that apply to non-GAAP financial information outside the financial statements, which expect each financial measure to be:

- Defined and a clear basis of calculation provided.
- Clearly explained why presented and why useful.
- Reconciled to nearest comparable GAAP.
- Equal and not more prominent than GAAP.
- Presented consistently over time.

But the guidelines do not address non-financial measures. They are also only guidelines and unless in the financial statements, the figures will not have been subject to an audit. We consider that auditors should be required to look at both financial and non-financial measures that are presented to investors in the annual report and accounts, the preliminary announcement of results and investor/analyst briefings. At a minimum, the auditor should assure that: for non-GAAP financial information ESMA's Guidelines have been followed; and that for any non-financial measures: they are defined with the basis of the calculation clearly disclosed; an explanation is given as to why they are presented and are useful; and they are presented consistently over time. In this context, the audit of such measures should not be used as a tool to expand auditors' business models unnecessarily.

- **Preliminary announcement of results.** A company's annual report and accounts contains extensive disclosures and is produced under harmonised reporting standards thus allowing investors to make comparisons between companies in the same and different sectors, and from one year to the next. However, it tends to be published sometime after the events to which it relates and is backward looking. Essentially it is a confirmatory document to the market. Thus it tends to be those documents, outside the annual report and accounts, such as analyst briefings, investor meetings, strategy presentations, and the preliminary announcement of results which help investors keep up to date with what is happening to a company. The important thing being that they can ultimately be referenced to the annual report and accounts that has been subject to a quality assurance, the external audit.

  In particular, the preliminary announcement of results is produced days or weeks before the annual report and accounts and is the main driver of investment and engagement decisions. One analysis of 134 annual reports in the UK showed that

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only 12 companies issued their annual report and accounts on the same day of the announcement of results; 23 took more than 30 days with one taking 78 days. The average was 20 days. However, it is not always clear if, and to what extent, the preliminary announcement has been audited. This needs to be addressed, clearly disclosed and the audit report issued at the same time.

- **Significant environmental and social issues.** In recent years companies' disclosure of environmental and social issues have become increasingly important to investors as they seek to integrate these factors into the investment process. This has resulted, in part, from the global threats from environmental damage, but also from broader socio-political concerns. These issues can also have an impact on the long term value of a company. In Europe, this recently took a major step forward with the Non-Financial Reporting Directive. From 2017 approximately 6,000 companies are required to report non-financial information under the Directive. However, there is no requirement to have this audited – auditors only have to check it has been provided.

  In this context, there is some dissatisfaction from investors with the quality and consistency of the information. The variety of reporting standards and frameworks around environmental and social issues can cause practical problems for investors in assessing a company's approach to these issues and comparing reports between different companies and industries. As awareness of the significance of environmental and social issues increases, investors have higher expectations for it being timely, comparable and verifiable. However, it is often inconsistent, not available or not verified. Also it is difficult for investors to determine what has been audited and what not, and understand what it meant by a reasonable or limited assurance. There needs to be more standardisation of the reporting frameworks and the level of assurance clearly explained and disclosed, particularly as the related data can impact KPIs and is used as remuneration targets.

- **Narrative reporting**. Reforms to corporate reporting following the financial crisis focused on making narrative reporting simpler, clearer and more focussed, with a particular emphasis on a company's strategy and business model. Narrative reporting is becoming increasingly important to investors who have higher expectations for it being timely, comparable and verifiable. Currently auditors are required to read this information and identify whether it is materially consistent with the accounts or the auditors' knowledge gained during the course of the audit. It is a concern that the FRC's AQR thematic review into this information noted that the nature, extent and quality of the audit work varied considerably both within and between audit firms, and linked this to a lack of prescriptive requirements on auditors. This is a quality issue that needs to be addressed before consideration is given to extending the scope of the auditors' work to cover such reporting.

- **Other matters**. We set out in question 8 our views on the scope of the audit in the banking and energy sectors, and in questions 30 and 31 our views on the capital maintenance regime.

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

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

For investors it is key that the product of the audit is a high quality audit where the auditor has challenged management's judgements and assertions and exercised professional scepticism. It is for the standard setters, regulators and audit firms to determine the best standards and processes to achieve that outcome effectively.

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?

We agree that the emphasis placed by auditors on 'completing the audit file' for subsequent inspections by the Financial Reporting Council's AQR can eclipse the desired focus on matters requiring the exercise of considered judgment. The IA's response to Sir John Kingman's Review of the Financial Reporting Council noted that: "members have concerns over the quality of FRC's enforcement and investigation work in the audit market, and question whether the FRC is doing enough to hold auditors to account. There are concerns that both auditors and the FRC are too focused on complying with a set process rather than achieving the right outcomes".

We still hold that view and set out elsewhere in this response our views on the right outcome of the audit process and what investors want from a quality audit.

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

The fact that companies' accounts are subject to an audit is vital to investors' confidence in those companies in that markets value the information and investors believe what they are told about their investee companies. The Financial Reporting Council in the UK was the first regulator to introduce an enhanced audit report for year ends ending after 30 September 2013 for premium listed companies that have to report under the UK's Corporate Governance Code. For the first time the audit report moved from the black and white pass fail of the true and fair view, and has become more discursive explaining the audit risks and the response – what the auditor did, the materiality used and the overall scope of audit work undertaken.

Investors welcomed this and in particular, the clarity around the risks of material misstatement and what the auditor did, however, only one audit firm reported on its findings – graduated audit findings – for around nine audits. That firm wrote to all the entities it audits asking if they would agree to their audit reports being enhanced in this way. However, clients refused in spite of investors asking for this. This did not send a good message to investors who rely on the auditors' work and to whom the auditor reports. Auditors should consider the investor community as the true clients of the audit process and disclosing graduated findings would give the investors more tools to hold both audit committees and auditors to account.

26. Could further narrative be disclosed alongside the opinion to provide more informative insights?
27. What would prevent such disclosures becoming boiler plate?

The enhanced audit reports are now tending to become repetitive and boilerplate. The firms should seek to innovate more and to differentiate themselves from their competitors. It would also be helpful if changes in the Key Audit Matters and materiality from one year to the next were clearly highlighted and explained.

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

We consider the dominance of representatives from the main accounting firms in the auditing standard setting process may have inhibited innovation and development for the benefit of users. In particular, as it currently stands each of the Public Interest Oversight Board's three Standard Setting Boards is made up of eighteen members of which only three are Public Members[11]. Whilst Public Members may have trained at an audit firm they will have held roles outside the profession and could be considered more independent. This is important in ensuring a broader perspective is involved in the standard setting process. We particularly consider, given the importance of audit to the investor community, it is vital that there is better representation of investors, asset managers and analysts, in the process.

CHAPTER 6 – LEGAL RESPONSIBILITES

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?

We are concerned that the FRC AQRT's thematic report of January 2014 highlighted that: "Although practice is not uniform across all firms and audits, there is a lack of focus on identifying the specific risks in relation to fraud and non-compliance with laws and regulations and there are a number of specific areas requiring improvement.

"The consideration of fraud risks and relevant laws and regulations, and the performance of related audit procedures, tends to be viewed as a compliance exercise rather than as an important and integral part of the audit. Improvements are needed to better focus attention on how these may affect the financial statements. We saw evidence of a presumption by audit teams that issues in these areas were unlikely to occur at the entity they were auditing. This suggests a lack of appropriate professional scepticism".

[11] Public members may in the past have had accountancy training, been employed by Audit firms or been active professional accounting practitioners, but they have broader experience of acting in the public interest in other roles and can therefore be perceived to be independent of the profession

We consider this needs to be addressed. We set out under questions 30 and 31 our views on the capital maintenance regime.

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?

In the main, investors do not consider that there is an inconsistency between company law and accounting standards as regards distributable reserves in that certain sections of the Companies Act and accounting standards have a different purpose.

Part 23 of the Companies Act requires directors to assess distributable profits by reference to the individual parent company accounts, as opposed to the consolidated accounts of the group. Section 830(2) of the Companies Act states that a company's profits available for distribution are 'its accumulated, realised profits… less its accumulated, realised losses', and section 853(4) 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 these sections refer to realised profits, there is no requirement for the accounts to contain only such profits. The profits in the relevant accounts are therefore a starting point, and need to be analysed and adjusted, just as happens with tax computations, in order to determine the amount of realised profit available for distribution. In essence the adjustments required are, in accordance with the ICAEW Guidance on Realised and Distributable Profits, aimed at enforcing a more prudent approach by restricting intra-group transactions and in a number of instances, fair value gains are not distributable.

The auditors, on the other hand, are largely concerned with the consolidated or group accounts of the main companies listed on the market. These accounts are prepared under international accounting standards or IFRS. Their aim is to tell the market how the group has performed during the year to enable investors to make investment decisions and hold management to account for its stewardship. They need to be transparent and comparable, and prepared under standards which are applied consistently internationally, IFRS. This helps ensure that the capital markets operate efficiently internationally and attract international investment. Moreover, international comparability helps reduce investors' costs in undertaking research and analysis.

In this context, the BEIS Select Committee Report into the Future of Audit argued that goodwill was part of the problem in respect of Carillion paying dividends and if that goodwill had been expensed it may not have paid dividends. However, in Carillion's parent company accounts, on which distributions are based, there is no goodwill in the balance sheet. The goodwill appears to arise on consolidation.

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

There are concerns when companies fail to maintain capital and pay unlawful dividends. The BEIS Select Committee Report into the Future of Audit noted a number of examples[12]. Investors would benefit from information on the level of distributable reserves (i.e. those reserves available for distribution through dividends or share buybacks). We thus agree that distributable and non-distributable reserves should be required to be disclosed in the audited financial statements. Whilst this disclosure will relate to the parent company accounts – see above - it should also address any restrictions on dividends paid by subsidiaries to the parent and why. This would enhance investors' confidence in management's stewardship by demonstrating that dividends are not being proposed out of capital and clarify the headroom between the level of distributable reserves and the proposed dividend. The fact this information is included in the audited financial statements will mean that it is subject to the audit.

That said, there are certain investors that believe capital maintenance is a central purpose of accounts such that, as well as reserves being analysed into distributable and undistributable, profits should be analysed into realised and unrealised. They do not consider that accrued income should be treated as realised in that realised profits should only be those that are realised in cash or near cash. In this context, they note that the ICAEW Guidance on Realised and Distributable Profits runs contrary to the purpose of capital protection in that it explicitly states that accrued income can be treated as realised for the purposes of distributions. If directors are permitted to distribute income they expect to receive, then they believe there are significant risks in the event this income does not materialise that dividends could be paid out of capital and thus contravene company law.

In this context, many investors are concerned about the implications should there be a requirement to disclose realised and unrealised profits for accounting and window dressing around the year end. Where there is a consensus, however, is that the ICAEW Guidance on Realised and Distributable Profits needs to be simplified and owned by a regulator as opposed to a membership body. We also draw your attention to our recent report on dividend payments that we conducted on behalf of BEIS. This calls for companies to improve their transparency and publish a 'distribution policy' setting out their approach to paying dividends to shareholders.

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?

The Companies Act requires that the auditor carries out such investigations as necessary to form an opinion that the audited entity's accounting records are adequate. Moreover, the auditor is required to disclose in the extended auditor report if such records have not been maintained. We consider that this requirement may be understood differently by different auditors, and applied with varying degrees of rigour. This needs to be addressed.

CHAPTER 7 – THE COMMUNICATION OF AUDIT FINDINGS

[12] Paragraph 60

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?

We do not support an annual assurance meeting between auditors and users of their reports. As it stands few institutional investors attend AGMs – such meetings tend to be clumped together in the same months of the year and are dispersed nationwide. That said, if an investor has a particular concern about a company that has not been addressed through direct engagement then they may well attend the AGM. We thus consider auditors should be required to attend AGMs and be given the opportunity to speak and answer any questions directed at them. Many investors also welcome audit firms engaging with the shareholders in an entity they audit in a less structured manner – see question 53.

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?

We agree that more of the communications and challenge to judgments that occur between the auditor and the audit committee should be transparent. In the UK standards require the auditor to highlight in its report the matters it reports to the audit committee that are not clarified in the audit committee report. However, in practice there are few, if any, such disclosures. This indicates that either there are no such matters or if there are, they are not being disclosed. Investors would like to see more tension and differences between the auditors' report and the audit committee's report as this would be an indication of the extent of challenge and scrutiny that is taking place. At present the two reports tend to be very much aligned giving little evidence to external users that this is happening.

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?

As noted in question 28, it would be helpful if changes in the Key Audit Matters and materiality from one year to the next were clearly highlighted and explained in the audit report.

CHAPTER 8 – FRAUD

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?

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

As noted in the Call for Views, an audit provides auditors with 'reasonable' assurance to support their audit opinion. Our understanding is that this is a high but not an absolute level of assurance in that UK auditing standards state that absolute assurance is not possible because of the inherent limitations of an audit. These include the practical and legal limitations to obtaining audit evidence, including the effect of fraudulent collusion, and the need for the audit to be conducted within a reasonable period of time, at a reasonable cost[13].

Users expect auditors to identify material misstatements in the financial statements whether due to fraud or error. However, they are particularly concerned that the need for the audit to be conducted in a reasonable time frame and at reasonable cost is an inherent limitation in being able to do so. The Standard should be reviewed and steps taken to enable auditors to reduce this risk.

38. Would it be possible to devise a 'reasonable person' test in assessing the auditors work in relation to fraud detection?

We note that the reasonable, objective and informed third party test is required to be applied in respect of assessing independence and conflicts of interest matters. However, in practice investors have had concerns that it has not been implemented properly in that there is no guidance on who the reasonable, objective and informed third party is. This would need to be addressed before this proposal could be taken forward.

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

We consider this should be addressed as part of the auditors' work on the internal controls systems on which we comment in questions 12 to 14.

CHAPTER 9 – AUDITOR LIABILITY

40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

We agree that the audit profession's willingness to embrace change may be constrained by its exposure to litigation. In this context, enhancements to narrative reporting caused directors to be concerned over their liability for negligence when making, for example, forward-looking statements in the directors' report, in particular, the business review. Thus Section 463 of the 2006 Act introduced a safe harbour in relation to directors' liability for the directors' report, the directors' remuneration report and summary financial statements. Directors are only liable to compensate the company for any loss it suffers as a result of any untrue or misleading statement in, or omission from, such a report if the untrue or misleading statement is made deliberately or recklessly, or the omission amounts to dishonest concealment of a material fact. The directors' liability is limited to the company rather than to third parties.

We understand that auditors do not benefit from such a safe harbour. If the scope of their work is to change to cover forward-looking statements, such as the viability

[13] Paragraph A47 International Standard on Auditing (UK) 200 (Revised June 2016)

statement – see questions 18 and 19 - then they would need to benefit from an equivalent safe harbour as the directors that make those statements.

41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?
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?
43. How quality of the audit product might be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

We do not consider a quantifiable limit on auditor liability would lead to improvements in audit quality and/or effectiveness. As noted in the Call for Views, the Companies Act 2006 introduced a clause allowing UK auditors to enter into liability limitation contracts on the basis that without a limit, there was a risk that one of the Big Four might fail as a result of litigation. (In this respect, reputational risk and legal action in the US resulted in the demise of Andersons and not its liabilities). The final clauses permitted limitation by any means - proportionality, fixed cap, variable cap, etc. - subject to shareholder approval annually, and the courts considering the terms of the contract to be 'fair and reasonable in all the circumstances of the case'.

At the time we did not support this in that there were concerns about the effect it could have on audit quality - exposure to liability induces service providers to be more diligent and reducing it could induce a lower quality of service. We particularly did not support a fixed cap, or quantifiable limit (question 41) in that:

- Auditors are engaged to scrutinise a company's directors' stewardship and disclosures. Any such agreement with the company would in effect be with the directors they are engaged to scrutinise.
- It could potentially encourage consolidation and less choice - in the absence of a cap it is the total of the larger firm's assets that are at risk as opposed to those of one of the pre-consolidation components.
- It would not assist choice in working against the smaller firms.
- For companies also listed in the US, the US does not permit liability limitation agreements.

In practice, liability limitation agreements have not been used much, if at all. Moreover, significant claims against auditors tend to be settled out of court thus avoiding the reputational damage of a court case. We thus consider that the current liability regime should continue in respect of the statutory audit and that liability should only be to the company and its shareholders as a body and not to wider stakeholders (question 42).

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?

This question is outside the IA's remit.

CHAPTER 10 – OTHER ISSUES

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?
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?
47. Are there aspects of current audit procedures or output that are no longer necessary or desirable?
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?

Questions 45 to 48 are outside the IA's remit.

49. Does today's audit provide value for money?
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?

For investors audit quality is key and the fee charged should be at the right level to ensure this. Given that a number of investors have concerns over audit quality – see question 6 – it is debatable whether the firms are charging sufficiently to enable them to deliver a quality product. That said, investors do not wish audit fees to become excessive.

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?

When our members invest in a company's equity they are in effect providing that company with capital - essentially risk capital in that when it all goes wrong they bear the residual risk. They want the annual report and accounts to provide them with the information they need when they invest, but also to help them fulfil their responsibilities as owners – assessing company management and the strategies adopted for the longer term.

The annual report is a vital tool in demonstrating management's accountability. Management is entrusted with shareholders' funds and the annual report should show how effectively it put those funds to use and the performance derived from those funds. It contains extensive disclosures and is produced under harmonised reporting standards thus allowing investors to make comparisons between companies in the same and different sectors, and from one year to the next. In this context, investors are increasingly tracking the quality of the accounts and accounting judgements in assessing a company's governance and using this in both fundamental and quant investment strategies.

The fact that companies' accounts are subject to an audit is vital to investors' confidence in those companies in that markets value the information and investors believe what they are told about their investee companies.

However, annual reports tend to be published sometime after the events to which they relate and are backward looking. It tends to be those documents, outside the annual reporting framework, such as analyst briefings, investor meetings, strategy presentations and stock exchange announcements, which help investors assess a company's prospects and make investment and engagement decisions. The important thing being that they can ultimately be referenced to the annual report that has been subject to a quality assurance – the external audit.

52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

Investors already periodically engage with certain audit committees when there are reporting and accounting issues with a company. Investors engage with individual audit firms, both the audit firms' Executive and Independent Non-Executives, on governance and audit quality issues. They also vote on auditor's and audit committee members' re-appointments annually. We set out in question 33 our views on an annual assurance meeting and in question 53 how shareholders could express concerns to inform the audit planning process.

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

Many investors welcomed one of the main audit firms reaching out to the major shareholders in the main entities it audits to determine if there were any areas they wished the auditor to focus on during the audit. They would like other firms to follow the same practice. Others, on the other hand, fear that this could potentially undermine the line of accountability from auditors to audit committee to investors.

We do not consider it is for shareholders to approve planning matters for each audit, including scope and materiality. This is the responsibility of a company's audit committee of independent non-executives. The audit committee should oversee auditor appointments and monitor the relationship with the auditor to ensure the auditor is independent and objective, and safeguards the interests of a company's shareholders. We thus support the proposal in the CMA's final report that the regulator:

- Should have the power and a requirement to mandate minimum standards for both the appointment and oversight of auditors.

- Should have the power and a requirement to monitor compliance with these standards, including the ability to require information and / or reports from Audit Committees.

- Should take remedial action where necessary, by for example issuing public reprimands, or making direct statements to shareholders in circumstances where it is unsatisfied with Audit Committees[14].

This scrutiny will help ensure that audit committees fulfil their function properly.

54. What assurance do shareholders currently obtain other than from audit reports?

Companies can now ask for a variety of reports to be assured, outside the accounts and the statutory audit, such as reports on diversity, and significant environmental and social matters. The level of assurance given can vary and it can be difficult for investors to determine what has been audited, what assured and what not. It can also be difficult to understand what is meant by a reasonable or limited assurance. More clarity and consistency is needed – see questions 21 and 22.

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

A company's culture is important for the effectiveness of its operations and the sustainability of its performance over time. Investors consider that it is important for a company's board to set, and report on how it monitors, culture. As to auditors reporting on an audited entity's culture, we question whether the current audit model and standards would engender a skill set and processes that would result in a report that users would find helpful. We do not consider that the current audit processes have been designed with such qualitative reports in mind or that there is a clear investment case for such a report. We do not consider this should be pursued.

56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgements underlying the audit report?

The important thing for investors is that a company in which they have an interest has appointed an auditor that can deliver, and has delivered, a quality audit. A quality audit means that the auditor has challenged management's judgement and assertions, and exercised professional scepticism.

Auditors can demonstrate they have exercised this challenge in their enhanced audit report. One means would be the graduated audit findings on which we comment in questions 25 to 27. We also understand that it can be common for the auditor to propose adjustments to the reported numbers. One of the main firms recently advised that it completes some 4,500 UK audits a year and collated that there had been a material change in the reported numbers following the audit in over 4,000 instances. However, this information is not disclosed to shareholders.

57. Should the basis of individual auditors' remuneration be made available to shareholders?

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It would be helpful if in the firms' transparency reports there was better disclosure of the basis of how individual auditors are incentivised and remunerated so that shareholders can assess the extent to which audit quality is taken into account. In addition, most players in the capital market operate under long term incentive plans that include malus and claw-back provisions that can be triggered by poor performance or personal misconduct. Audit firms are constituted under partnership law where profits are paid out annually. Given the systemic importance of the firms and the need to develop and innovate over the long term, in the interests of ensuring audit quality, consideration should be given to requiring them to operate under long term incentive plans. This may mean that any constraints in partnership law that prevent the operation of such plans need to be addressed.

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

Investors want the auditor that will provide the highest quality audit selected and prospective auditors should demonstrate clearly that they can provide a quality service. The IA's members consider it important that the Audit Committee ensures that in making its recommendation it puts audit quality as its main criterion. In this context, it is important that fees are considered as part of the tender process in that they should be reasonable, i.e. not too low to suggest audit quality could be impaired and not too high as to be excessive.

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

Currently companies disclose in the annual report and accounts the cost of the audit and of non-audit services provided by the auditor. However, we are also aware of the time pressures that auditors can be under when completing the audit and that in the case of BHS, the lead audit engagement partner only spent two hours on the audit before BHS failed. We consider it would be helpful for a breakdown of the hours spent on the audit were disclosed such that the time spent by and the involvement of senior individuals can be assessed. This need not necessarily be in the accounts but could be on the company's web site or in an AQR report if the audit has been subject to a review.

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

This question is outside the IA's remit.