



18th June 2019

Brydon Review Secretariat
Department for Business, Energy & Industrial Strategy
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Via email: brydonreview@beis.gov.uk

Dear Brydon Review Secretariat

Independent review into the quality and effectiveness of audit: Call for views

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the **Independent review into the quality and effectiveness of audit: Call for views** issued 10 April 2019.

The CRUF shares the concern of the Review that corporate failures such as HBOS, BHS, Carillion and Patisserie Valerie occurred despite the fact that all these companies received clean audit opinions.

This raises questions from those in the investment community about the effectiveness of audit and in particular the application of the going concern principle in the preparation of financial statements. This does not mean that we believe that auditors are as culpable for the failures as the executives, some of whom appear to have attempted to make the deterioration of the business less obvious. In addition, we believe that the non-executives should be sceptical and independent, acting as our agents, using the auditors as their support to challenge the accounts with more rigour than could be achieved internally.

Responses to the questions raised in the Review that relate to the issues that concern investors are set out below.

Chapter 1 Definitions of audit and its users

Q1. For whose benefit should audit be conducted?

The CRUF understands that an audit is technically conducted for current investors and that potential investors also benefit. Other stakeholders benefit from the trustworthiness of audited financial information, including employees, suppliers, customers and governments. Society as a whole benefits from trustworthy financial information through more efficient asset pricing and better capital allocation.

Q2. Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

The CRUF believes that the scope of the audit should remain in the financial statements and not extend to the auditor to 'vetting' the business model. We appreciate that auditors may give

assurances on financial and non-financial information outside of the financial statements. However, the myriad of possible assurances, relating to various different aspects of an entity, should not be confused with the specific assurance of the audit which is clearly defined both in scope (financial statements) and nature (adherence to GAAP).

Chapter 2 The expectation gap

Q4. Do respondents consider there is an expectation gap?

The CRUF acknowledges that there is an expectation gap, but this varies a great deal between different types of users. The CRUF feels that the expectation gap is widest for the public and some non-investor interest groups. The CRUF believes that for investors the expectation gap is much narrower as they have, in general, a realistic expectation of the assurance provided by the audit of the financial statements. Having said that, one key expectation gap from a user perspective is the level of assurance on numbers outside the financial statements, such as those in the “front half” of the annual report (see response to Q5 and Q33 below).

Q5. If so how would respondents characterise that gap?

With regard to the financial statement audit, one example of an investor’s expectation gap is the degree to which auditors have exercised their professional scepticism in relation to management’s judgements. The CRUF believes that most investors understand that a clean audit opinion only means that the accounts adhere to GAAP, and within GAAP there is often a wide scope for management to be more or less conservative in their assumptions.

Another example of an investor’s expectation gap is the level of assurance provided outside the financial statements, over the “front half” of the annual report and in other documents produced relating to the results, including presentations to capital markets. While the CRUF appreciates that the audit opinion only covers the financial statements, we understand that auditors check for consistency in the “front half”, but not at information produced outside of the annual report. Many CRUF participants would welcome more details about the assurance of information in the “front half”.

Chapter 4 The scope and purpose of audit

Q15. Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

Some CRUF participants consider that the assessment period to be at least 12 months from the end of the reporting period as stated in International Accounting Standard (IAS) 1 *Presentation of Financial Statements* (paragraph 1.25) is not long enough (for UK reporting this period is twelve months from the date of approval of the financial statements).

This is to a certain extent mitigated by the viability statement which the directors are required to provide under the UK Corporate Governance Code. In this statement, the timeframe specified by the directors is usually extended beyond the period of 12 months from the signing of the accounts (longer than IAS 1.25) up to usually 3-5 years. However, the viability statement is not audited and as a result its content could be regarded as less robust than other forward-looking reporting that is subject to audit, for example, provisions.

Other CRUF participants believe that to ask an auditor to give a going concern assurance beyond 12 months from the date of signing is perhaps asking too much, especially for riskier early-stage companies which may well not survive. The speed at which a business collapses depends on the trading environment and validity of the business model, as well as actions by management.

As users we need it to be clear as to what we can realistically expect auditors to sign-off as “going concern”. The auditor should not be asked to stare into a crystal ball, or be expected to be able to predict industry dynamics, and a clean bill of health by an auditor doesn’t mean the company can't have problems in the foreseeable future. Whilst saying this, the areas of risk and scepticism could be highlighted more clearly, and not just in the audit report; management should tell investors what they consider to be the Achilles heel of their business model, so that investors who aren't industry experts can make their own judgement calls.

A useful analogy may be a surveyor that gives their professional opinion on the structure of a building but does not necessarily give assurance over an extended period. In fact, most professional opinions of this nature explicitly limit expectations and legal liability. A going concern “rating” over 1, 3 and 5 years may be helpful, along with some narrative. Such narrative may say, for example, “This company should exist in 5 years’ time, with the main risk being nationalisation under a new government”.

Q16. Should there be greater transparency regarding identified “events or conditions that may cast doubt on the entity’s ability to continue as a going concern”?

The CRUF expects the auditor to have sufficiently considered the events or conditions to decide on whether there is appropriate disclosure in relation to them in the financial statements.

In the absence of detailed information, investors have to rely on management’s judgement that no material uncertainty related to going concern exists and that the auditor concurs with this view. The CRUF agrees that there should be greater transparency of events or conditions which may cast doubt, but is also aware of the risk that if such disclosure is too detailed it may be self-fulfilling.

Chapter 7 The communication of audit findings

Q33. 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?

As noted above, the CRUF believes that one key expectation gap from a user perspective is the level of assurance on numbers outside the financial statements, such as those in the “front half” of the annual report. Given that the CRUF is of the view that this lack of assurance from the auditor in this area is a contributory factor to the expectation gap (see response to Q4 and Q5), an annual assurance meeting could provide an opportunity for investors to acquire greater insight into the audit and assurance process. However, there is a need to be realistic about the time that investors have to attend such meetings.

In addition, the CRUF notes that the auditor has access to non-public information and is able to use this to ask management probing questions. This is the key value add of any audit, but it is not necessarily conveyed in current audit reports. Investors are therefore in a very different position to auditors as they do not have access to the same information. Care would need to be taken to ensure that in such meetings the risk of the investor being classed as an insider is addressed.

Q34. 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?

The CRUF believes that the quality of the reporting has a part to play in this area. Inevitably questions arise following corporate collapse because it is not always apparent that there are problems from the reporting in the audit report and the audit committee report. More public disclosure of the communication between the auditor and audit committee would be welcomed by users, to help get a sense of the level of management conservativeness and the level of auditor scepticism. Also see our response to Q35.

Q35. 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?

The CRUF agrees with the suggested enhancement of an obligation to update on key audit matters featured in the previous audit report.

More generally, the CRUF believes that the design of the audit report could be improved to enhance users' confidence in the financial statements. The audit report contains a lot of additional information which adds to the investor's picture of the overall governance of the company and highlights key areas of judgement, which can be extremely helpful. However, there is room for improvement. If the audit report provided more detail around significant issues, it would be less of a surprise if there was a subsequent corporate failure. For example, for key areas of judgement it would be helpful to disclose the range of assumptions which were considered. This would also enable users to generate their own scenarios. One CRUF participant suggests, as a thought experiment, that the key differences between the initial management accounts and final audited accounts could be disclosed. Material differences may provide some information about the level of auditor scepticism.

The CRUF believes that, in principle, a graduated opinion would be more informative than current opinions. This would go some way towards reducing the binary nature of the audit opinion. The CRUF accepts that it is a challenge to ensure consistency of a rating system between different auditors and across different countries. However, this is no different from the credit rating agency ratings which investors also utilise. The CRUF also notes that the vast majority of audit opinions are "clean" and therefore do not serve as a tool for differentiating one company's reporting quality from another's.

The CRUF believes that together the audit report and the audit committee report could provide more useful information that would enable investors to gauge where the directors are pushing the boundaries. The audit committee report has provided a lot more colour on the significant issues and ways in which they have been mitigated. The CRUF welcomes this improvement in disclosure and would encourage as much detail as possible when describing risk mitigation.

Chapter 8 Fraud

Q36. 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?

Q37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

Q38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

The CRUF accepts that the detection of fraud is not a primary function of the audit but there is a perceived need for increased awareness of auditors' practice across industries with respect to fraud. It would be remiss of the auditors and the audit committee to dismiss the possibility of its presence in the business. Fraud should be an integral part of risk management.

Chapter 10 Other issues

Q51. 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?

Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

See our response to Q33.

Q53. 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?

The CRUF believes that, in general, it is unrealistic to expect shareholders to engage with the audit plan, due to the large number of companies that most investors have to deal with. There is also a fundamental issue regarding such shareholder engagement for active managers: if they have a material concern about the company and the quality of the accounts then they owe a duty of care to their investors to sell the shares. This negates their ability to influence auditors and non-executives.

The only group of shareholders which are "forced owners" of companies are index funds which are perhaps the only shareholder group that could be called upon to have large departments to engage with auditors and non-executive directors. Because they simply replicate an index it would be possible to give them exemption to hold material price sensitive information as long as they stayed replicated.

Active manager selling and short selling by hedge funds can be a useful signalling indicator to the auditor and the non-executives that there are market concerns which they should reflect in their audit plans and increase the level of scepticism applied.

Q54. What assurance do shareholders currently obtain other than from audit?

The CRUF believes that the level of assurance to be obtained other than from audit can be found by focussing on information available about individual companies and industry sectors outside of the reporting periods.

In addition, while equity research can reassure investors in so far as it comments on the plausibility of management's statements in the context of general industry dynamics, it cannot technically be considered assurance.



About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers and corporate governance professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings held globally. Local country differences of opinion are noted where applicable.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

(Signatures)

Anna Czarniecka
Financial Reporting Consultant

Jeremy Stuber

Peter Elwin

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Greg Collett
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