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To whom it may concern,

<u>Independent Review into the Quality and Effectiveness of Audit</u>

We welcome the opportunity to respond to the Independent Review into the Quality and Effectiveness of Audit.

The Quoted Companies Alliance *Financial Reporting Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-size quoted companies. A list of Expert Group members can be found in Appendix A.

Overall, we welcome your work to review the issues associated with audit and address the perceived widening of the audit expectations gap. In light of recent company failures and increasing expectations, a greater focus on audit has developed, and it becomes increasingly paramount to make changes in order to better serve the public interest. It is essential that a greater understanding of what an audit is, as well as further clarification of an auditor’s role and responsibilities, transpires as a result of the review. Bearing in mind the small and mid-size companies we represent, we are particularly encouraged that it is stated that the Review "will be mindful of the proportionality of any recommendations in terms of its costs to business."

If you would like to discuss our response in more detail, we are happy to do so in our planned, upcoming roundtable together.

Yours sincerely,

Tim Ward
Chief Executive

Responses to specific questions

Chapter 1

Q1 For whose benefit should audit be conducted? How is it of value to users?

We believe audit should primarily be conducted for the benefit of a company's shareholders. The fundamental purpose of an audit is to express an opinion that a company's financial statements have been prepared in all material respects in accordance with the applicable financial reporting framework and are true and fair.

Whilst we acknowledge that audit is of value to other users, in that it determines whether a company's financial statements are materially accurate and reliable, it would be unrealistic, and challenging, to expect an audit to cater to all users. This is because each individual stakeholder has their own remit and needs which are often at odds with the primary purpose of an audit.

We are therefore of the view that an auditor's duty of care should not be extended to anyone other than the company and its shareholders as a body.

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

As an audit's primary purpose is to provide an opinion on the truth and fairness of a company's financial statements and that they have been prepared properly in accordance with the applicable financial framework, we do not believe that an audit can necessarily be 'designed' to enhance the degree of confidence of intended users. Unless the scope of audit is changed, it is not for the auditors to give this confidence. Rather, it is for the directors themselves in how they present their company, which they do predominantly in the annual report.

Q3 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 do not believe that greater clarity can be given over the purpose of an audit in UK law. The meaning and purpose of audit is already set out clearly in UK law. We believe the issue lies in the interpretation and understanding of the purpose of audit, which is often construed in different ways.

Chapter 2

Q4 Do respondents consider there is an expectation gap?

Not only do we believe that there is an expectation gap, we also believe there is a knowledge gap in the purpose of an audit. The review identifies this well:

"The key decisions in relation to the future prospects of a business are taken by its directors (rather than the auditors), and it is the directors who establish the company's system of controls and oversight and approve the audited entity's financial statements."

Q5 If so, how would respondents characterise that gap?

The expectation gap in audit can be characterised by the difference between what is expected from an audit and the actuality of what an audit does and what auditor's responsibilities are. It is often wrongfully perceived that the audit should provide assurance over the viability of an entity or that auditors can be expected to identify all situations where fraud occurs.

It is not possible to expect an auditor to understand and have the same knowledge of a company as the directors and management who are responsible for running the entity. Auditors are external to the company, perform the audit on a historical basis and are reliant on the information supplied to them by the company itself. There are clear limitations to an auditor's ability to access certain forms of information about a company, and, as a result, the extent and depth of analysis of a company conducted by an auditor is restricted and thus cannot be a guarantor of assurance. Further education around the auditor's role and responsibilities would help to address this expectation gap.

Q6 Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

We have no comments.

Chapter 3

Q7 What should be the role of audit within wider assurance?

Within the current framework, audit acts as a reasonable form of assurance that relates predominantly to financial statements. We believe this is sufficient and appropriate.

Q8 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 level of assurance provided by an audit should be consistent irrespective of the differing business sector and the nature of the entity's risks. Auditors should understand the business and identify the level of risk associated for that entity and tailor their audit approach accordingly. This means that audits on larger and more complex entities may require more specialist skills and experience, but the level of assurance should remain consistent. There is also a risk that, in varying the level of assurance given by an audit, the expectation and knowledge gap of the purpose of an audit is widened even further.

Q9 Are the existing boundaries between internal and external audit clear?

Yes, we believe that the existing boundaries between internal and external audit are clear.

Q10 To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

The external auditor's use of the work performed by internal auditors is already considered within the International Auditing Standard (ISA) 610. We do not believe further changes are needed to the existing auditing requirements in this regard.

Q11 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?

We have no comments.

Chapter 4

Q12 Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

We do not believe that directors should make a more explicit statement in respect of risk management and internal controls. The amount of information required already overburdens the annual report, any further statements required only add to this.

Q13 Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

Additional clarity over the auditor's and directors' responsibilities regarding the effectiveness of an entity's system of internal control would be helpful.

We also believe that, any clarity or extension in the auditor's responsibilities in this regard should appropriately reflect the differing size and complexity of entities subject to audit. At present, the International Standards on Auditing are expected to suit audits of all sizes. It is therefore important that any amendments are appropriately scalable.

Q14 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?

We believe that the requirement for auditors to report to audit committees their views on the effectiveness of relevant internal controls is sufficient and these views do not need to be reported publicly. The board should explain what corrective actions have been or are being taken to remedy any weaknesses within their company's system of internal controls in the annual report.

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

The current regulatory framework relating to going concern is appropriate. However, we acknowledge that there needs to be greater clarity between 'going concern' and 'long-term viability' as they are often conflated.

Q16 Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?

We do not believe that there should be improved transparency for the auditor to provide an opinion on whether management's assessment of identified events or conditions that may bring into question the ability of the entity to continue as a going concern, as we believe that the current requirements are appropriate. The auditor already assesses whether such uncertainties are disclosed appropriately in the financial statements and, if an uncertainty exists with regard to going concern, attention is drawn to this within the auditor's report and the auditor will assess whether disclosure is necessary to give a true and fair view.

Q17 Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

We do not believe that viability statements are currently performing an effective role in determining the sustainability of an entity's business model. A large part of the content which is included in the annual report is inserted as part of a 'box-ticking' compliance exercise. That said, it is difficult for either a company or an auditor to predict the sustainability and the future of an entity, which makes any such statement inherently difficult to provide and support. The achievement of a 'fair and balanced' disclosure within the annual report is often challenging both from the company's and the auditor's perspective. We do not see that any material benefit would be derived from such a statement due to the uncertainties described.

Q18 Should such a statement be subject to assurance?

See response to Q17.

Q19 Who might be capable of giving such assurance?

See response to Q17.

Q20 Is there a case for a more forward-looking audit? What would be the main benefits and risks?

To an extent, there is a case for a more forward-looking audit. Companies publish a significant amount of relevant and important forward-looking information that is currently not subject to audit. We have identified what we believe are the benefits and risks below.

Benefits

- It would help to reduce the expectation gap in this area and improve the consistency between and within audit firms on what is supposed to be subject to audit within the annual report, if further clarity is given.
- It will encourage companies to spend more time assessing their long-term viability, as well as analysing their internal processes and their ability to overcome future risks. This is information that investors have increasingly been keen to obtain from companies.
- Forward-looking audit would help to provide assurance over the metrics a company applies and the veracity of their KPIs.

Risks

- An unintentional consequence of subjecting the forward-looking information in the annual report to audit would be that it may further overload the amount of information included within the annual report.
- From the perspective of small and mid-size quoted companies, it may be difficult for these companies to cope with the additional time and resource input required to satisfy an audit of their forward-looking information. Typically, these companies have fewer resources meaning that the additional administrative burden may place strain on the capacity of these companies. Therefore, any case for a more forward-looking audit must not inadvertently impact smaller companies.

Q21 Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Firstly, we believe that clarity needs to be given on what is and what is not audited within the annual report. The auditor's opinion on such elements within the annual report is often misunderstood, despite references within the audit report itself. Additionally, there needs to be a clear understanding of what is meant by 'assurance' over financial and non-financial information, as well as determining what stakeholders are expecting 'assurance' over. Auditors are able to determine whether KPIs have been calculated correctly, extracted properly from the financial statements and are consistent year on year. However, as reflected in our response to question 17 above, there may be other areas in the annual report which may be more difficult for an auditor to provide the level of assurance expected by stakeholders.

Q22 If so, what information might usefully be subject to audit or another form of assurance and why?

The annual report is currently overloaded with information. It is often too long and obscures the financial information which the audit is concerned with. If much of the information within the annual report is reduced, or removed entirely, this would allow for assurance to be given separately in different reports.

Chapter 5

Q23 Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

Yes – we agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process.

Q24 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?

Yes – audit, especially of public interest entities, is highly regulated and as such the focus is on completing a 'compliant file' rather than exercising considered judgement.

Q25 What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

The issue of binary audit opinion needs to be addressed to allow more helpful disclosures that do not immediately seal the fate of a company. When concerns are raised under the current binary opinion system, this can often be a catalyst for withdrawn financial support and difficulties in obtaining finance and negotiation of payments. From the perspective of small and mid-size quoted companies, this is particularly concerning. Binary audit opinions can be extremely detrimental to these companies who have fewer resources and more limited capacity, meaning that any withdrawal of financial support can severely inhibit their growth. If there is a transition to a more graduated disclosure of auditor conclusions, such as greater focus being granted to analysing risks, the benefits to all companies would be significant.

It is imperative that any changes made take into consideration the value any such amendments would have on smaller companies. As auditing standards are expected to fit all entities, any broad ranging approaches to amendments have to consider the value created for all and should not disproportionately impact smaller companies.

Q26 Could further narrative be disclosed alongside the opinion to provide more informative insights?

If further narrative is disclosed, it must be ensured that this does not place a disproportionate burden on smaller companies. Whilst greater disclosure improves the level of insight into a company, it could inadvertently create a scenario whereby companies are unnecessarily challenged on relatively insignificant matters. Smaller companies may not have the resources to cope with the additional pressure and users' increased scope to influence the company.

Q27 What would prevent such disclosures becoming boiler plated?

It is very difficult to prevent boiler-plating particularly when proxy voting agencies adopt a 'tick-box' approach. This creates a defensive approach by companies rather than a discursive one.

Q28 To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

We have no comments.

Chapter 6

Q29 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?

It is unrealistic to expect auditors to ensure that directors comply with all relevant laws and regulation which may affect them. This would significantly and disproportionately increase the scope, cost and burden of an audit. It could also effectively pass the responsibility for compliance from director to auditor.

The auditor's role, which we believe is clear, and the resulting audit opinion already distinguishes between matters which may materially affect the financial statements and other matters.

Q30 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?

Greater clarity may be achieved if there is additional work on company law and distributable/non-distributable reserves. This is largely a legal matter and often subject to interpretation. The role of an audit does not currently cover this distinction as there is no requirement for a company to separately report distributable and non-distributable reserves.

Q31 Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

We have no comments.

Q32 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 discharge of the auditor's obligation in this regard, which is predominately established under the Companies Act 2006, is embedded throughout everything they do under an ISA compliant audit. In order to support the figures reported in the financial statements, the auditor will have regard to the accounting records of the entity both in terms of assessing the system of internal control and in verifying the amounts included in the accounts. It is in essence a fundamental element of the audit and, even where an entity is not

UK incorporated, the auditor would still need to consider the impact of 'adequate accounting records' on the audit opinion. If there was insufficient audit evidence to support an item in the accounts and it was material and/or pervasive, then a modified opinion must be issued. If it was a UK incorporated entity, then the auditor would also need to modify the matters on which the auditor is required to report by exception under the Companies Act.

We believe that the existing statutory requirements are effective in setting the bar at a high enough level and we do not believe a change to the existing statutory obligations for auditors is necessary, as there does not appear to be a fundamental failing on the auditor's responsibilities in this area. It is also difficult to establish what additional work would arise to better confirm that adequate accounting records have been kept by an entity.

Chapter 7

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?

In order to determine whether there should be more open dialogue between the auditor and the users of their reports, the purpose of the company needs to be clarified. When the purpose of the company has been clearly defined, it can be determined whether there is need to have a more open dialogue with all stakeholders.

For the vast majority of companies, however, their purpose will be to serve the interests of their shareholders and they will not have the capacity to satisfy the needs of all stakeholders to whom they are not directly accountable. As such, paragraph 96 is incorrect in saying "the broad range of stakeholders to which directors are accountable". This is so as s170-177 of the Companies Act 2006, which outline the general duties owed by a director of a company to the company, does not state that directors are accountable to persons to whom they do not have any duties. If a director has accountability to all stakeholders, the interests of these persons may conflict with the interests of the company's shareholders. For this reason, and under such circumstances, a more open dialogue between auditors and all stakeholders is not suitable.

Furthermore, it is rare that there is communication between stakeholders and the auditor at the annual general meeting, thus meaning it is unlikely that an annual assurance meeting would be better attended or engender further communication between the auditor and stakeholders.

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 communication of audit findings to the users of the financial statements has been improved following the introduction of reporting on key audit matters in the auditor's report. The content included in the audit report is consistent with that communicated to the audit committee. This has helped to make the process more visible and transparent.

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?

Whilst we agree that further enhancements to the extended audit report would be useful, we disagree with the suggestion that an update on key audit matters featured in previous audit reports should be included.

The audit report issued is for the current financial year and does not provide an opinion matters relating to the previous financial year. It would be incorrect, especially considering the ISA 701 requirements in this regard, for an auditor to comment on a key audit matter that was relevant in the previous year but is not an area of focus, or is irrelevant, in the current year.

Chapter 8

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?

No – we believe that users' expectations of the auditor's role in this regard is inconsistent with UK law and auditing standards requirements. As mentioned above, there is a knowledge gap in the role of an auditor in fraud detection. It is inherently difficult to expect an auditor to do more to detect fraud due to their position outside of the company and the scope of their work as currently set out in the auditing standards.

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

Auditors already determine whether there are sufficient controls in place to prevent fraud and whether these controls are operating effectively. They are also required to determine whether there has been intentional misstatement of financial information including override of internal controls by management. The existing auditing standards therefore engender the required level of fraud detection mindset based on the current auditor's responsibilities relating to fraud.

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

We have no comments.

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

See response to Q37.

Chapter 9

Q40 Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

We have no comments.

Q41 If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

We have no comments.

Q42 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?

We have no comments.

Q43 How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

We have no comments.

Q44 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?

We have no comments.

Chapter 10

Q45 How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

We agree that the use of new technology and data analytics will help foster a more comprehensive and robust audit product and that this is fundamentally important, both immediately, to improve the quality of audit, and for the future of audit.

However, for many smaller firms, the use of new technology is limited because it is not currently a cost-effective approach. In larger firms, resources are often dedicated to utilising new technology and adapting their audit methodology accordingly. Smaller firms do not have the same level of resources to utilise such technology.

Q46 In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

New technology can be used to better understand the detail behind the nominal ledger. It can analyse whole populations and identify anomalies which require further investigation by the auditor. However, it will not, and cannot, overcome the need for the auditor to apply professional scepticism in areas that are subject to significant management judgement that are undertaken outside of the accounting system (e.g. impairment reviews, going concern etc.).

Q47 Are there aspects of current audit procedures or output that are no longer necessary or desirable?

We have no comments.

Q48 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?

Audit is conducted in order to ascertain whether the financial statements are true and fair and whether they have been properly prepared in accordance with the financial reporting framework and underlying legislation. Potential failure is therefore not the predominant reason for audit.

Q49 Does today's audit provide value for money?

Today's audit only provides value for money to a limited extent. Audit would provide greater value for money if scalability is considered by looking at smaller audits which are less cost-effective and add less value.

Q50 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?

We believe strongly that the requirements arising from any extension of audit should not lead to disproportionate costs for small and mid-size audited companies, particularly where there is a marginal social benefit.

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?

We have no comments.

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

There is often little interaction between shareholders and auditors at the AGM. As such, it may not be worthwhile to arrange interaction outside the AGM. Such interaction could not be done on a selective basis.

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?

We do not believe that shareholders should be involved in audit planning. The directors of the company have that responsibility and act on their behalf.

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

We have no comments.

Q55 In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

We have no comments.

Q56 How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

We believe that the extended audit report has gone some way to allow auditors to demonstrate the areas where professional scepticism has been applied. This is demonstrated in the disclosures pertaining to the audit procedures that have been performed on the judgemental areas that are reported as key audit matters.

Q57 Should the basis of individual auditors' remuneration be made available to shareholders?

We have no comments.

Q58 Do respondents view audit costs as generally too high, about right or insufficient?

We have no comments.

Q59 Would users of financial statements wish more detail on the make-up of audit fees?

We have no comments.

Q60 Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

With regards to smaller entities, and given the volume of work required on them, it is difficult to make a smaller audit cost-effective. For this reason, the profitability of the audit function is not sufficient to sustain a high-quality audit industry for entities of all sizes.

Appendix A

The Quoted Companies Alliance *Financial Reporting Expert Group*

Matthew Howells (Chair)	Smith & Williamson LLP
Rochelle Duffy (Deputy Chair)	PKF Littlejohn LLP
Edward Beale	Western Selection PLC
Matthew Brazier	Invesco Asset Management Limited
Elisa Noble	BDO LLP
Anna Hicks	Saffery Champness LLP
Mark Hodgkins	Trackwise Designs LLP
Clive Lovett	Bilby PLC
Laura Mott	Haysmacintyre
Claire Needham	KPMG LLP
Matthew Stallabrass	Crowe UK LLP
Jon Wallis	Grant Thornton UK LLP
Peter Westaway	Deloitte LLP