

Recommendations for Reform of the UK Audit Market

by Alan Bailie

In December 2019 the UK Government published Sir Donald Brydon's report on the quality and effectiveness of audit. The review commissioned by the Department of Business, Energy and Industrial Strategy (BEIS) follows two other recent consultations/studies of the UK audit market.¹

The report seeks to build on the two previous studies of the UK audit market through examining audit as a product. This looks at the scope of audit, how far it can or should evolve to meet the needs of users of accounts and to serve the public interest, other forms of assurance that might be needed and to define and manage any residual expectation gap.

This expectation gap, that is the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail, has been brought into greater focus by corporate failures such as Carillion, Patisserie Valerie and Thomas Cook. The initial focus of the review was on the audit of Public Interest Entities, while being cognisant of the effects on other relevant entities and proportionality.

A total of 64 recommendations are made in the report which can be broadly grouped under the following headings:

- Definition of audit purpose
- Audit profession
- Audit report
- Additional directors' reporting
- Fraud
- Role of shareholders and other stakeholders
- Other recommendations

Redefinition of Audit and its Purpose

The report concludes that while audit has lost its way, it is not broken but lacks a "clearly understood and fully encompassing purpose". As a result, it recommends that a plain English guide to audit be written including a clear explanation of what the elements of an audit report mean. Additionally, it is recommended that the following definition of audit purpose be adopted and enshrined in Company Law, to reflect the role of audit as a public interest function that demonstrates more than just compliance with laws and rules.

"The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements."

A New Audit Profession

Sir Donald recommends that a new corporate auditing profession be established as "auditing is too important to be left an adjunct of another profession". This new profession would be governed by its own principles, qualifications and standards. The proposed new statutory body to replace the Financial Reporting Council (FRC) by the Kingman Report, the Auditing, Reporting and Governance Authority (ARGA), would have responsibility for the establishment and regulation of this new profession.

The Audit Report

The report highlights the growing challenge in using the term "true and fair", in light of the increasing use of estimates and judgements in financial reporting frameworks, recommending that the term be

replaced with 'present fairly', in all material respects.

He supports the retention of the binary audit opinion but suggests expanding what auditors include in their auditor's report to cover "original information that is likely to have a material impact on users' decisions". The existing obligation on the Auditor to read and consider other information in the Annual Report and to report if they consider it be materially misstated, he argues should be extended to material outside the Annual Report such as investor presentations and RNS announcements.

The audit report should include a new section in which the auditor states whether the directors' have complied with their obligations under Section 172 Companies Act 2006. It should also disclose details of the audit work including the number of hours spent on the audit by each grade of staff.

Recommendations are also included aimed at enhancing the informative nature of the auditor's report including the creation of continuity between successive audit reports, calling out inconsistencies in information made public and referencing external negative signals and how they have informed the audit.

Directors Reporting

Included in the report are a number of proposals in relation to directors reporting including a three-year rolling audit and assurance policy, a resilience statement and an annual public interest statement.

The directors would be required to present shareholders with an audit and assurance policy indicating their approach to various matters including the appointment of auditors, the

scope and materiality of all auditing and fees.

In addition, the board would be required to produce a resilience statement that incorporates and builds upon the existing going concern and viability statements. The statement would comprise three sections including a going concern opinion for the short term, a statement of resilience in the medium term and consideration of the risks to resilience in the long term. The going concern opinion would be subject to audit in the same way as the current going concern statements.

The level of assurance on the statement of resilience in the medium term would be determined by the audit and assurance policy presented to shareholders by the directors and the consideration of risks to resilience in the long term would not be required to be subject to further assurance.

A new public interest statement would be required to be presented annually explaining the company's view of its obligations to the public interest (statutory, self-determined or other) and how the company has met those obligations over the previous year.

Fraud

Brydon challenges the perception that auditors have no obligation to detect fraud, arguing that auditors should endeavour to detect fraud. He recommends ISA 240 (UK) be amended to oblige the auditor to "detect material fraud in all reasonable ways".

He also recommends that directors have a new reporting duty setting out annually their actions taken to prevent and detect material fraud. A corresponding new duty would be imposed on the auditor to state how they have assured the directors' statement in material fraud and any steps they have taken to assess the effectiveness of relevant controls and to detect fraud.

Other measures aimed at raising the prominence and transparency of fraud prevention and detection by auditors include:

- Auditors to undergo initial and ongoing training in fraud awareness and forensic accounting;
- ARGA to maintain a case study register detailing corporate frauds; and
- The establishment of an independent Auditor Fraud Panel to judge auditors' culpability.

Role of Shareholders and other Stakeholders

The report includes recommendations to enable and encourage a company's shareholders to influence the scope of the audit, and to hold the Audit Committee and Auditor to account, including:

- A process to be established whereby a company's shareholders are given a formal opportunity to propose matters they wish to be covered in the audit; and
- A standing item on the AGM to allow questioning of the Audit Committee and/or Auditor.

While recognising that currently the statutory audit report is legally required to be prepared for the company's shareholders, the report recognises its' relevance to other stakeholders. Recommendations to recognise the relevance of these other stakeholders include:

- A statement in the Principles of Corporate Auditing that auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders;
- Directors actively seek the views of employees regarding audit scope and report back to them how their views have been taken account of;
- Statutory auditors be added to the list of 'prescribed persons' under the Public Interest Disclosure Act; and
- Bringing existing company disclosures on supplier payment reporting into the annual report

and that this be subject to a level of audit as described in the company's Audit and Assurance Policy.

Other Recommendations

A number of other recommendations are made in the report on areas such as the use of technology in audit, auditor transparency, the capital maintenance regime and the extension of audit work to areas such as alternative performance measures (APM's) and key performance indicators (KPI's).

What's next?

The UK Government in the Kingman Report, the CMA's study of the Statutory Audit Market and now Sir Donald Brydon's Report have a number of recommendations for reform of the UK audit market. As recognised by Brydon it is now for the Secretary of State for BEIS to consider how these recommendations can best be implemented. Some of these recommendations would require legislative change while others will fall under the remit of ARGA.

Confidence in the auditing profession in the UK has undoubtedly been eroded as a result of a number of high-profile corporate failures - doing nothing is not an option. However, the proposals will require careful consideration, as if fully implemented would result in radical change both for the auditing profession and directors of businesses in the UK.



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¹ The Independent Review of the Financial Reporting Council by Sir John Kingman (December 2018) and the Competition & Markets Authority 'Statutory audit services market study' (April 2019)