

ACCIF event – 31 January 2019

On 31 January 2019, the Audit Committee Chairs' Independent Forum held an event to discuss the following three reviews:

- CMA – Statutory audit services market study – Update paper
- Kingman - Independent Review of the Financial Reporting Council
- Launch of the Brydon Review (including the expectation gap findings from the CMA inquiry)

The discussion focused on three specific elements of the debate:

- The expectation gap
- Audit committee accountability
- Joint audit

The discussion was led by a panel made up of representatives from the Audit Committee Chair, CFO, Investor and Auditor community:

Douglas Flint - Chairman	Chairman of Standard Life Aberdeen since 1 Jan 2019 Prior to that Chairman of HSBC Holdings 2010-2017 and 15 years as HSBC Group FD and before that KPMG
Brendan Nelson	BP AC Chair RBS AC Chair Member of the Financial Reporting Review Panel
Lucinda Bell	Rotork AC Chair Previously CFO at British Land NED at Derwent London and Crest Nicholson Member of the Kingman Advisory Group
Liz Murrall	The Investment Association's Director of Stewardship and Reporting Member of the FRC's Codes and Standards Committee and Corporate Reporting Council
Brian Gilvary	With BP since 1986 and CFO since 2012 Current Chairman of 100 Group Non-executive Director at Air Liquide SA
Sarah Kokot	EY Audit Partner, previously from France, audit partner on Airbus and Lafarge (both joint audits)

The meeting was attended by 18 Audit Committee Chairs.

The Expectation Gap

The expectation gap was selected as the first topic for discussion as the ACCIF believes it is the overarching question that needs to be addressed in order to set the context for the

many, and appropriate, questions raised by the Kingman and CMA reviews regarding the regulation of financial reporting and the operation of the statutory audit market, respectively.

The discussion was wide ranging and covered the following areas:

- Investors seek the comfort of a “quality audit”, but there are many different definitions of what this means and how this might be evidenced; there is a call for more transparency in reporting but to date there is no evidence that investors have shown much interest in the greatly increased level of communication by audit committees and auditors on key accounting, reporting and audit issues in their reports.
- The issues at the heart of the expectation gap relate to viability/going concern and fraud prevention and detection and the extent of the responsibilities of auditors in relation to those two issues.
- With regard to the going concern basis of accounting, it does not guarantee that a company will not fail (new material facts may emerge or business conditions significantly change). However, there is a sense of disbelief that where a going concern statement makes no reference to any material uncertainties that might result in the use of the going concern basis of accounting being inappropriate in future reporting periods, a corporate failure can arise within 12 months from the date of approval of the financial statements. Much greater clarity is required on the assumptions made regarding financial and operating risks in assessing whether to adopt the going concern basis of accounting, such that the wider public can judge whether a corporate failure is/is not at odds with a prior positive conclusion about being a going concern.
- The going concern position is further confused by the purpose of the longer term viability statement in which the directors state that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment. It is doubtful whether the inherent uncertainties underlying these viability statements are widely understood by users of accounts. The FRC, supported by certain investors, has encouraged companies to lengthen the period of their assessment but this would increase the inherent uncertainties and reduce the degree of assurance that could reasonably be given regarding future viability.
- As regards responsibilities for preventing and detecting fraud, where financial statements are materially misstated as a result of fraud, criticism is levelled by commentators against the directors for failing to prevent the fraud and against the auditors for failing to detect it. As against that, fraud, and especially collusive fraud, can be extremely difficult to uncover.
- In relation to both viability/going concern statements and material fraud, the respective responsibilities of directors and auditors need to be reviewed having

regard to what is desirable in the public interest and what is practicable in terms of cost-benefit. In any event, the limits or boundaries of such responsibilities need to be clearly established and publicly communicated in a very clear manner.

- These important areas for debate arise out of the recent high profile cases of corporate failure. It is the board of a company that is first and foremost responsible for a company's performance and viability. A corporate failure therefore does not necessarily mean there has been an audit failure; the root causes need to be understood in order to assess the extent to which the auditors did not properly discharge their responsibilities or whether they in fact did so and allegations that they did not reflect the expectation gap.
- The scope of the Annual Report and Accounts has become wide-ranging; the financial statements are the bedrock, are historic and are audited; the other reports in it include a range of historic and forward looking information, policies, assessments and data reported by the Board little of which is subject to any degree of independent assurance; the degree to which this mishmash of reporting can be "relied upon" is not consistently understood.
- In recent times the demand for environmental, social and governance (ESG) reporting (including in relation to climate change) has added to this complex picture and, particularly as a result of the multiplicity of reporting frameworks there is a lack of consistency of what preparers are delivering.
- As more emphasis is placed on reporting beyond the financial statements and becomes more forward looking, thoughtful consideration needs to be given to safe harbour provisions to provide appropriate protection for directors in relation to information about the future that is diligently prepared but is subsequently found to be erroneous; and recognition that to the extent assurance is required, different providers with different areas of expertise are likely to be required.

From a number of different viewpoints, therefore, the meeting concluded that there is much important work to be done to seek to tackle the expectation gap and, importantly, that if this is not done as the next step, there is a real risk that many of the proposals being put forward to change the audit market, the role of audit and so forth will not address the right areas and, worse, could well exacerbate rather than narrow the expectation gap.

Comments made by individual Audit Committee Chairs during the discussion included the following:

- Although there is currently a loss of confidence in audit there has not been any examination on a case by case basis to identify the causes of recent corporate failures. So solutions are being framed without knowledge of which specific remedies would have made a difference.
- There is a view that auditing hasn't been through a post financial crisis shake up unlike other financial markets. However, there has been a huge amount of change

e.g. the EU statutory audit directive and we don't yet know the impact of the changes that have been made.

- On average the UK experiences two or three failures per year, which is the same as other jurisdictions and has not changed much in recent years. We have got to keep the issue in perspective: the incidence of failures isn't that great. The number of corporate failures, regrettable that they are, is small and has to be seen in the context of the entire population of more than 2,000 listed companies.
- Rachel Reeves (chair of the BEIS Committee) has stated that a key issue in the expectation gap is corporate viability. She believes that audit has to be more forward looking and that the viability statement could go further on the assumptions made and the sensitivities arising.
- It has been suggested that stronger viability statements would be a good way forward. However, what is meant by 'stronger viability statements'? Is the intention that it should involve as much effort as a working capital report and that it would be reviewed by the auditors in the same way as working capital adequacy is reviewed by reporting accountants under prospectus requirements, or is the view that the viability statement should just provide more transparency on what the key assumptions are and a commentary? The reporting accountant's task of reviewing the adequacy of working capital for a company that is about to make an IPO is likely to be far more straightforward than a similar task for many current listed companies which, repeated annually, would involve significant management time and significant additional professional fees.
- The FRC has not helped, by encouraging companies to look more than three years forward – the further ahead these statements seek to look, the less certain they can be about the future and therefore the less assurance they can reasonably provide about future viability. The statement should focus more on going concern and a one to two year lookout period.
- The viability statement should specifically respond to the risks and uncertainties discussed in the annual report and accounts. Management should have tested the ability of the company to withstand the potential impact of the principal risks it has identified and discussed in the annual report.
- Companies often find it difficult to clearly explain the likelihood and impact of their principal risks nor is it always clear how well the risks are managed, and most make very bland statements on internal controls which, in accordance with the FRC guidance, address internal controls in the context of principal (business) risks rather than in the more specific context of financial reporting.
- Where there has been a failure by the directors to report the existence of material going concern-related uncertainties and the auditors have not taken issue with the directors over the omission, the fact is that in most cases it is individual auditors and

not audit firms that have failed. Audits are a personal service and it is necessary to understand what has made these people fail.

- A clean audit opinion does not tell you anything about the quality of internal control. The auditors don't have to do controls testing, they can just do substantive testing. What would be the cost of having auditors report on the effectiveness of internal control systems in preventing fraud? It could be enormous (as the Auditing Practices Board concluded based on its research study in the 1990s).
- With regard to internal controls over financial reporting and the accuracy and reliability of annual report disclosures, the Sarbanes Oxley experience shows that issues can arise when the legislation is very poorly put together. It required a lot of cost and investment initially but has now evolved to be an effective regime.
- The audit opinion continues to be somewhat binary - options available to the audit partner are either I'm going to qualify (or include an emphasis of matter paragraph) or not. A qualified audit report tends to have serious negative consequences for the company concerned (rather than, as suggested by the CMA, providing an opportunity for remedial action to overcome the problems identified) - if there was another way then that would be better.
- Nevertheless, by describing the key audit matters and how the scope of the audit responded to them, the extended auditors' report, introduced in 2013, tells you a lot – but it needs to be read!
- A graduated audit report could help to explain how aggressive or conservative the assumptions and judgements underlying financial statement items are – although such judgements can be highly subjective and alternative indicators such as sensitivity analyses may often be more appropriate.
- It is clear that there is a lack of understanding about exactly what is meant by “assurance”. It is likely that that contributes to the expectation gap by overselling. Possibly a term such as “assessment” would be better. That could reduce the expectation gap by being a bit more realistic. The price of certainty is very high - assurance conveys a degree of certainty beyond which is intended. The general public do not understand the difference.
- The information on corporate performance and financial condition that is most important for the capital markets is that provided at investor presentations on results. Although there are not within the scope of financial statement audits. This would require standards to be developed for such presentations.
- The board and the auditors should behave with honesty and integrity. If a set of incorrect accounts is produced knowingly then someone is being dishonest. Competence, diligence and moral courage are what make for a good audit partner, CFO and Chair of Audit Committee. We need to emphasise and support those qualities rather than apply yet more process requirements and rules.

- There are many demands for ESG metrics in sector and across sectors, but comparability is a real issue. Agencies which have examined the correlation of existing ESG reporting frameworks show that whereas audited financial data has a correlation 0.95, ESG metrics have a correlation of just 0.3.
- The numerous, existing reporting frameworks on sustainability are not comparable, not verified and it is not clear what 'limited assurance' means in relation to reports on this information.

Audit Committee Accountability

ACCIF wanted to look at this topic as the recommendations in both the CMA report and Kingman would result in a very different modus operandi for Audit Committee Chairs (ACCs). In particular, the ACCIF was interested to gauge views on: oversight by a regulator of the audit tender process; the proposed requirement to report to a regulator throughout the financial reporting and audit cycle; the view that Audit Committees (ACs) do not prioritise audit quality sufficiently; and the recommendation that auditor appointments be made and their fees set by an independent body or that there be provision for regulatory intervention in certain circumstances.

The debate centered on the following key points:

- There is already a model for oversight and moderation of audit committees within financial services and governed primarily by the PRA; if that process is demonstrably fit for purpose, non-financial services (FS) ACCs accepted that an equivalent regime would be warranted if it could in practice be applied effectively across the entire spectrum of listed companies; however, it was noted, quite strongly, that the task of implementing such a regime across all listed companies should not be underestimated; the number of companies involved would be considerable, reflecting a multitude of business models and without the capital adequacy models that exist in FS. In short the ACCs believe the scale of this task has been hugely underestimated.
- The proposal for regulatory oversight of the audit tender process also raised some challenge; the view was clearly expressed that it is the AC that "owns" the decision to change and appoint the external auditors; this was endorsed by the CFOs (current and past) who recognised that the ACC and the AC hold sway over the CFO and management in this regard; the decision to select an auditor is a complex one, a key part being to select a lead partner (and team) who have the right skill set and experience to be able to challenge management in a robust, yet constructive, way; with the many different business models and value chains that exist, there was significant doubt that a sufficiently informed regulator could be created that would be capable of monitoring the quality of the audit effectively (or of assessing how effectively such monitoring was being carried out by the AC).

- ACCs believe that they are extremely highly motivated to assess and challenge audit quality; it is just not in the interest of ACs to accept a poor quality audit; there was some disquiet about how in practice ACs would report to a regulator on the conduct of an audit as it progresses and to whom at the regulator.
- There was much discussion about the involvement of challenger firms in the audit tender process; the ACC experience was fairly universal, namely that so-called “challenger firms” were very often invited by listed companies to tender for their audit but either decided not to tender or their credentials (geography and/or sector) did not measure up. If an independent body were to actively appoint challenger firms (or if a joint audit regime were introduced with the requirement that one of the joint auditors should be a challenger firm) this was seen as a real threat to quality.
- There was considerable disquiet that the CMA had concluded that they didn’t “trust audit committees to have sufficient regard to shareholder interests” in making their decisions. Recommending the appointment of the auditor is but one responsibility the independent directors have under the UK Corporate Governance Code and if they can’t be trusted to undertake this with integrity, what does that say about the other - often more important - decisions that independent directors undertake?
- It was noted that more needs to be done to strengthen engagement between ACs and investors. This should be an important channel for investors and it was felt that more emphasis should be placed on this line of communication in relation to audit tenders and risk management matters too rather than introducing another layer in the form of a regulator, although it was acknowledged that despite the Stewardship Code identifying the quality of company reporting and audit as areas for asset owners and asset managers to monitor, this was currently more honoured in the breach than in the observance.
- It was recognised by ACCs that the Kingman recommendation that the regulator should have the power to step into the company/auditor relationship in certain defined circumstances made sense; it was noted that careful thought was needed as to exactly how this power would be applied and how the assessments they made would be transparent and understood.

Detailed comments made in the discussion included:

- There has been some discussion of the extent to which aspects of the FS regulatory regime should be applied across the board and the Kingman Review has recommended, for example, that auditors should have a duty to report viability or other serious concerns to the regulator, a duty that FS auditors already have. In the case of FS, however, the auditor’s duty to alert applies against the background of explicit solvency and capital adequacy requirements which do not apply outside the FS sector.

- With regard to the AC's responsibility to assess the effectiveness of a particular audit process, current audit quality reviews are not statistically representative, in many cases only look at certain aspects of audits, and audit deficiencies may have been identified in a particular industry sector that cannot be assumed to have occurred in a different sector. They therefore do not assist in assessing the quality of a firm as a whole and may well have no relevance at all to the audit with which an AC is concerned.
- We need audit quality measures which are more informative. It is not helpful to just have to rely on high-level statistics such as the proportion of audits reviewed classified as "improvements required". It is good for audit committees to ask audit firms about their quality processes and look at continuous improvement. The firms can have quite different approaches and need to be able to explain their results. Audit committees should also follow up on references when there are changes in the senior members of an audit team.
- The firms need to be more brutal about underperforming partners and network offices/firms.
- There remains a perception amongst investors that it is the CFO who appoints the auditor. In reality, however, the process is now driven by the Audit Committee and in particular by the Audit Committee Chair.
- Tenders are taken very seriously. Audit Committee Chairs are looking for someone who will challenge management robustly and arrive at their own conclusions. It is about more than just compliance with IFRS and what is in the audit report – Audit Committees look to the auditors to provide them with insights into, for example, the quality of the company's finance teams and finance systems.
- Auditors have never had more power: they have far more authority than they have ever had.
- It is very hard for challenger firms to compete against the international strength of the Big Four firms. Further, although 40% of FTSE 100 companies operate primarily in the UK, when the challenger firms are invited to participate in the tender they very often decline saying that they do not wish to bear the risk of regulatory fines or that the likelihood of success is not sufficiently high to justify the cost of tendering.
- In proposing a joint audit regime for listed companies, the CMA is in favour of mandating that at least one of the audit pair is a "challenger firm". This ignores the incentive that audit committees have to have effective auditors. Audit committees (and their companies) are damaged by weak auditors.
- It is strange that the CMA remedy would place a responsibility on the audit committee to report to the regulator throughout the audit and throughout a tender process, when really they should be reporting on these matters to their investors. One might expect investors to want to know how the audit committee satisfied itself

that it had appointed a quality auditor and that the audit had been effective and also what aspects of the financial statements it had challenged and the conclusions it reached. Audit committee reports have been required by the Code to discuss these matters since 2013. This provides a basis for investors to engage with audit committees but in practice they have not done so.

- By contrast, investors spend a good deal of time on directors' remuneration even though the amounts involved are usually insignificant by comparison with the profitability of the company, or indeed in relation to the viability of the company, which are addressed in its annual report and accounts.
- The Investment Association is planning to organise teach-ins for investors so that they can better understand the whole audit process. In addition, IVIS, the voting service, plans to place more focus on audit matters and the IA intends to do more to interact with AC chairs (including through the ACCIF).

Joint Audit

This proposed remedy from the CMA was selected for discussion as it would represent a significant departure from the existing UK audit model as we know it and as such would significantly affect how ACCs and ACs would interact with and monitor the performance of auditors. In order to provide practical insights into the operation of joint audits, a French audit partner now based in the UK with significant experience of joint audits was invited to be a member of the panel. She was a very helpful and well-informed contributor to the debate. The CMA justifies its proposal that joint audit (of at least the FTSE 350) "would increase competition without risking audit quality" and if, as the CMA would prefer, it was mandated that at least one of the joint auditors is a challenger firm, it would lead to a significant increase in the size of some challenger firms which, in the CMA's view, would make the audit market "more resilient".

The key points discussed in the debate were:

- In overall terms, the meeting was not persuaded that a move to joint audits would raise quality and considered that if one of the joint auditors was required to be a challenger firm there would be a high likelihood that the impact on audit quality would be negative. However, it is more important to be clear on what a "quality audit" looks like and to assess the quality of current auditing before considering the need for any change, which would need to be justified on the basis of; the clear view was that any change in this regard should only be contemplated once the Brydon review has been carried out.
- Various individual experiences of joint audits were shared, including as an ACC; there was a universal lack of enthusiasm for joint audit which was seen as adding complexity, cost and time; none of the participants could cite an example of where they had seen a joint audit really improve quality.

- Given the current UK market and the very significant difference in scale between the Big 4 and the challenger firms, the ACCs considered that there would be a real risk to quality in a shift to a joint audit model until such time as the challenger firms could demonstrate that they could field audit teams with similar breadth and depth of relevant experience and expertise as the Big 4 firms; a transition of this sort would cause significant upheaval over a lengthy period without any certainty that it could be completed; the ACC's disagreed with the CMA's view that "joint audit would increase competition without risking audit quality".
- The French audit partner was able to compare her experience of both audit models: she informed the ACCs that her approach to an audit was the same in both a joint audit and a sole audit; the quality produced and the processes underpinning the audit were the same; she did not believe a user should view the quality of the audit report on a French CAC30 any differently from the audit report on a UK FTSE100; yes there are the other firm's eyes in a joint audit, but all of the firms have significant internal independent review processes (other eyes) for sole audits.
- The meeting was shown data (see Appendix) showing that in the French audit market since 2000 there has been significant auditor consolidation; the smaller players have dropped out of the market when a balanced work share between joint audit firms was encouraged by the regulator.
- The international dimension of UK companies was discussed; the CMA's consideration of the audit market was very UK centric whereas UK companies, especially larger companies, are international/multi-national businesses; the CMA's joint audit proposal is out of step with the wider world just at a time when the need for UK business to keep in step with it is increasing with Brexit; the Big 4 are multinational businesses and while we need to form our own view it is not in our interest to introduce an audit model that unnecessarily complicates the way business is done, puts us out of step with almost all G20 and OECD countries, and has the potential to jeopardise quality.
- In essence the view was that the real challenge is to focus on defining what is meant by audit quality and then set about measuring whether this is being achieved; the Kingman review has already concluded that aspects of the regulatory assessment of audit quality require upskilling and upscaling; ACCs believe the focus needs to be on seeing those changes through and allowing the Brydon Review to complete its work

In addition the following detailed points were made:

- Joint audit was considered back when the EU Audit Directive was being developed but it was not taken forward.
- Mazars is the main non-Big 4 player in the French joint audit market for large listed companies due to its legacy presence in the French market. Other smaller firms have not been able to maintain a presence in this market segment.

- Current & past CFOs don't see any benefit from a joint audit as it adds additional complexity and extra cost. It is very difficult to imagine how implementation would play out.
- The Bank of England in its review of the failed bank BCCI noted the danger of the use of more than one auditor where that arrangement was used to give neither firm a complete picture of its affairs.
- If there were to be a requirement that one of the two joint auditors should be a challenger firm, where would the capacity in the challenger firms come from?
- It is the experience of some Audit Committee Chairs that challenger firms can pull out of a tender process right at the last minute.
- For some tenders where there has been a challenger firm on the list, they have come quite a distant fourth, and feedback was given.
- Joint responsibility can quite quickly mutate into no responsibility. "Yoking two wimps together doesn't create a strong individual". It could lead to a weaker audit market.

Appendix - The statistics below show how the presence of the smaller firms in the French joint audit market has fallen away:

CAC 40

	No. of mandates - 2000	% Total	No. of mandates - 2019	% Total
EY	8	10.0%	23	29,5%
Andersen	15	18.8%	0	0,0%
Deloitte	9	11.3%	15	19,2%
PwC	16	20.0%	16	20,5%
KPMG	13	16.3%	11	14,1%
Total Big	61	76.3%	65	83,3%
Mazars	9	11.3%	11	14,1%
Total Big + Mazars	70	87.5%	76	97,4%
BDO	0	0.0%	0	0,0%
Constantin	2	2.5%	0	0,0%
GT	0	0.0%	1	1,3%
Salustro	0	0.0%	0	0,0%
Others	0	10.0%	1	1,3%
Total *	80	100%	78	100%

SBF 120

	No. of mandates - 2000	% Total	No. of mandates - 2019	% Total
EY	28	12,0%	56	23,9%
Andersen	29	12,4%	0	0,0%
Deloitte	25	10,7%	44	18,8%
PwC	32	13,7%	37	15,8%
KPMG	15	6,4%	37	15,8%
Total Big	129	55,1%	174	74,4%
Mazars	18	7,7%	42	17,9%
Total Big + Mazars	147	62,8%	216	92,3%
BDO	0	0,0%	0	0,0%
Constantin	4	1,7%	0	0,0%
GT	7	3,0%	8	3,4%
Salustro	13	5,6%	0	0,0%
Others	63	26,9%	10	4,3%
Total*	234	100%	234	100%

**Some companies listed in France are not French companies and therefore not subject to joint audit.*