ShareSoc
UK Individual Shareholders Society
Suite 34, 5 Liberty Square, Kings Hill,
West Malling, ME19 4AU
Phone: 0333-200-1595 Email: info@sharesoc.org
Web: www.sharesoc.org

UK Shareholders' Association
UKSA, 1 Bromley Lane, Chislehurst, BR7 6LH
Phone: 01689 856691
Email: officeatuksa@gmail.com
Web: www.uksa.org.uk

3rd June 2019

INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Dear Sirs,

This is a joint response from UKSA and ShareSoc on behalf of individual investors.

UKSA and ShareSoc represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Overview – A fresh approach

Many of the questions in the Review overtly or implicitly prompt debate about how the external audit can be made more robust and more relevant in future. Underlying this is a requirement to find ways of making auditors more accountable to those they are meant to be serving – namely the shareholders. **Our view is that this cannot be achieved by adding more layers of narrative and written information in the annual report.**

Action to improve auditor accountability to shareholders has to focus on providing direct face to face contact between the auditors and those they are supposed to serve. This allows appropriate interaction in the form of dialogue and questioning. Importantly, it avoids the scope for well-intended expansion of audit reports and comment using the written word to degenerate into compliance-oriented boiler-plate and obfuscation.

Our proposals for at least one semi-formal meeting each year between the auditors and shareholders are summarised in our response to Question 7 (para7.2) below. We believe that at these meetings the members of the audit committee and senior personnel from the internal audit team should also be present and accountable. The AGM remains an appropriate place for the executive directors to be held accountable to shareholders on wide-ranging topics such as strategy, staffing and business development. It is not normally the place, however, for detailed discussion about the audit or the thinking and justification behind the presentation of the financial statements.

Our responses to the questions in the consultation are given below.

CHAPTER 1 – DEFINITIONS OF AUDIT AND ITS USERS

Definitions

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

The audit is and should be primarily for the benefit of the shareholders. However, it should also be of significant benefit to other stakeholders – in particular, those with a financial risk in the company. This includes suppliers (unsecured creditors), customers, bondholders and other lenders (those providing debt finance). These all have an important interest in the veracity and reliability of the financial statements. Potential investors and others carrying out financial research will also depend heavily on company financial statements. They will want to be sure that the financial statements accurately reflect the trading performance of the business and are not misleading in respect of its future prospects before they consider investing in it themselves or recommending it to others.

Wider stakeholders also have a legitimate interest in the reliability of company financial statements and hence the audit. These include, for example, local authorities who may be interested in potential impacts to the local economy, from business rates through to local employment, and of course the taxpayer.

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 audit should enhance the degree of confidence in the entity. Enhancing the degree of confidence in the financial statements (rather than the entity) appears to be the situation that we have created and which is proving unsatisfactory. 'Enhancing the degree of confidence in the financial statements' leaves far too much 'wriggle room' for preparers of accounts and auditors. It can easily be interpreted as meaning that the financial statements have been audited and, as far as the auditors are concerned, they comply with all legal and regulatory requirements. There is currently plenty of scope for financial statements to be prepared and presented in a way that flatters the financial strength and performance of the business with a view to ensuring that management achieves large bonuses. As we saw with Carillion and have seen with other companies, the presentation of the audited financial statements was seriously misleading in terms of the financial robustness of the entity – despite the arguments that have been made that there was nothing illegal in the presentation of the financial statements.

It is this which has lead to a mismatch of expectations over what the audit is supposed to achieve and which has contributed to an undermining of trust in business. As discussed in later questions, we believe that the accounting profession has sometimes been ignoring the law on capital protection.

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?

Yes, the law must be amended. But the current law in respect of capital protection has not been properly enforced; strongly enforcing this would have a beneficial impact even without a change in the law. Many would argue that the current system of audit is worse than useless. At the root of this is the fact that management select the auditors and the managers are heavily conflicted in the outcome of the audit. Investors and others have realised that the audit cannot be depended on and

has in too many cases been giving them and other stakeholders a sense of false security about the robustness and financial wellbeing of the business.

The audit should be something that all key stakeholders (as indicated in Q1 above) can depend on when making an assessment of the financial strength, creditworthiness and future financial viability of a business. Amongst other things, the following issues should be addressed in considering financial reporting and the role of the audit:

- Are measures of financial performance used by the preparers appropriate? Are they meaningful and consistent or have they been subtly amended from year to year to flatter performance and perhaps measure against targets that are easy for management to achieve but which give a false impression of true performance and finial strength?
- Has there been any external review or audit of the narrative sections of annual report? As one FRC manger commented wryly to UKSA and ShareSoc, the annual report can often look like a pantomime cow in which the back half and the front half are dancing to different tunes. Again, Carillion's final annual report was a prime example; the chairman's statement gave a glowing account of the Company's finances, order book and prospects. The financial statements told a different story – although even here you had to look hard to spot the more egregious differences in the musical score underpinning the narrative and financial sections of the report.
- How meaningful and useful are current standards of so-called risk and viability reporting? Many so called 'risks' (and the supporting analysis) is nothing more than discursive notes on subjective issues of uncertainty that management has identified. Viability reporting only looks three years ahead – despite the fact that the entity may have recently issued a 20-year bond.
- Is an audit supposed to identify whether fraud is taking place? The answer seems to be that this is not the purpose of the audit but that nonetheless the systems applied in carrying out the audit should be sufficiently detailed and robust to identify fraud. Similarly they should be able to identify the scope for fraud – something which should mentioned in the auditor's report and drawn to the attention of shareholders.
- Do auditors have a duty of care to the shareholders? It appears that legally they don't. The only duty of care they have is to the Company (the client) as confirmed by the Caparo judgement. This cannot be right. There is an obvious conflict of interests in this. The auditors are supposed to be looking after the interests of the shareholders and other investors, not the company management.
- The Caparo judgement limited the ability of shareholders to sue the auditors. This needs to be reversed by enacting new law.
- Auditors are allowed to limit their liability via their contractual terms of business. The limits they set are far too low. This needs to be revised either by a change of law or via the FCA/FRC/ARGA.

These are just some of the areas in which change is needed. A number of these changes may need legislative backing.

CHAPTER 2 – THE 'EXPECTATION GAP'

Q4: Do respondents consider there is an expectation gap?

Yes. Our responses to Questions 1-3 above have already referred to this. However we would also suggest that there is a delivery gap, in that audits have failed to deliver what the law requires. We would suggests that the term "expectation gap" is one that has been put forward by the audit profession itself in order to deflect the debate towards arguments they feel more comfortable with. The BEIS committee report concluded there was more of a delivery gap than an expectation gap, and we would agree with this.

Q5: If so, how would respondents characterise that gap?

Investors believe, quite rightly, that a satisfactory audit means that they can rely on the financial statements as giving a fair and accurate view of the financial performance, health and robustness of the business. Many will believe that a satisfactory audit means that there are no obvious weaknesses in the reporting systems which allow scope for fraud. Many would also think that the auditors have a duty of care to the shareholders in terms of the thoroughness of the audit and the opinions expressed by the auditors. These are all reasonable expectations – so we would suggest that a "delivery gap" is a better characterisation of the situation.

In reality, the audit seems to have been reduced to a 'tick-box' exercise by auditors in which basic compliance-checks are made and no further questions are asked. In some cases professional scepticism on the part of the auditor is nowhere to be seen.

There are obvious conflicts of interest in the current relationship between auditors and the companies they audit. The auditors are supposed to look after the interests of the shareholders. Unfortunately, at present the shareholders have no rights to input to the appointment of the auditors (although they can ask questions at AGMs, submit questions to the company at other times, give their views on the auditors and vote on the appointment and fees at the AGM). The auditors are appointed by the company's audit committee which allows plenty of scope for influence of the appointment from the executive directors. The CMA Update Paper confirms that this happens. The executive directors are the people who are having their homework marked by the auditor. They have every incentive to choose an auditor who will take a relaxed approach in exercising 'professional' scepticism'. It is also worth noting that the contractual relationship is between the company (the executive directors) and the audit firm. This reinforces the perception that 'He who pays the piper is calling the tune'.

In many cases, the way in which certain items in the accounts are presented will be influenced by the large bonus payment that directors stand to gain by achieving predefined outcomes. Challenging the way in which these items are presented and treated in the accounts is not something the executive directors are likely to welcome. Auditors who are keen to retain the audit instruction are for their part unlikely to want to upset company management.

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?

Yes, the failure to follow the capital protection requirements of the Companies Act is one aspect. Simply "following the accounting standards" is not good enough. Another is the "it's not our job to look for fraud" argument, where failure to spot a really material fraud suggests a lack of professional scepticism.

Furthermore, as the consultation document explains, the role of audit is not clearly defined nor is it consistently understood. The FRC itself reports that only 70% of audits are satisfactory with the rest needing improvement. Individual investors and the press who tend to have a good understanding of the concerns of individual investors are heavily critical of cases such as Carillion. The rapid growth in fines levied by the FRC is further evidence of this gap.

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

Overview & Who provides assurance?

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

Some of these issues are dealt with below in connection with the scope for auditors to report on company culture (Questions 55 - 57). However, there are three particular areas in which we believe that audit could provide wider assurance:

- The role of audit in providing at least a degree of assurance over at least some of the content in the narrative part of the annual report.
- The appropriateness and limitations of auditors providing nothing more than a brief written report as evidence of an often expensive (for shareholders), time-consuming, detailed and complex programme of work over a twelve-month period. In order to provide proper and wider assurance something more is required.
- A requirement for a proper explanation given to shareholders following early termination of the audit contract (by either side).

Each of these is discussed in more detail below.

<u>7.1 Provision of assurance on emerging forms of reporting, such as integrated reporting, sustainability reporting and non-financial reporting on environmental, social and governance matters</u>

Sustainability and ESG matters are becoming increasingly topical in the wider public debate about the role and responsibilities of business. Much of the investment community pays little more than lip-service to these topics. Much reporting on environmental matters is 'green-wash' with companies seeking to burnish their environmental and ESG credentials without actually demonstrating whether their actions are having any real impact. There is much work to be done to ensure that key terms within the ESG and environmental area are effectively defined and standard measurement criteria are developed. The British Standards Institute (BSI) is starting work on this. Once this has been done this whole area should be more readily auditable.

We have commented further on the auditing of non-financial metrics in our response to Question 21 below.

7.2 Effective follow-up to the auditors' report

Currently there is no formal system which ensures that the auditors, those who appoint them (technically the audit committee) and the internal audit team within companies are properly held to account. Internal and external audit are critical assurance services which deal with complex issues. Shareholders pay handsomely for them and deserve meaningful feedback on them. This cannot be done simply by increasing the amount of content in the annual report.

Approving the audit report is a formality at the AGM. Furthermore, the AGM is not normally an appropriate forum for a detailed discussion between shareholders, the auditors and the audit committee about the work carried out by the auditors and the key outcomes from the work[1].

Better and wider assurance could be achieved by having, in addition to the AGM, at least one meeting a year between shareholders on the one hand the auditors and members of the audit committee on the other. The executive directors should probably not be present. Issues covered should include:

- The programme of work of the external auditor;
- Particular aspects of the company's accounting and controls that the auditor has investigated, why and what they found;
- Issues that the audit committee has asked the auditor to look at, why and the conclusions reached;
- Adjustments to the accounts – what were they, how significant were they, what was finally agreed and why?
- The amount of time spent on the contract by the audit partner responsible;
- The programme of work agreed for the internal audit team and the outcomes, conclusions and, where appropriate, the actions resulting from their work;
- Whether the FRC have done an AQR or CRR and if so what were the key issues raised and actions that resulted. Also, what was the last AQR rating of the company's audit and why was this so?

The meeting should be semi-formal with presentations from the external auditors, the head if internal audit and the audit committee chair. There should be plenty of scope for shareholders to ask questions. Points of details requiring further discussion include:

- Timing of the meeting in relation to the AGM
- Should there be any formal voting on issues such as the re-appointment of the auditors? This might be better remaining a matter for the AGM
- How can private shareholders with shares in nomine accounts be included? If the meeting is semi-formal with voting matters reserved for the AGM the involvement of beneficial shareholders may be easier to achieve.

Implementation of this suggestion should be easy to do and is easily justifiable given the importance of the audit. It would help to address the clear conflict of interests that currently exists whereby the auditors are effectively appointed by the executive directors (via the audit committee) and are in effect working for the directors as the managers of the company. It is worth noting that, currently, it

[1] In the event that there have been problems and controversies with a company's financial statements or audit, we would expect shareholders to wish to raise these at the AGM.

is to the company that the auditors have a legal duty of care, not to the shareholders (Caparo)[2]. This is not satisfactory.

7.3 Early termination of audit contracts. Currently there is no requirement for the company or the auditor to say why an audit contract has been terminated. If an auditor resigns the audit or is dismissed by the company the shareholders must be told why.

It has to be assumed that an auditor will only resign the audit contract or be dismissed by the company if serious disagreements have emerged and the working relationship has broken down. In this situation it is vital that shareholders are told exactly what has gone wrong. There are strong arguments for suggesting that the company should be forced to call an EGM so that both parties can be questioned by shareholders.

The importance of this is illustrated by the experience of an UKSA member and shareholder of Tex Holdings plc. A few weeks ago the company announced it was in breach of bank covenants; our member immediately sold his shares at 84p per share (purchase price 100p per share). Two weeks after this announcement the company said it was unable to complete the 2018 accounts and the shares were suspended.

He decided to review the 2017 accounts to see if he had missed anything, but I could not find them on the website. He went into 'Company's House' and found them. He then went in to look at other documents filed and found that on 31 October 2018 the company's auditor, BDO LLP had resigned as the company's auditor. He found the last paragraph of their resignation letter disturbing:

"We confirm that none of the reasons for us ceasing to hold office and no matters connected with our ceasing to hold office need to be brought to the attention of members or creditors of the company."

The auditors must have known that the company was in trouble. It is one thing for them to resign the audit contract on account of this. It is quite another for them to gloss-over their concerns in any public statement about the termination of the contract. No wonder audit's role in providing wider assurance is being questioned.

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?

Maybe; there are certain sectors such as banking which perhaps require more assurance because a major business failure in this area can pose systemic risk to the entire economy. However, it needs to be recognised that audit is not the only way of providing assurance and in these circumstances there may often be other better ways of providing additional assurance. Better regulation with regulators such as the FCA, PRA and FRC working in unison is one line of defence.

The nature of the risk is also relevant. Over the last ten years cyber threat has become more important. With the move to 5G networks it will become even more critical as the risk increase that services on which we all depend could be maliciously compromised. These include financial services (the ability to make and receive payments) and also the disablement of critical infrastructure. It is not clear, however, whether reporting on cyber threat should be (or become) the responsibility of auditors as we know them today.

[2] Caparo did at least establish a duty of care to the company.

Internal Audit

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

No. It is very unclear where the boundaries lie. One of the least satisfactory aspects of most audit reports is that they give hardly any information about the work of the internal audit team or how this relates to the programme of work carried out by the external auditors.

Internal audit is an important function. It should be one of the key lines of defence in ensuring that the business is not exposed to fraud, theft, loss and unnecessary business risk as a result of systems weaknesses, employee ignorance, lack of awareness, malevolence and / or general incompetence. External auditors have been castigated for failing to spot fraud taking place – sometimes over many years – in companies such as BT and Patisserie Valerie. Surprisingly, there appears to have been very little debate about what the internal audit function was doing and how it came to be looking the other way. Although not a case of fraud, it is appropriate to ask what the internal audit team was doing at Carillion as costs on a number of major contracts spiralled out of control, milestones were missed and major delays occurred.

Whether it is outsourced (as in the case of Carillion) or resourced by full time employees of the business, internal audit is a cost to the business (and the shareholders) and should be required to give much fuller account of how it has spent its time during the year. This should include an account of how its priorities were identified and approved and what the outcomes of its investigations (and any recommendations) were. This should be a key part of the annual meeting between shareholders and the auditors / audit committee referred to in 7.2 above.

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

They absolutely should. The external auditor should have the power to force the internal auditors to hand over evidence and other information. This may not just be a case of wanting to make use of evidence gathered by internal audit. The external auditor might have doubts about the robustness and reliability of some of the work carried out by internal audit and might want to review it for this reason.

Much has been made recently about the benefits (or otherwise) of having two external auditors for FTSE 100 company audits. Nothing has been said about the role of the external auditor in simply checking that there are no obvious signs that the internal audit team is under-performing and why.

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 agree that this area needs major review. The eligibility rules look outdated in the context of market innovation needs today. The widespread and increasingly complex use of IT has, for example, created a need for specialist skills in this area. We support the view that audit firms should not be able to offer consultancy services – with a few well defined exceptions. Although there are supposed to be rules in place to prevent abuses in this area, we have doubts about the rules. Some consultancy services which appear legitimate for an auditor to provide (such as tax services) are not allowed, while other services such as work on large and highly profitable corporate strategy assignments are allowed.

Despite all the current rules that are supposed to ensure auditor independence, we do not believe that auditors are truly independent at present (as indicated in our response to Q5). They are, in effect, appointed by the boards of the companies they are auditing. They are appointed by those whose homework they are supposed to be marking and they have every incentive (in terms of retaining the audit instruction) to acquiesce to the blandishments and requests of those who are signing off their invoices.

We are in a situation, therefore, in which auditor independence is already heavily compromised and innovation is potentially being stifled – the worst of all worlds.

CHAPTER 4 – THE SCOPE AND PURPOSE OF AUDIT

Risk and internal controls

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?

It is not appropriate or practical to expect the auditor (or any third party) to check every aspect of management activity. Management is paid (often ridiculously well paid) to run the business and needs to be allowed to get on and do this.

Having said that, risk reporting to shareholders by many businesses remains very poor. The risk report is often nothing more than a list of areas of uncertainty assessed on a vague and subjective basis by the management. Many stated areas of so-called 'risk' are general waffle covering issues which shareholders will already have guessed (and probably researched) for themselves. **Most if it is completely un-auditable** - for example, the impact of technological disruption in the retail sector.

There would be no harm in giving auditors the power to prevail upon management to remove most of this nonsense from the annual report and to report only on true risk - known or potential. We have also commented on this in our response to Question 21. A number of the issues we have raised in our responses to Questions 15 and 16 are also relevant to the wider debate about risk reporting.

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

This is an area in which we would expect to see the external auditor working closely with the internal auditor. We would expect to see from the internal auditor a meaningful commentary on the work and the checks carried out. We would also expect the external auditors to confirm that they had discussed with the internal auditor the programme of work carried out, that they were satisfied with the thoroughness of the work (or not) and that the internal auditor's report was a fair summary of the work and its outcomes.

Feedback to investors on this should be provided at the annual shareholder audit meeting discussed in 7.2 above. This would give shareholders the opportunity to probe and ask questions. Simply shoehorning this information into the annual report is only likely to lead to more boiler plate.

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?

Yes.

Going concern

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

One issue is that the Going Concern principle is not clearly articulated in IFRS or in GAAP. The usual understanding is that a business is a going concern if there is no threat to its solvency 'for the foreseeable future', usually understood as the next 12 months. Given that debt over a longer period than 12 months is often a threat to solvency, we would strongly recommend that such threats are assessed over a longer period. As there is a long-established science of default risk assessment used in credit and ratings analysis, we do not see why this science could not be extended to accounting practice. As for company law, it emphasises a fundamental duty of a firm to keep the capital intact for the safety of the creditors. Once again, assessing the safety of creditors requires an assessment of default risk over a longer period of 12 months. **Most senior debt is issued over a far longer period.** It will be rated by an external independent agency and it is important is that they (rating agencies) have access to the information needed to do their rating and that the information is accurate.

In making their assessment of going concern, auditors should note any concerns from rating agencies and other sources (analyst reports, shorting activity, movements in share price, etc), that may indicate that others are interpreting the data differently to the view of management.

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"?

As noted in our answer to Q15, over-reliance on long term debt is often a material factor leading to insolvency. There is rarely sufficient information provided in the statutory reports to assess the extent of such reliance. Separating debt into 'amounts falling due within one year' and 'amounts falling due in more than one year' is simply not good enough. See also our remarks on Q18 on increasing levels of debt (some of it hidden), 'problem contracts' and so on.

Viability

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

In theory, yes. However, in practice, why on earth would they pursue a business model which they did not think was sustainable? The other problem, is that most business model reporting remains poor. The business model is often badly explained, poorly articulated and full of self-congratulatory banalities. It should be fair and balanced and not a marketing puff.

Hence, we wonder what the value of any additional statement by the directors would be. We have, however, discussed in our responses to Questions 19 and 43 the possibility of requiring a Sarbanes-Oxley type of declaration from the directors.

Q18: Should such a statement be subject to assurance?

What is the point? We are paying the directors to run the company - not the auditors or some other third party. An assurance statement about Carillion's business model by a third party would probably not have revealed much about the business model itself. All we needed was a decent audit which ensured that proper attention was drawn to the lack of tangible assets, the optimistic valuation of certain intangibles, increasing levels of debt (some of it hidden), changes in the business model and a number of large 'problem contracts'.

A Sarbanes-Oxley approach to ensuring the truth of statements made by directors might be more appropriate (See Q19 and 43).

Q19: Who might be capable of giving such assurance?

It would be worth considering whether this should become the responsibility of the executive directors and the chairman under a modified form of the Sarbanes Oxley legislation in the USA.

Unaudited information

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

As discussed above (Q18), it is the executive directors and senior managers who are charged with running the business. They are the ones who are supposed to understand the markets in which the company operates and to set and implement the strategic direction for the business. They must take full responsibility for this. If the auditors have doubts they should be able to make comment via the risk report. There are strong grounds for believing that the risk report should receive some form of review and assessment by the external auditor.

There is also a strong case for auditors being required to raise their concerns if they believe that a company is heading for serious financial trouble. This should take place in three stages:

1. The issues should be raised in writing with senior management and a credible written response should be provided;
2. The issues are raised with a third-party (probably the regulator) if the auditor is dissatisfied with the response given by management and remains concerned;
3. The auditor still has serious misgivings and resigns the audit contract; this should in turn trigger an EGM.

In a world in which audit was functioning properly this process should have happened at Carillion. It can’t possibly be right that auditors can sign off a set of accounts suggesting that a company is in sound financial health only for it to be declared bankrupt less than a year later.

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?

This would be helpful and should be of benefit to users. It would be helpful if auditors were at least to audit key performance metrics used by companies. Questions here should include:

- Are measures consistent from one year to the next?
- Are measures relevant in that they clearly link to and support the business strategy?
- If measures have been added or dropped or if the definition of the KPI has changed, why was this done?

It would also be helpful if the auditors were to comment on the extent to which key measures of performance for the business are linked to directors' pay awards (although we note that some proxy agents already do this, so it might be duplication) and the extent to which achievement of outcomes is really within the control of the directors in the time period under consideration. Comment is also needed on whether the performance targets for threshold, target and maximum performance were set at suitably stretching levels. Shareholders want to know not only if the right measures were used, but whether soft or tough targets were set. For an example of apparently consistently soft targets, see https://www.sharesoc.org/wp-content/uploads/2019/05/Screenshot-2019-05-11-at-09.57.19.png

As indicated in our response to Question 15, it should also be possible for auditors to audit, or at least comment on, risk reporting by companies. There is plenty of scope for auditors to comment on financial risks they have identified in the company's financial statements.

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

See response to Q21 above.

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

Overview

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; there are plenty of examples in the field of audit (and elsewhere) in which process and procedure become the prime considerations while issues of outcomes and their usefulness are forgotten.

Auditors themselves have commented to us that auditing has become a 'box-ticking' process. Provided a given step in the process has been completed, no further questions are asked and no 'sense-check' is made. Not only is professional scepticism left at the door, so are questions of 'Does this look right?', 'Is it credible?' and 'What does it tell me?' Investors and others with a financial risk in a company have a right to be provided with something better than this.

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?

Our suspicion is that this is true. However, we are not sufficiently close to or involved in the audit process to comment with any authority.

Binary nature of audit & Producer-led audit

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

It would provide a better basis for further follow-up that would allow investors (and perhaps others) to probe and to ask more detailed questions and seek further comment from the auditors (external and internal and from the audit committee). Our suggestions are outlined in 7.2 above.

The written report has to be the starting point. However, even a graduated disclosure of auditor conclusions is likely to require further elaboration in a face to face meeting with shareholders. Indeed, graduated disclosure might help to encourage a process of formal or semi-formal follow-up with investors.

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

Some further narrative would be helpful in many cases. However, as indicated above, there are limits to what can be achieved by simply expanding the written narrative. One of the problems with annual reports today is that as the requirement for more narrative has increased so the annual report has become increasingly voluminous, more difficult for readers to use and find their way around and more prone to subversion through boiler-plate content.

Q27. What would prevent such disclosures becoming boiler plated?

See answers to Questions 25 and 26 above. As long as reporting is limited to the use of written content and as long as there is a compliance requirement with the content there will always be a risk that disclosure reverts to useless boiler-plate.

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

It must have played a major role. It is always easier to go on doing what you always did, particularly when the task has become heavily hedged around with prescriptive processes, regulation and other rules which make any change of approach difficult and potentially risky. The situation is not helped by the relative lack of competition in the audit market. Nobody is going to break ranks when there is no pressure to do so.

It has to be added that users in the form of the large investors have, with some honourable exceptions, been **relatively supine**. They have done little to question the status quo (the average AGM vote in favour of auditor appointments is over 98%). On the contrary, the IA and most of its members seem to have been very happy for financial reporting and audit to drift along as it always has. Even now the idea of having an independent third party (probably the revised FRC) appointing auditors for FTSE100 companies has been flatly rejected. This is despite the fact that it would deal with the conflicts of interest inherent in the current system and the fact that currently the large investors take no interest and play no practical role in auditor appointment.

Private investors, who might take more interest, have been systematically disenfranchised by the dysfunctional way in which the system of nominee accounts now works in the UK to deprive them of their normal rights as shareholders and stewards of their own money.

CHAPTER 6 – LEGAL RESPONSIBILITIES

Overview & Director obligations vs. auditor obligations

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?

Firstly, when a Board is considering a difficult issue, it will seek legal advice on whether it is operating within the law.

Secondly, we believe that the Companies Act provisions in respect of capital maintenance are entirely appropriate. The fact that the principles apply irrespective of what accounting standards may say is a logical consequence of the fact that accounting standards have a different objective. The capital maintenance provisions are there for good reason, to protect the interests of the shareholders and also other parties. Arguably, signing off that those provisions have been complied with is as important as any other aspect of the audit process.

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?

The important thing is to be clear that company law of each country may legitimately have its own requirements for additional information that has to be disclosed, over and above the requirements of IFRS.

For example, reserves in the accounts are rightly assumed by the public (i.e. investors and all others with a financial risk in the company) to be distributable unless otherwise stated. If the auditors sign off statements where that is not the case, that will obviously not 'meet public expectations'. Furthermore, there is quite correctly a set of provisions in company law relating to what is distributable.

However, international accounting standards are not designed to fit with the law, or indeed public expectations, in any given country. A major purpose of IFRS is consistency in the provision of

company financial information across different countries and we would not advocate changing this. The law in each country should always prevail, but resolving this is not the insuperable problem that auditors might suggest it is. It appears from the evidence to the Select Committee that many auditors would rather that it was the accounting standards that should prevail and it appears that the accounting profession has tried over the years to manoeuvre towards this position. This is tantamount to manoeuvring to get round principles enshrined in law that the auditors or their client company managements find inconvenient.

Public expectations rightly include that companies should not make distributions out of reserves which are not distributable under UK company law. Company law, including the capital maintenance provisions, is designed to protect not only the shareholders of a company but also all the parties that rely on companies being strong enough to meet their commitments, including employees, customers and suppliers. This requires the principle of prudence be applied; sadly, prudence has been virtually written out of International Financial Reporting Standards (IFRS) in favour of neutrality. Furthermore, IFRS has not always even achieved neutrality, as the experience of the asset impairment rules for banks showed in the last financial crisis.

Acknowledging that the conceptual framework of IFRS, including the principle of neutrality, is different from the principles enshrined in company law is an essential first step in achieving clarity. There is no problem in companies preparing numbers in accordance with IFRS as a first step, providing they then explain clearly in their reported statements what the correct interpretations are under company law and disclose the information and any explanations that company law requires. A similar principle has always applied for taxation; generally accepted accounting principles, applied consistently over time, may be a start point, but the rules applying to tax calculations normally involve adjustments, and the tax rules can change at any time.

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

Clearly the company must, as a matter of law, know what its distributable reserves are. Otherwise how can it declare a dividend? As a material part of the financial information of the company (material to creditors as well as shareholders) it should be declared publicly and for the same reason it should be audited.

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?

We do not have the technical knowledge to comment on the first sentence in the question. On the second, we suggest that weaknesses are not primarily about 'level' but about tying a statutory requirement (Financial Reporting) to a set of principles over which the UK has no control (IFRS). See also the answer to Q30 above.

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?

Yes – see response 7.2 above.

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?

Yes – see 7.2 above.

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?

Yes, this would be helpful for investors in providing continuity.

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?

We believe that there is a serious lack of clarity over exactly what the auditor's role is in fraud detection and that this has helped to create a mismatch between users' expectations and auditors' understanding of the assurances they are required to provide.

We assume that auditors will check the bank balances to verify the reported cash. Likewise, we assume that the auditors will check a sample of:

- Invoices sent, to check the amounts invoiced equals amounts paid and that the revenue recognition procedures are being followed.
- Invoices received, to check the amounts paid equals amounts invoiced and the cost allocation to P&L and periods), capitalisation and accruals are correct and the procedures are being followed.
- Stock to see that it exists and is in good shape.
- Contracts, to see if there are any provisions that may incur costs, reduce future income, permit early cancellation.
- Documents justifying goodwill and brand values, etc

At present the guidance seems to suggest that auditors are not specifically charged with checking whether fraud is taking place but that the checks that they run should be sufficiently detailed and robust to identify (as a by-product of the audit) whether there is scope for fraud and whether it seems likely that fraud could be occurring. It is worth remembering that fraud is invariably opportunistic; someone (or group of people) identifies a weakness in the company's control systems and realise that they can exploit this for their own benefit.

This suggests that it is really the role of internal audit to be on the look-out for situations in which internal controls are weak or incomplete and where there is an opportunity for fraud. At present there is a serious lack of any requirement for internal audit to give an account of its work and actions in ensuring that internal controls stand up to close scrutiny. This needs to change (see 7.2 above).

One thing external auditors certainly should check is whether client companies have effective procedures for whistleblowers to report suspected fraud. Reporting suspected fraud is never easy. Employees may be afraid of falsely accusing colleagues. Some may also worry about how they should report the fraud and to whom for fear that those they report it to are also involved.

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

It appears not. However, as discussed above (Q36) we believe that internal audit is the most effective line of defence within the company for limiting the scope for fraud. Robust whistle-blowing procedures are also important. This should include provision of a well-publicised phone number which any employee can use (on or off-site) to raise their concerns directly with the external auditor.

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

Possibly; it is worth remembering that the best fraud probably never gets detected. There are also plenty of cases of suspected fraud which are impossible to prove (to the extent that they would stand up in a court of law). Often these involve payments to third party suppliers for legitimate goods and services but at inflated prices. It subsequently transpires that friends or same-family members work in both the customer and supplier organisations. In many cases it would not be reasonable to expect external auditors to spot this. This is primarily the responsibility of internal audit. It has to be assumed that they are not going to be complicit in the fraud – although nothing can be fully assured.

More worrying is the fact that there have recently been serious cases of apparent fraud (BT in Italy and Patisserie Valerie, to name but two examples) which were not spotted by the auditors even though they seem to have been taking place over relatively long periods. A reasonable person in these circumstances might have expected the external auditor to spot that something was amiss and to have looked more closely at what was going on.

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

Yes, this would be practical. As outlined in the response to Q36 they could:

- Comment on work done by internal audit to check the company's internal control systems;
- Run their own checks where appropriate;
- Check that the company has bullet-proof systems for enabling whistleblowers to report suspected fraud;
- Check that the company has a well-define approach for handling cases of suspected / actual fraud to a successful conclusion;
- Using their own professional scepticism; it should not have escaped the notice of Grant Thornton that Patisserie Valerie's gross margins were double the norm for the café / teashop industry. If it looks too good to be true it probably is. Perhaps investors should also have spotted this.

It is important to remember that ultimately it is the responsibility of the company and the executive directors to ensure that systems for preventing fraud are robust and fully implemented. It is, for

example, surprising how many companies fail to take up references when appointing new employees to positions of trust and influence – despite claims that this is standard procedure.

CHAPTER 9 – AUDITOR LIABILITY

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

We are not able to comment authoritatively on this. However, it seems inevitable that exposure to litigation must have some impact on their willingness to embrace change.

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

It is not clear that setting a quantified limit will lead to improvements in audit quality or effectiveness. A more appropriate approach is for the FRC (or its successor) to use the sanctions at its disposal to penalise firms for audit failures. This includes penalising individuals where they have demonstrably fallen short of meeting professional standards.

In general, it seems likely that threats to reputational risk, plus the prospect of significantly higher professional indemnity premium, are most likely to focus auditors' attention on the quality and reliability of their work.

We would support the new regulator that replaces the FRC having greater powers, including over company directors. Where the directors of a company have behaved egregiously, it is not appropriate for all the opprobrium to be directed at the auditors.

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?

Yes, the auditors should have a duty of care to all those who depend on the quality and reliability of their work. It is not just the patient who can sue a doctor for negligence; the family can as well. The rules should be similar for other professional advice / services such as audit.

It should be noted that auditors at present only have a duty of care to the company that has engaged them (the entity with which they have a contractual relationship). The Caparo judgement demonstrated that they have no duty of care to the shareholders. This is wrong and needs to change.

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 comment to make on this other than to say that it is primarily the responsibility of the directors of the company to ensure that they are acting in the best interests of the shareholders and that they are applying high standards of governance and stewardship in managing and running the company. The audit can only ever be a back-stop in providing stakeholder assurance.

If this seems too vague then probably the next step is to move to a Sarbanes-Oxley approach as in the USA. Under Sarbanes-Oxley legislation Directors are ultimately providing declarations that:

- Their organisations are honest, competent and trustworthy.
- Third parties have confidence in their organisations' integrity and capability.
- Operations are carried out under worthy leadership and within an appropriate culture, meeting all relevant regulatory, professional and organizational standards.
- Board, management and staff feel positive about being part of the organisation, aligning their behaviour and relationships to stated corporate values.

The same or similar requirements would be appropriate in the UK.

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 are unable to comment on this.

CHAPTER 10 - OTHER ISSUES

Technology

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?

Our understanding is that use of big data can allow 100% sampling as well as using sophisticated algorithms to scan for unusual patterns in data (for example, certain invoices always being paid on a Sunday when hardly anyone is likely to be in the office.

Increased use of machine learning might also have a role to play – for example, by running comparisons with other firms in the same industry. In the case of Patisserie Valerie a comparison of gross margins might have helped to alert auditors to the fact that there was something suspicious or different about the Company's financial reporting.

This should allow a higher level of assurance. However it also calls into question the whole role of the external auditor. Why have the external auditor running these checks? What is there to stop the company's risk management and internal audit teams doing their own 100% checking and monitoring for suspicious activity on a regular basis? This suggests that there is a 'single truth' that the company can produce for itself. But what if that has been corrupted? What is the role of the auditor in identifying that? Maybe this leads us more towards a Sarbanes-Oxley approach to assurance as outlined above in the response to Q43.

The same issues arise with the use of artificial intelligence (AI). The term is much over-used and currently covers a range of evolving computer capabilities, including analytics and machine learning. One of the key features of true AI is that it is not easily auditable. In machine learning, for example,

learning algorithms – not computer programmers – create the rules. Thus it can become extremely difficult to check how the machine reached its conclusions.

It is important to add a note of caution when discussing technology-based "solutions". We believe that audits are more about the consequences of behaviour of people than simply "accurately counting things". Hence the importance of auditors having the right levels of understanding of the businesses they audit and the imagination and mindset that will enable them to exercise professional scepticism, no matter what new technology aids to the process are developed.

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?

See the response to Q45 above.

Proportionality

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

We are unable to comment on this.

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?

The cases of Carillion, Interserve, Conviviality and Patisserie Valerie all suggest an audit failure rate of around 1%. We think this is too high. We suggest 0.25% to 0.5% might be a better target.

We very much support the idea of a target as this focuses the discussion on the cost benefit issues.

Q49. Does today's audit provide value for money?

No. The way the whole system works has resulted in the audit becoming subverted so that it provides what the company and its directors want. It is not providing shareholders and others with a financial interest in the company with the assurance they need and want.

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?

The benefits of change need to be assessed over time following their implementation. Too often changes are implemented with the best of intentions following a review of some other intervention but with no further follow up. The result is that:

- Requirements for more information are subverted so that they become worthless boiler plate adding only to cost and complexity without providing any additional benefit.
- The law of unintended-consequences asserts itself and the new requirements end up creating dysfunctional behaviours which make matters worse rather than better. Nowhere has this been truer that in the area of performance related pay for directors following successive reports and recommendations by Cadbury, Greenbury and Hempel.

The FRC recently ran a post-implementation consultation on audit standards and ethics. A similar process (to be carried out, say, every two years over the next ten years or so) is probably the best way initially of trying to assess the cumulative costs and benefits of any extension of audit.

Shareholders

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?

It seems likely that large investors with significant resources at their disposal will make use of audit reports and that they will use proxy agents, debt rating agencies and stockbroker analysts to help them. They will also use computer software to scan company reports for key words and phrases. However, we have little insight into this.

For private investors the sheer size and unwieldiness of many company reports makes them very time-consuming and difficult to use. Most annual reports still adopt a format that was designed for reading in hard-copy format and which does not lend itself well to reading on-screen. While these comments relate to the annual report they also apply to the audit report. They are a further factor suggesting that **additional extensions to the audit report are the last thing we want to see. A meeting with the auditors (as suggested in 7.2 above) would be vastly preferable**. An appropriate use of technology would be the adoption of video conferencing for these meetings so that shareholders could join the meeting from various centres around the country.

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

Yes, definitely. See our response to Question 7, paragraph 7.2 above.

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?

Yes, the audit plan for the coming year should be presented to and discussed with shareholders at the audit meeting outlined in 7.2 above.

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

UKSA and ShareSoc currently organise meetings with company management. These meetings are useful to members as they provide an opportunity to meet with senior management and ask questions on a range of matters from the financial statements and the audit to corporate strategy.

Beyond this, many members will make use of media reporting and comment in the financial press.

It should be noted that one of the perverse consequences of MIFID has been to make it uneconomic for most brokers to provide advisory services to private clients. The sheer time and cost of having to write comprehensive reports following any provision of advice means that almost all have now withdrawn the service. Private clients are now offered ‘execution-only’ services or ‘discretionary’ services whereby the broker makes all the investment decisions. Invariably for discretionary services

the shares have to be held in a nominee account. Thus the MIFID system that was supposed to offer better protection for savers and investors has resulted in:

- Less choice of service
- Poorer protection for those who opt for the execution-only service
- Disenfranchisement (and additional cost) for those who accept the discretionary service.

This is another classic case of the law of unintended consequences which has left private investors with less access to information and assurance rather than more.

Culture

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 are doubtful about this. Any assessment of culture is likely to be subjective. There are however a few areas in which auditors could review and comment, including:

- The consistency of key performance measures from year to year and whether they are based on industry norms or whether management appears to have chosen them to flatter their own performance (and likelihood of achieving bonuses)
- Overly aggressive performance-related pay systems that are likely to encourage dysfunctional behaviour at all levels in the organisation (as proved to be the case at Wells Fargo and at UK banks in the run up to the financial crash).
- Use of senior management performance targets that are not really very demanding or which are easy to manipulate.

Feedback on adjustments to the accounts – for example, what they were, how significant they were, what was finally agreed and why – might also give further insights into the culture of the entity.

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

It is difficult to identify quick and easy ways in which auditors can do this. Part of the problem currently stems from the perceived culture and conflicts of interest inherent in many audit firms, namely:

- Audit has become a box-ticking exercise; provided the auditor has the necessary information to put a tick in the box no further questions are needed.
- Audit is a 'feeder' for consultancy services; all the large audit practices run lucrative consultancy practices alongside their audit work; in may accountancy firms audit accounts for only 25-30%of fee revenue with the rest coming from consultancy. There are strict limitations on what non-audit services can be sold to audit clients and this limits direct conflicts. However we remain concerned about the contagion of the consultancy culture (which is heavily sales driven, highly profitable and focussed on relationship-selling to executives), and the scope for this to overwhelm the audit part of the firm which is much smaller. We have recommended separately to CMA and Kingman that the Big 4 firms should be split up.
- The relationship between the auditors and the company management is 'cosy'. The audit contract is with the company and the auditors are appointed in effect by the executive

directors. The needs and wants of the shareholders and other stakeholders are of secondary importance.
- Career progression incentives within the large audit and consulting practices area motivation for the auditors to develop relationships with company management in order to retain the audit instruction.

We would like to see a situation in which the senior audit partner is feared and respected in equal measure by the directors of the client company.

In terms of demonstrating greater auditor independence (and hence professional scepticism) we support:

- The CMA's proposal that audit and consultancy services should be split. Auditors should not be offering consultancy services. If they need special input from people who are essentially consultants they can buy these skills in on an ad-hoc basis.
- We favour the appointment of auditors by an independent third-party (probably the regulator - FRC / ARGA). Appointment by the client company creates too many potential conflicts of interest. **We support the proposals made by Sir John Kingman in his letter to the Secretary of State, Greg Clark, on auditor appointment.** Shareholders would still have an ultimate power of veto over the regulator's recommendation although it is hard to see why they would need to use this except in the most exceptional circumstances. **We have written to Greg Clark about this. A copy of our letter is appended.**

These changes will not in themselves demonstrate that auditors have applied professional scepticism but they should help t remove some of the conflicts of interest which exist at present and call into question auditors independence and willingness to apply professional scepticism.

Providing shareholders with the opportunity to probe and question the auditors on the issues outlined in 7.2 above would help to reassurance about their judgement, scepticism and objectivity.

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

No. If an individual shareholder particularly wants this information there is no reason why it should not be made available e.g. on the company website. However, there seems little point in publishing it in the annual report as a matter or course.

Cost

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

They represent poor value for money for what we are getting at present i.e. something which doesn't meet the needs of investors (and probably most other users). That is not to say that the costs are too high – just that we are paying for a service that is not particularly helpful to us.

We believe that most investors would almost certainly be prepared to pay more for an audit service that meets our needs.

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

This would be helpful, particularly if there are to be meetings between shareholders and the auditors and the audit committee. The make-up of audit fees would provide useful background information for the meeting and any discussion.

If there is not to be any change and there is to be no process of implementing auditor /audit committee / shareholder meetings there is little point is providing more information on fees. In the vast majority of cases it will just be more information packed into the annual report which fails the 'so-what?' test.

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

We are unable to comment as we do not have sufficient insight into the profitability of the audit function and / or the extent to which it is subsidised by consultancy work in the major audit and consultancy practices. However, we note that Audit partners are well paid. We have yet to see a poor audit partner!

Given the enormous amounts of money that regularly receive overwhelming approval from shareholders at the AGM (and for often mediocre performance related to undemanding performance measures) it is hard to believe that shareholders would not be prepared to pay significantly more for sustainable high-quality audits if this meant an increase in audit fees.

One other issue which we feel compelled to mention is the claim by many auditors and accountants that splitting consultancy services from audit in the larger multi-disciplinary practices will seriously limit the ability of firms to recruit good quality people to their audit teams. Their argument runs that high-calibre people can only be recruited to audit if they are provided with a ready escape route into consultancy a few years later. Not only is this a lame argument for insisting that consultancy and audit should remain together, it is also a damning reflection on the depths to which audit has sunk as a career choice. The implication is that it has become a dreary backwater to which those with limited ambition and ability gravitate to lead a life of secure drudgery. Good people will want to get out as soon as they reasonably can.

It does not have to be like this. The world of audit should be able to recruit the brightest and best from the world of accountancy, finance and, perhaps in future, the world of IT. Certainly it can be a legitimate and useful stepping-stone for those for those wanting to move on to other areas of management. In an ideal world, and one to which audit should aspire, audit partners and senior audit staff should be respected (and slightly feared) by client management for their experience, expertise, intellect and ability. As already indicated, most shareholders will be happy to pay higher fees for high-calibre audit teams. However, the profession itself needs to start work now to ensure that it provides and is seen to provide a challenging and rewarding career path which, like most other professions, carries a high level of status.

Peter Parry – Policy Director, UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

Appendix

Copy of letter from UKSA and ShareSoc to Secretary of State Greg Clark on auditor appointment

UK Shareholders' Association
UKSA, 1 Bromley Lane, Chislehurst, BR7 6LH
Phone: 01689 856691
Email: officeatuksa@gmail.com
Web: www.uksa.org.uk

ShareSoc
UK Individual Shareholders
Suite 34, 5 Liberty Square, Kings Hill,
West Malling, ME19 4AU
Phone: 0333-200-1595 Email:
info@sharesoc.org
Web: www.sharesoc.org

The Rt Hon Greg Clark MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H OET

18th February 2019

Dear Secretary of State,

Re: Appointment of auditors

We are writing to you on behalf of the United Kingdom Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc). Our two organisations represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Sir John Kingman in his letter to you in December 2018 made a very clear recommendation that auditors of Public Interest Entities (PIEs) should in future be appointed by the new regulator which would replace the Financial Reporting Council. He set out his proposals under the heading 'A different model'.

We believe that Sir John's proposals for the appointment of auditors make eminently good sense. The current system for appointing auditors has failed miserably. It is riddled with conflicts of interest and effectively creates an unhealthy and inappropriate dependency between the auditors and the executive directors of the client companies. It creates a situation in which there is every incentive for auditors to acquiesce to the blandishments of the executive directors over the presentation of the financial statements and to suspend professional scepticism.

We are most unhappy about the resistance from the Investment Association (IA) and its members to Sir John's proposals on auditor appointment. The large institutional shareholders have for many years been complicit in going along with a system which patently fails to protect the interests of their customers, the end-investors. Even in cases recently in which there have been serious audit failures, it has been common for the auditors be reappointed at the AGM by an overwhelming majority of votes.

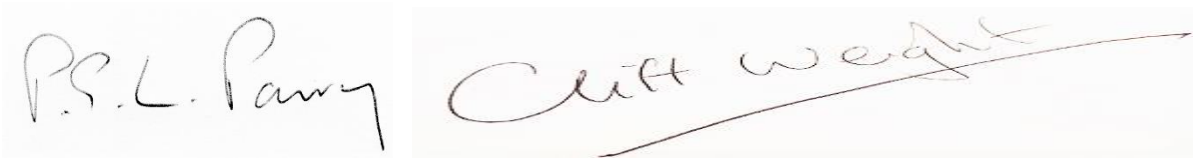
We are particularly concerned that Sir John in his letter to you appears to row back so readily from pressing his case for serious reform in the face of stiff resistance from the IA. The fact that the IA is a powerful lobby with a loud voice is not a reason to cave in to its call for retention of the status quo with minor amendments. The time for fiddling around on the periphery is over. Radical change, as suggested by Sir John, is overdue.

Appointment of auditors by a third party with the relevant skills and expertise would, once and for all, **break the current link of excessive dependency between auditors and those they audit**. It is a change that should not be difficult or costly to implement and would be effective in achieving much greater auditor independence than at present. Auditors are currently appointed for a maximum term of ten years. If, on a trial basis, the Regulator started by managing the appointment of auditors for FTSE 100 companies this would mean an average of ten appointments a year. This should not be a particularly onerous workload for a team of experts. It is low-risk and requires relatively little investment.

We strongly urge you and your Department to consider very seriously the recommendations that Sir John has made. Many of those arguing for minimal change have shown themselves to be very poor stewards of other people's money. Please do not give in to their Siren voices.

We would appreciate the opportunity to meet with you to share our experiences and observations in more detail.

Yours sincerely,



Peter Parry – Policy Director – UK Shareholders' Association

Cliff Weight – Policy Director - UK Individual Shareholders' Society