



## DELIVERING AUDIT REFORM

Issued 28 August 2020

ICAEW welcomes the opportunity to respond to the call for evidence *Delivering Audit Reform* published on 20 March 2020 by the Business, Energy and Industrial Strategy Committee, a copy of which is available from this [link](#).

ICAEW emphasises the urgency of audit reform and as a leading global professional body for chartered accountants is committed to contributing to the restoration of trust in the profession. We are pursuing a number of major projects to support the achievement of our **five goals for audit reform**. These include projects on *Developing a new audit qualification* and *Enabling companies to develop an Audit and Assurance Policy*. Our activities on audit reform are evolving and we look forward to updating the BEIS Committee at the hearings.

This response of 28 August 2020 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 186,500 chartered accountant members and students around the world. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

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## KEY POINTS

1. We welcome the opportunity to respond to the call for evidence *Delivering Audit Reform*, published on 20 March 2020 by the Business, Energy and Industrial Strategy (BEIS) Committee.
2. ICAEW emphasises the urgency of audit reform and as a leading global professional body for chartered accountants is committed to contributing to the restoration of trust in the profession. Following the publication of the Brydon report at the end of last year, ICAEW analysed the recommendations from the three recent reviews and in February 2020 published **five goals for audit reform** and are pursuing a number of major projects to support their achievement:
  - a. Establishing ARGA is essential to allow the recommendations in the Kingman report relating to directors' responsibilities and their enforcement to be implemented: we are liaising with the FRC in its response to the crisis so that, once established, ARGAs will be in the best possible position to move forward with reform.
  - b. An inclusive audit profession: we are pursuing a project on *Developing a new audit qualification*, alongside drafting a report on the modern audit profession.
  - c. A more reliable core audit, with a renewed focus on fraud, going concern and internal controls: we have been prioritising the development of resources in response to the crisis and encouraging our members to renew their focus on these three priority areas.
  - d. On-demand audit extras: an enhancement of the part played by shareholders in the commissioning of assurance, alongside a more proactive role for audit committees, may help track progress made by companies in meeting the UK's Sustainable Development Goal commitments.
  - e. Pre-tested requirements, which involves enhancing existing requirements as preparation for introducing new requirements: we are pursuing a project on *Enabling companies to develop an Audit and Assurance Policy* which will explore practical ways to help audit committees to understand and meet the assurance needs of shareholders and other users.
3. We have been informing and influencing the debate on audit reform, including through a major Audit and Assurance Faculty thought leadership initiative<sup>1</sup> launched last year. Our first two reports are background papers on the financial reporting system and the current role of audit. Since then we have published a number of other reports, including *Internal control effectiveness: who needs to know?*, which makes the case for strengthening the internal controls responsibilities of both directors and auditors, using lessons learnt from experiences of the Sarbanes-Oxley regime in the US, and *Shared and joint audits: are two auditors better than one?*, which explains what shared and joint audits are and how to make a success of them.
4. We are continuing to publish *Future of Audit* thought leadership essays and are currently working on reports on standard-setting and on audit quality. We hope that the BEIS Committee and other policymakers have found our reports useful.
5. While the three reviews focus predominantly on public-interest entities and their auditors, ICAEW also emphasises the critical importance of small and medium-sized entities to the economy. This is sometimes overlooked in the debate about audit reform. Small and medium-sized businesses matter, and continuing to understand their needs and represent their interests is a top priority for ICAEW alongside the three reviews of audit.

<sup>1</sup> ICAEW Audit and Assurance Faculty *Future of Audit* thought leadership essays are available to all at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit).

6. Our activities on audit reform are evolving and we look forward to updating the BEIS Committee at the hearings.

## ANSWERS TO SPECIFIC QUESTIONS

### ***Question 1: Do the proposals from the three reviews of audit fit together as a coherent package that can deliver meaningful reform?***

7. The proposals from the three reviews do not constitute an integrated set of reforms, but this is not surprising. They each cover different aspects of reform – the audit regulator, the audit market and the future role of audit – and were not intended at the time to form a single integrated package. The essential task for BEIS is to synthesise and integrate the proposals from all three reviews to *form* a coherent package. We set out below some observations about this task.
8. While the *shortcomings of audit*<sup>2</sup> may have been the starting point for the three reviews and for the *Future of Audit* inquiry by the BEIS Committee, one of their central findings is the need for reform by all players in the financial reporting system. The Brydon report states that *all the actors in the audit process bear some measure of responsibility* and that *changes need to be made by those other actors also*. While the priority for reform must be to improve audit quality, we agree with this analysis. This means, however, that the implementation cost of the package for business is likely to be significant at a time of unprecedented economic difficulty. It is therefore vital that reform supports, rather than hinders, economic recovery. A proportionate approach will be critical, with certain reforms targeted only at the largest, listed companies and their auditors.
9. ICAEW emphasises the urgency of audit reform and as a leading global professional body for chartered accountants is committed to contributing to the restoration of trust in the profession. Following the publication of the Brydon report at the end of last year, ICAEW analysed the recommendations from the three reviews and in February 2020 published **five goals for audit reform**:
  - a. Establish ARGA
  - b. An inclusive audit profession
  - c. A more reliable core audit
  - d. On-demand audit extras
  - e. Pre-tested requirements.
10. We believe that these goals would form the basis for a coherent package that can most effectively deliver meaningful and proportionate reform and we are pursuing a number of major projects to support their achievement.
11. While the three reviews focus predominantly on public-interest entities and their auditors, ICAEW also emphasises the critical importance of small and medium-sized entities (SMEs). This is sometimes overlooked in the debate about audit reform. SMEs may not be of public interest individually but collectively are crucial to the economy; National Statistics reveal that at the start of 2019 total employment in SMEs was 16.6 million (60% of the total), while turnover was estimated at £2.2 trillion (52% of the total). The audit of SMEs is therefore a public interest issue and another key aspect of audit reform.
12. ICAEW submitted a **response** to the International Auditing and Assurance Standards Board's (IAASB) discussion paper on this topic last year. We urged the Board to take the opportunity

<sup>2</sup> The Commons Select Committee webpage which launches this inquiry references the origins of these reviews as being what it refers to as the *shortcomings of audit*.

to re-invigorate the audit of less complex entities (LCEs) and in June 2020 wrote a **letter** to the Chair of IAASB expressing support for the early development of a separate standard for LCE audits. A number of SMEs may be exempt from a statutory audit but may still choose to have a voluntary audit, review or other assurance engagement.

13. ICAEW's report ***The 99.9%: small and medium-sized businesses***, finds that accountants are the number one advisors to such businesses. This help and support is more critical now than ever. ICAEW is committed to providing practical business advice for its members in practice and in business. Small and medium-sized businesses matter, and continuing to understand their needs and represent their interests will contribute to rebuilding the economy after the crisis has subsided. This is a top priority for ICAEW alongside the three reviews of audit.

**Question 2: Which reforms can be delivered without legislation and what progress has the FRC made in implementing such reforms ahead of future legislation?**

14. We welcome the progress the Financial Reporting Council (FRC) has made in implementing reforms ahead of future legislation. The FRC is best-placed to comment more fully on this progress. However, while some reforms can be delivered without legislation, certain key reforms do require changes to UK law. ICAEW's first audit reform goal remains the establishment of ARGAs at the earliest opportunity as a prerequisite for delivering meaningful reform to governance, reporting and auditing. In this connection we welcome the creation of the FRC's Transformation Programme and its six work streams covering setting up the new regulator; audit scope & regulation; corporate regulation; corporate reporting; corporate governance; and market reform. ICAEW is liaising with the FRC in its response to the crisis so that, once established, ARGAs will be in the best possible position to move forward with reform.
15. Sir Donald Brydon emphasised in a speech on 14 February 2020 at ICAEW that the audit profession does not have to wait for others to put many of his recommendations into action as a number of reforms can be delivered without legislation or regulation. ICAEW's second audit reform goal is an inclusive audit profession. Sir Donald recommended that the audit profession encompasses *all 'corporate auditors', including the statutory auditors of the financial statements, and auditors of other corporate information*, and in his speech he asked *why should not senior auditors get together and design a profession for themselves?* This is a key area where ICAEW hopes to contribute. We are moving ahead with a project on *Developing a new audit qualification*. We are also currently working on a report, *Design for Building a Modern Audit Profession*, which will reflect several years of knowledge and insights from our AuditFutures initiative. We would be delighted to share our thinking with the BEIS Committee.

**Question 3: Will the reforms proposed by the audit industry itself address the failings that were identified by the reviews and the BEIS Committee's Future of Audit Report?**

16. No. All those involved in audit recognise the need for change, and we welcome voluntary measures taken by individual firms to improve audit quality. These include the significant investment made by larger firms in particular in the application of new technologies to audits. However, such measures will not in isolation address all of the issues. The three reviews encompass governance and reporting, as well as auditing, and to achieve meaningful reform all players in the financial reporting system<sup>3</sup> have to make changes.
17. ICAEW's third audit reform goal is a more reliable core audit, with a renewed focus on fraud, going concern and internal controls. The coronavirus pandemic has impacted immediate policy priorities, but the paramount priority for users, as Sir Donald Brydon put it in his speech on 14 February 2020 at ICAEW, remains whether the company is being honestly run and is likely to have a future. Indeed, the need to address the issues underlying recent corporate failures is even more pronounced in the current climate. ICAEW has therefore

<sup>3</sup> Further information on the roles of the players in the financial reporting system, including directors, audit committees and shareholders, is in ICAEW's *Future of Audit* background paper, ***Financial reporting: who does what?***, published in May 2019.

been prioritising the development of resources in response to the crisis and encouraging its members to renew their focus on these three priority areas.

18. At the start of the crisis we launched a **Coronavirus hub**, featuring on-line guidance for auditors and companies. We then launched a **Global Recovery hub** and have most recently created a **hub on going concern**. The resources we have produced include:
  - a. **COVID-19 and going concern** – guidance for directors of SME businesses. We have also produced guides for **auditors** and for **preparers** on going concern considerations.
  - b. **Introducing reverse stress testing** – testing the point at which an entity's business model becomes unviable can help companies and auditors enhance their going concern assessments and identify gaps in their risk assessments.
  - c. **Understanding audit reports** – these FAQs are designed to help investors and other users of audit reports to better understand the different types of audit report wordings used by auditors, including material uncertainties related to going concern, and their significance.
19. In June 2020 we published a *Future of Audit* thought leadership essay on **Internal controls reporting: Sketching out the options**, based on a series of interviews with members and chairs of audit committees and external auditors. Our interviewees were broadly in agreement in the six areas listed below:
  - a. Critical to the success of the reforms will be the quality of the reporting framework adopted and the guidance available for management and external auditors. Everyone involved must understand what internal control effectiveness – and ineffectiveness – look like.
  - b. Whatever the framework adopted, the focus must first be on company reporting on the effectiveness of internal controls over financial reporting (ICFR), not on reporting by external auditors.
  - c. Enhanced public reporting of weaknesses in the UK represents a significant step forward for most companies and will require courage. Larger companies will be expected to set the standard.
  - d. The short-term focus must be on ICFR. Reporting on the broader controls framework is important, but would be a step too far at this time.
  - e. The pace of change and scoping both matter. Some sort of phased implementation will be necessary, taking account of different types of company, as well as any external auditor involvement.
  - f. Companies may obtain assurance from their external auditors on ICFR. However, the extent of external auditor involvement with public reporting by companies needs to be determined, at least initially, by companies themselves and the market.
20. We also note that external auditors should be included in the development of principles for internal controls reporting to ensure that assurance can be provided on such information.
21. We are also scoping projects on our other priority areas of going concern and fraud with the aim of producing practical guidance for auditors and others. We can learn lessons from the crisis and draw on the guidance we developed in response to it, and, in doing so, should help ensure that reform contributes to recovery. We would be happy to update the BEIS Committee on developments in this space.

**Question 4: When will the Government bring forward its proposals and the necessary legislation where required?**

22. The completion of the three reviews provides the opportunity for the UK to show global leadership in developing solutions to issues under consideration in many other major jurisdictions around the world. We therefore call for Government to bring forward its proposals and the necessary legislation as a matter of urgency.



23. ICAEW is standing ready to assist BEIS with developing its proposals. BEIS is best-placed to comment on their timing.

**Question 5: Will audit reform help track progress made by companies in meeting the UK's Sustainable Development Goal commitments and in particular Net Zero?**

24. Audit reform cannot ensure that companies meet the UK's Sustainable Development Goal commitments but it *may* help track their progress. Assurance, alongside governance and reporting, plays a key role in supporting credibility and trust in non-financial reporting, and the independence of assurance practitioners is central to that credibility and trust. Auditors are facing increasing demands from investors to demonstrate that they have tested, as part of the statutory audit, the reasonableness of management's judgements in the preparation of the financial statements, and could offer separate assurance services on the progress made by companies in meeting the UK's Sustainable Development Goal commitments. A recent ICAEW [blog](#) raises awareness of the recent International Accounting Standards Board (IASB) guidance on accounting for climate change.
25. ICAEW's fourth audit reform goal relates to on-demand audit extras. We advocate an enhancement of the part played by shareholders in the commissioning of assurance, alongside a more proactive role for audit committees. Assurance of virtually any area of corporate activity is possible, but decisions need to be taken about what's most important to the business, and shareholders should assume a shared responsibility for those decisions.
26. ICAEW's December 2019 *Future of Audit* thought leadership essay on [User-Driven Assurance](#) calls for shareholders to be empowered to require the commissioning of bespoke assurance engagements that are tailored to the specific situation and risks of the company. The flexibility inherent in this approach would ensure a natural proportionality, with shareholders driving the scope of assurance. It may also increase competition and choice in the market by encouraging the development of niche assurance practitioners with particular assurance specialisms. Sir Donald Brydon recommended a discretionary extended audit scope which would be proposed by the audit committee. The audit committee would invite shareholders to comment on the information which they wish to have audited or assured and in what manner. We consider practical ways this could be achieved in our answer to Question 6.
27. There are also some relevant European developments in this space. In ICAEW's report [Non-financial reporting: ensuring a sustainable global recovery](#), we state that there is a pressing need to expedite the sustainable rebuilding of economies the world over and make a number of recommendations. We recognise the particular momentum in Europe in this area, and the EU's stated intention to achieve climate neutrality by 2050 and to restart economic activity post-COVID-19 by building on the European Green Deal.
28. Given the urgency of the challenge of transitioning to sustainable and resilient business, we welcome the EU's prioritisation of action with regard to non-financial reporting, as also evidenced by the current review of the Non-Financial Reporting Directive (NFRD). In our [response](#) to the recent consultation on the revision of the NFRD we strongly encourage all efforts to move towards the establishment of a single principles-based and internationally recognised global framework providing comparability and consistency for non-financial reporting. We believe that the EU can act as a global leader to catalyse international alignment and the establishment of a new global corporate reporting framework. BEIS should bear these developments in mind and consider both the role of the UK in the revision of this directive and in due course the value of any equivalent changes to UK law.
29. ICAEW has in the meantime demonstrated its commitment to meeting the UK's Sustainable Development Goal commitments. On 25 February 2020 the CEOs of many of the world's leading accountancy bodies, including ICAEW, issued a [statement](#) against the backdrop of

the UN Climate Change Conference which had been due to take place in the UK later this year. This calls for members of the profession to play a full part in addressing the challenges of climate change, including through their roles in reporting and assurance.

### **Question 6: How will audit reform fit with wider corporate governance reform?**

30. Legislation to establish ARGAs is essential to allow implementation of the recommendations in the Kingman report relating to directors' responsibilities, and their enforcement. The reforms should be considered holistically; while staggered implementation is perhaps inevitable, the final outcome of any changes must not be confusion over the respective responsibilities of auditors and directors. Uncertainty could create inefficiencies as well as hamper the ability of ARGAs to hold individuals accountable. However, it should be possible to do more than just avoid negative consequences arising from inconsistencies. The intended benefits of reform will be maximised if changes to whistleblowing, discussed below, and stakeholder engagement are congruent.

### **Whistleblowing**

31. Whistleblowing within companies has been strengthened in the revised Corporate Governance Code (the Code). The Code places greater emphasis on anonymous reporting. Boards rather than audit committees must now routinely review whether there is a means for the workforce to raise concerns and ensure that arrangements are in place for proportionate and independent investigations and follow-up action.
32. These changes would be reinforced by the whistleblowing reforms being considered for audit. Categorising auditors as 'prescribed persons' for the purposes of the Public Interest Disclosure Act (1998) (PIDA) would encourage company employees (and others) to blow the whistle to them. This will also provide auditors with more information on risks and therefore facilitate their risk assessment and response, and the corollary may be improvements in audit quality. However, such reforms must not lead to confusion over the responsibilities of directors for any matters reported to auditors.
33. We also support a new duty for auditors to blow the whistle to ARGAs about viability or other serious concerns, and we have suggested that auditors should also be able to blow the whistle to ARGAs about less serious concerns. Receipt of this information will be critical to the effectiveness of ARGAs' proposed market intelligence function.
34. Another important source of information for ARGAs should be whistleblowing by NEDs. However, this area is not covered by the reforms, even though NEDs are not protected by PIDA because they fall outside of the statutory definition of 'worker' and despite the fact that NEDs have the added complication of interpreting any confidentiality clauses in their service contracts. In addition, reliance on the Code requirement concerning NEDs' resignations<sup>4</sup> is inadequate for a number of reasons. We would be happy to provide further information on these.

### **Stakeholders**

35. Stakeholders' interests have been a major theme in recent corporate governance reform, as reflected in the Code<sup>5</sup> and in new reporting requirements for some companies<sup>6</sup>. ICAEW's *Connect and Reflect* series explores some of the opportunities for making changes within the existing requirements.
36. Stakeholders have not been forgotten in audit reform. ICAEW's December 2019 *Future of Audit* thought leadership essay on **User-Driven Assurance** states: *Audit committees will... need to communicate their assurance planning with shareholders, and, to do so, will need to undertake discussions with both management and auditors.* The ICAEW report clarifies that

<sup>4</sup> Provision 8.

<sup>5</sup> Principle D and Provision 5.

<sup>6</sup> The Companies (Miscellaneous Reporting) Regulations 2018.

one way for audit committees to both understand and meet the assurance needs of shareholders, as well as communicate their assurance planning to them, would be by using an assurance map. We have also suggested that auditors make presentations to shareholders at AGMs.

37. The Code requires companies to engage with their workforce. It mentions three methods for this, although the Code also allows alternative methods if the company can explain that they are equally effective. One of the methods mentioned in the Code is the formal appointment of a director from the workforce, but as these directors are not independent NEDs they are unable to join audit committees. In fact the most popular method for employee engagement is the formation of a formal workforce advisory panel, and auditors could usefully present to these panels.
38. Sir Donald Brydon recommended that the audit committee publish *a three-year rolling Audit and Assurance Policy which would be put to an annual advisory vote by shareholders for approval*, and in his speech on 14 February 2020 at ICAEW he asked *why should shareholders not demand the extensions of assurance proposed in the report?* ICAEW is moving ahead with a project on *Enabling companies to develop an Audit and Assurance Policy* which will explore practical ways to help audit committees to understand and meet the assurance needs of shareholders and other users. This is particularly important in the light of the increased focus on directors' responsibilities under section 172 of the Companies Act 2006. We are currently engaging with stakeholders to identify ways of implementing these ideas in practice. We would be delighted to update the BEIS Committee on the initial findings of our outreach.