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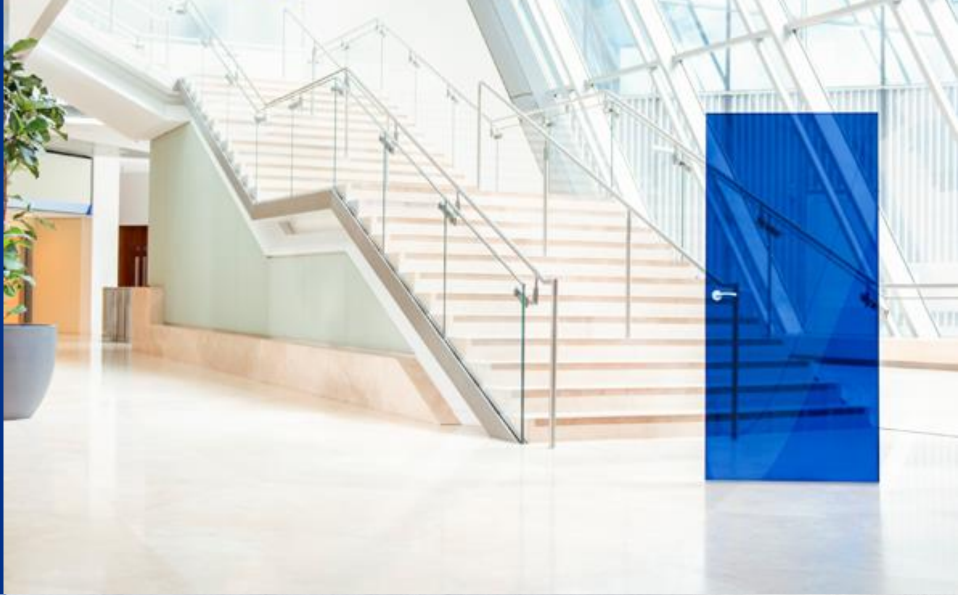
A conversation with Sir Jon Thompson

KPMG Audit Committee Institute



Chief Executive of the FRC, Sir Jon Thompson, kindly addressed a meeting of our FTSE100 audit committee chairs group to discuss the broader landscape of audit reform and specifically its impact on audit committees. A summary of the conversation is set out below.

Audit reform is not just about auditors. The role and responsibility, behaviour, training and qualifications of auditors is important. But in addition, investors need to increase their engagement to ensure better stewardship (a common point raised by board members); boards and executive teams need to raise the standard for all companies to the standard of the best (financial management, risk management, corporate governance, control and transparency); and the FRC needs to radically change what it does and how it does it.

As a recap, the reforms were kicked off by Sir John Kingman who made 83 recommendations. 42 about role and remit of the FRC and 24 on the FRC's methodology. Overall the FRC was found to be not fit for purpose. Then other recommendations addressed by Kingman included the transparency of audit process as well as the definition of a Public Interest Entity (PIE). And finally there were seven recommendations on companies – a stronger UK framework for internal controls reporting being the main one.

The CMA then made four recommendations linked to competition within the statutory audit market – including the recommendation for an audit committee regulatory framework which sets out minimum standards for audit committees.

Then Sir Donald Brydon concluded on the quality and effectiveness of audit making 67 specific recommendations.

So that's 155 recommendations in total. Also, the BEIS Select Committee are very keen on audit reform and have made 55 recommendations themselves.

The FRC have synthesised all the recommendations into six projects – irrespective of where the recommendation came from: transforming the FRC; audit scope and regulation; corporate regulation; corporate reporting; corporate governance; and audit market reform.

The balance of reform therefore feels like it might rest with companies (rather than auditors) but ministers are of the view that if you can raise standards in companies to the standards of the best then that will have a significant impact on the audit (which follows naturally from the decisions made in the board room). Corporate success or failure is determined by the board – its the board which runs the company, not the auditors.

A consultation – bringing together the Government's planned response to all the recommendations – is expected at the at the end of November.

In broad terms, the proposition is to scrap the FRC and create ARGA and then delegate 130 or so of the recommendations to ARGA to get on with. The Government would then need to make its position clear on around 25 big public policy issues including the need for an audit committee regulatory framework, the purpose and scope of an audit, and whether it is in favour of a stronger UK framework for internal controls reporting.

So thinking from an audit committee perspective there are broadly three key areas:

— Audit scope
— Transparency of audit
— Specific responsibilities of audit committees and boards

Scope

Currently only 25 to 40 percent of an annual report is actually audited. However, the recommendations from the various reviews would increase this to cover APMs, risks, predicting the future and ESG reporting. Importantly, it is not expected that you get assurance from one single assurer – so, a company could get assurance over its statements regarding cyber security from a specialist in cyber.

Transparency

On transparency there are recommendations to expand the audit report. Graduated findings is a key area. Investors want to know where judgements and estimates are on a scale from prudent to aggressive. That might be too simplistic, but they want an easier way to identify outliers.

There are also specific recommendations on consideration of fraud risk, and an expectation that AQR reports should be reported publicly. The later is not without its issues – not least that negative AQR would lead to investors (and the wider public) questioning the impact this has on the company and the reliability of their financial information.

Another area of focus for the FRC has been the audit quality indicators used by different audit firms and how can these be more transparently and reported coherently to the audit committee.

Specific responsibilities of audit committees and boards

There is a recommendation for a three year rolling Audit and Assurance Policy which would cover the audit committee's approach to the appointment of auditors, the scope and materiality of all auditing (including that of the financial statements), the assurance budget and the relationship of any audit to identified risks. Shareholders would be invited to express their views on this policy in an advisory vote – informed by a statement of risk and uncertainties published sufficiently in advance of the Audit and Assurance policy and investor outreach on the appropriate emphases.

Also, a business resilience statement – with some degree of associated assurance – to replace the existing going concern and viability statements.

On internal controls the view is that the Government will proceed with the introduction of a stronger framework for internal control reporting. It is anticipated that ministers will be supportive of the recent ACCIF draft paper and the intent to introduce a stronger controls regime without additional legislation.

It is also expected that the Government will proceed with an audit committee regulatory framework – potentially defining minimum audit committee standards, work programmes, scope, membership and qualifications.

Finally, and perhaps controversially, the proposal to hold all relevant directors to account for their duties to prepare and approve true and fair corporate reports and to deal openly and honestly with auditors – not just members of professional bodies is likely to proceed.

Respective roles and responsibilities

There were a number of questions around the respective role and responsibilities of the board, management and auditors in the light of the COVID-19. One attendee felt that the auditor's delay in signing-off on the year-end audit due to concerns around going concern felt like the auditor was in control of the company's public statements rather than the board.

Unusual circumstances (like COVID-19) demand unusual outcomes. Nevertheless, it is still the CEO's responsibility to run the company on day to day basis and the board's responsibility to provide appropriate stewardship and oversight. And the auditor audits the financial statements. As one attendee put it, if board members wouldn't sign off the annual report without the auditors say-so, then they are not doing their job.

Sir Jon was adamant that if we don't recognise the respective roles and responsibilities of the different actors then the only way to drive audit reform is to hammer the auditors – and that will not bring about the desired improvements.

Sir Jon was also keen to point out that policymakers should not design systems around failure. Implementing a whole series of reforms because of poorly performing companies will not prevent businesses collapsing.

It was also noted that while auditors had carried out additional processes and procedures in relation to COVID-19 (particularly around going concern) – and that this may have introduced tension into the relationship between the audit committee and their auditors – the FRC believe that introducing such additional procedures was the right and proper thing to do.

COVID-19 has only intensified the importance of audit committees and boards having robust communication channels with regulators and major shareholders so they appreciate any issues ahead of time and are not unduly panicked if (say) a year end is deferred for a good reason.

Joint audits

It is likely that the CMA's joint audit recommendations will be dropped in favour of managed shared audits. The idea is being developed, but essentially the primary auditor would audit the group statements but share the subsidiary audits with a second firm (for example, a 'significant other' firm would audit (say) 30 percent of the subsidiaries). This 'second' firm would have to have some exposure at group level (and with the audit committee) to develop their experience of auditing the biggest groups

The move from joint audits to shared audits was expressly welcomed by a number of attendees. Questions were raised over the legal obligations of the 'second' audit firm auditing a proportion of the subsidiaries both in respect of the holding company and in respect of the group auditor. Sir Jon acknowledged that some thought needed to be given to the legal position but noted that ultimately it is the lead auditor who signs-off on the group audit and is therefore the focus of the audit committee's considerations around audit quality.

Audit and assurance policies

There was a feeling that three year rolling audit and assurance policies were an interesting and pragmatic development. Nevertheless, there were concerns that investors have little appetite to engage.

One attendee noted that while the audit committee can commission different firms to provide assurance over specific areas outside of the financial statements (say cyber specialists providing assurance on cyber), there is a risk is that Big 4 firms scoop up all the specialist assurance providers in order to provide a one stop shop.

Other attendees also expressed their support for using more than one firm noting the necessity to call upon the best expertise especially in areas such as the business resilience statements. Companies fail because their business model was inappropriate. The skills required to provide assurance over business resilience statements, and the liability taken on by those doing it, are entirely different to what auditors are currently required to do.

Internal controls over financial reporting

A number of attendees expressed their support for a stronger framework for reporting on internal controls over financial reporting and the ACCIFs initial thoughts. One noted that if this and resilience statements could be done well, it would make the UK a more attractive capital market.

Other attendees noted the importance of reciprocity (as recommended by the ACCIF Position Paper) given the well established reporting frameworks in the US and Japan.

Sir Jon noted that the FRC had cleared the current version of the ACCIF's Position Paper. There were open questions over the need for mandatory independent assurance and to who any new regime should apply. A phased approach to its introduction was not discounted.

Audit quality indicators

It was noted that different audit firms have different approaches to communicating the quality of their audits. Sir Jon agreed that different firms focus on different audit quality indicators and it would be useful if audit committees had access to those indicators.

The FRC have carried out some research into the audit quality indicators adopted by the six largest audit firms and potentially there is some peer learning for the audit firms in terms of the information that might be useful to audit committee chairs.

The Canadian regulator have an interesting approach whereby the audit firms report on the key controls used to assure the quality of their audits and then assure to both the audit committees and the regulator that those controls have operated as described. This is something that the FRC are looking at in more detail

Timetable

Expect legislation in 2021 and ARGA to have powers in 2022. However, some of the bigger public policy issues might need to be phased in. For example, a stronger framework for reporting on internal controls would potentially need an extra year to fully embed

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