



The future of **Assurance**



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It should be noted that the working group members and observers were acting in a personal capacity and were not representing the organisations for which they work.

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1 Introduction

Effective capital markets need trust: trust in the integrity, skill and competence of a company's directors and management and trust in their reporting. The role of assurance is to inspire trust in corporate reporting.

A global financial crisis has damaged faith in both corporate reporting and assurance and forced us all to ask some difficult questions - many of which are naturally directed towards the accountancy profession. ICAS represents a wide spectrum of stakeholders, including preparers of financial statements, auditors and investors and all have an interest in the preservation and promotion of trust.

With this publication we offer our vision for the future of assurance. Assurance is more than external audit – it is a process which begins with the company itself – and we have not confined our thoughts to the traditional external audit of the financial statements. We have considered the internal processes in the company, the corporate reporting and the role of the audit committee - while recognising the critical role of the independent external audit.

Our working group represents the key stakeholders: preparers of financial statements; institutional investors; audit committee chairs; audit professionals; representatives from banking, academia and the media; and observers from the key UK regulators. We present our thoughts to you in a UK listed company context but we believe they will be relevant across the globe.

ICAS represents a profession with many often competing interests but our overriding consideration must always be the public interest. This publication represents our vision of how to promote the trust in the capital markets that is so fundamental to that public interest.

2 Executive Summary

The working group's recommendations focus on: an improved corporate report; more assurance on the front half of the annual report; and more transparency and accountability on the reporting and assurance.

The Corporate Reporting Model

- An annual report which tells a coherent story of the business - with a new requirement for the Board to outline their rationale and key assumptions for concluding that the business is viable for at least the next twelve months.

The Audit Committee

- An expanded and meaningful audit committee report that will specifically disclose the key areas of discussion between the committee and the external auditor;
- The audit committee should disclose its policy for ensuring an effective external audit process. Building on the annual review audit committees are currently required to perform, the audit committee should declare what they believe to be a suitable timeframe to re-tender the audit appointment. With a focus on audit quality they should then either comply with their own policy or explain why on that occasion they have chosen not to. In addition to the annual review of the audit appointment, the audit committee should perform a more in depth review every 5 years – in particular, this review would include engagement with the shareholders.

The External Assurance Process

- The external auditor to provide an explicit opinion on the directors' going concern judgements;
- Assurance to be provided on the front half of the annual report by a new "balanced and reasonable" opinion. Although not an "audit" opinion in the traditional sense, this new opinion would utilise the auditor's knowledge of the business to provide comfort over the narrative reporting of the Board.

3 Our Vision

the highest quality of reporting facilitating efficient capital markets and an assurance framework to inspire confidence in that reporting.

The Foundation

Our vision is presented in the context of the UK model of corporate governance and its “comply or explain” approach – with the effective audit committee at its heart – and is addressed primarily to listed companies. Our framework is premised on the assumption that shareholders and other stakeholders will engage with companies and that this engagement should be a key driver for quality reporting and assurance. This engagement is a critical foundation of our recommendations – albeit we recognise that not all stakeholders may wish to engage.

The Corporate Report

The corporate report forms the basis of a constructive dialogue between the stakeholder and the company; language is no longer boilerplate; the Board tells a balanced and coherent story of the business – including the business model and strategy, the key risks, assumptions and future prospects; and assurance lends credibility to the reporting, inspiring the confidence of all stakeholders. In the longer term, the key communication document could be shorter and more integrated, containing only the key messages and summary financial information, with the remaining detailed information and full financial statements available and searchable on the company’s website.

The Audit Committee

The audit committee’s role is further strengthened through increased disclosure and transparency. The audit committee report becomes the primary vehicle for delivering visibility of the assurance processes, both internal and external. Rather than simply a compliance statement, the report allows the user to understand how the audit committee has discharged its duties with respect to the risks to the business and, specifically the external audit process. The reader will gain an insight into the audit committee’s relationship and discussions with the external auditor; and its role with respect to the appointment of the external auditor is stronger and more transparent.

The Assurance Processes

Assurance begins with the company. It can take many forms – internal audit; regulatory reporting and oversight; the risk management processes; an independent review of the company’s sustainability report; and of course the external audit. The Board relies on a “package” of assurance to mitigate the impact of the risks facing the business – risks which are strategic, operational and financial. The audit committee report clearly maps out the assurance processes which address the risks, and the audit committee is accountable to the shareholder through the Board for the oversight of the company’s risk management and assurance.

The External Auditor

The external auditor continues to give an opinion on whether the financial statements are true and fair, with an additional opinion explicitly stating that the Board's review of the going concern status of the company is reasonable. Going beyond the "traditional" external audit of the financial statements, an assurance report is provided on the remainder of the annual report, giving the user comfort that the "story" presented by the Board is balanced and reasonable. The external auditor explicitly states that the Board's review of the going concern status of the company is reasonable. Disclosure of the key areas of discussion between the external auditor and the audit committee is contained within the audit committee report, to which the external auditor explicitly refers in the assurance report. One audit report contains all external assurance opinions. The audit profession is recognised as one comprising highly skilled business professionals valued for their ability to exercise judgement and challenge management.

Achieving our Vision

For our vision to become a reality, there is a need for courage: on the part of the Board to speak honestly to the user; from the external auditors to step beyond their traditional role and be able to provide a meaningful opinion on the "front end" of the annual report; from all stakeholders, including the markets, to make informed decisions based on all the information available and to engage with companies; and from Government and regulators to allow this vision to become a reality.

4 The Challenge

Our greatest challenge as a working group was also our greatest asset: the diversity of our group's membership. Naturally those current and former audit practitioners have a greater in-depth knowledge of the external assurance process, while the preparers were more familiar with the internal mechanisms of a company. Our investor members approached the discussion from their perspective as stewards, while the audit committee chairs considered their own oversight of the executive directors. Even within these broad categories, our members did not always agree – but each member's contribution added a rich spectrum of views to the table and, as a result, the quality of the debate was exceptionally high.

The process by which our group reached its conclusions is as relevant as the recommendations themselves. During the course of our meetings there were a number of important consultations and debates taking place at the UK and European levels, particularly around the external audit. We debated the ideas put forward by these consultations and the robustness of our own recommendations derives from our consideration of a number of often radical ideas. Some members of our working group would have preferred the more radical alternatives, while others felt that some of our recommendations went too far – but following an extensive debate, we present this report with the full support of the group.

Setting the scene

A natural consequence of the timing of this report is the backdrop of the financial crisis. While the UK House of Commons Treasury Committee questioned whether the external audit was useful if it did not alert users to an impending crisis¹, the European Commission has issued a thought provoking Green Paper on audit policy, raising a number of issues and making some controversial suggestions for the future role of the external auditor². The UK House of Lords is currently conducting its own investigation into the role of auditors, specifically focusing on the issue of market concentration in the audit market.³

We recognise that high quality reporting must underpin an effective assurance process and the external audit should not be considered in isolation. Many commentators share the view that corporate reporting has lost its focus and become overly complex, and ICAS has made its own contribution to the complexity debate with its publication *Making Corporate Reports Readable*⁴ – ideas which the working group considered in developing our own recommendations.

Meeting the Needs?

Identifying the needs of the user is a prerequisite to the development of a suitable framework. A recent ICAS research report⁵ suggests that narrative reporting is increasing in its importance but is

1 House of Commons Treasury Committee, Banking crisis: reforming corporate governance and pay in the city, Ninth Report of Session 2008-09, Report together with formal minutes (House of Commons 12 May 2009) P76 paragraph 221 (see <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51902.htm>)

2 European Commission Green Paper, Audit Policy: Lessons from the Crisis, Brussels, 13.10.2010 COM(2010) 561 final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

3 House of Lords Economic Affairs Committee inquiry: Auditors: Market Concentration and their Role (see <http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/news/economic-affairs-committee-publishes-call-for-evidence/>)

4 Making Corporate Reports Readable – time to cut to the chase, February 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf)

5 Meeting the Needs? User Views on External Assurance and Management Commentary, Fraser, Pierpoint, Collins and Henry, 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/res/Fraser_Users_Report_April_2010.pdf)

often constrained by “boilerplate” language. There is concern that the commentary around risks and future prospects is vulnerable to management “spin” and that some form of external assurance would be desirable. The report also suggests a demand for enhanced reporting from the external auditor, and the research provided a useful basis for discussions.

If it's not broken...

Our recommendations do not start with a blank canvas. The UK model of corporate governance requires boards to explain how they have satisfied the principles of the Corporate Governance Code⁶ and then either comply with the guidance provisions or explain why have chosen not to – a model respected worldwide. Audit committees have evolved into a fundamental part of a company's governance structure (we use the term audit committee throughout this report but we recognise that some companies may also have risk committees which perform part of the functions we attribute to the audit committee). The audit of the financial statements, conducted against the standards developed by the International Auditing and Assurance Standards Board (IAASB)⁷ and the International Ethics Standards Board for Accountants' (IESBA) Code of Ethics⁸, is considered a robust model – strengthened by the recent project to “clarify” and revise the standards. We have used the existing governance, reporting and assurance framework as our starting point.

6 The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

7 International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB). These standards are adopted in the UK and Ireland by the Auditing Practices Board (APB). The “clarified” ISAs will be effective for audits of financial statements of periods ending on or after 15 December 2010. The ISAs (UK and Ireland) are available at <http://www.frc.org.uk/apb/publications/isa/oct2009.cfm>.

8 The UK Auditing Practices Board (APB) issues its own Ethical Standards for Auditors based on the IESBA Code (see <http://www.frc.org.uk/apb/publications/ethical.cfm>)

5 The Corporate Reporting Model

BACKGROUND

High quality corporate reporting is fundamental to effective assurance.

A key communication document

The corporate report is viewed by many as an exercise in regulatory compliance. Its function as the key communication document to stakeholders can be lost in a sea of boilerplate and unenlightening disclosures which differ little from company to company.

In 2010 ICAS published *Making Corporate Reports Readable*⁹ - representing the Institute's contribution to the debate surrounding the complexity of corporate reporting. The premise is simple: replace the current annual report with a shorter document of approximately 30 pages. This report provides a clear integrated exposition of: the business model, strategy and key risks; the most significant judgements and accounting policies; and summary financial information. It is recommended that all other information, including the full statutory financial statements, are easily accessible and searchable on the company's website.

Our recommendations for the future of assurance are built around the annual report as we know it today. We believe that the integrated short form report contained within *Making Corporate Reports Readable* represents a vision of where corporate reporting should be heading. Our recommended assurance framework could also be adapted if necessary.

Regardless of its form, the top level corporate report must tell a cohesive story of the business. It should be the primary communication document for all stakeholders, while recognising that there will be other sources of information to complement and enhance this report.

To whom are we speaking?

The content of the annual report is dictated by a wide variety of legislation and guidance – the Companies Act¹⁰ (which reflects the requirements of European law); the UK Listing Rules¹¹; the UK Corporate Governance Code¹², to name but a few. But is the audience the shareholder? The regulator? The government? The general public? Identifying the user is the critical first step to effective communication.

The UK corporate governance model is premised on the corporate report and associated assurance reports being addressed to the shareholders. However, the stakeholder community of a company is far wider, increasing as a function of the public interest in that company. We believe it is appropriate for the corporate report and assurance reports to be addressed in law to the shareholders – but the interests of other stakeholders must be considered by the Board in the telling of its “story”.

9 Making Corporate Reports Readable – time to cut to the chase, February 2010 (The Institute of Chartered Accountants of Scotland) (see http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf)

10 Companies Act 2006 (see <http://www.legislation.gov.uk/ukpga/2006/46/contents>)

11 As issued by the UK Listing Authority (see <http://fsahandbook.info/FSA/html/handbook/LR>)

12 The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

A risky business?

An effective assessment of a business by a stakeholder is dependent on an understanding of the risks facing that business and the company's appetite for risk. Companies are currently required to disclose the "key" or "principal" risks facing their businesses¹³, but in reality this can amount to a disclosure of a number of generic risks that differ little between companies in the same industry.

An informed user does not need the Board of a financial institution to tell them that the company's risks include market risk, credit risk and liquidity risk – what they need is to understand the relative potential impact on particular areas of the business. For example, is there one particular category of asset where the exposure to credit risk is particularly severe? Or, in a manufacturing company, is the business model premised on winning a particular contract?

Concerns may be expressed that meaningful disclosure of risk and risk mitigation will result in the publication of commercially sensitive information. This would not be in the best interests of the company or its stakeholders. However, we believe that a significant volume of such information is already in the public domain and we simply recommend that this information is made more explicit.

A going concern?

Corporate and financial reporting is based on the premise that the business will continue into the future – to change that premise is to change the very nature of the reporting. Understanding how the Board reached its conclusion that the business will continue is therefore critical to understanding the basis for its reporting.

The corporate report should flow logically through the story of the business, concluding where the Board sees the company in the future. "Going concern" is defined in company law and financial reporting terms¹⁴ as the company continuing for at least 12 months into the future from the date the financial statements are signed – but it does not have to be limited to 12 months. Boards should be encouraged to interpret the company's going concern status to cover a period appropriate for the business – which in some cases could be substantially longer than 12 months.

A principled basis

ICAS has always strongly advocated financial reporting standards based on a clearly articulated set of high level principles¹⁵ – the same is true of corporate governance and narrative reporting. Creating detailed rules increases complexity and can lead to boilerplate disclosures. Principles allow companies to exercise judgement while retaining a degree of consistency. The Board is ultimately accountable to its stakeholders and consequently must be trusted by stakeholders to apply these principles appropriately. The assurance process should then engender confidence in the reporting.

13 This is a requirement of the Companies Act 2006 as part of the Business Review (s.417) (see <http://www.legislation.gov.uk/ukpga/2006/46/section/417>). Risk disclosures are also required under the Listing Rules issued by the UK Listing Authority (see <http://fsahandbook.info/FSA/html/handbook/LR>)

14 See the Financial Reporting Council (FRC) Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009 for further background on the assessment of going concern (see <http://www.frc.org.uk/images/uploaded/documents/Going%20concern%20and%20liquidity%20risk%20-%20guidance%20for%20directors%20of%20uk%20companies%20094.pdf>)

15 See Principles Not Rules: A Question of Judgement (2006, Institute of Chartered Accountants of Scotland). (see http://www.icas.org.uk/site/cms/download/rs_Principles_v_Rules.pdf)

Taking responsibility

The Board is responsible for the quality of its reporting. We believe that this responsibility should be explicit at the front of the annual report: the Board should declare that it believes that the corporate reporting in the “front half” of the annual report provides a balanced and reasonable review of the company. This statement should be immediately followed by the Board’s declaration that the financial statements are true and fair¹⁶.

OUR RECOMMENDATIONS

Our recommendations focus on improving the current annual report.

We believe that the primary communication in the “front half” of the annual report (everything excluding the financial statements) should be governed by the following set of principles:

- The narrative should tell a clear, logical and understandable “story” of the business;
- The “front half” of the annual report should present a balanced and reasonable picture of the company.

The “front half” of the annual report should include:

- A sign-off by the Board on the first page of the annual report that it believes that the narrative represents a balanced and reasonable review of the company and that the financial statements are true and fair;
- The rationale for concluding that the business is a going concern and an articulation of whether the period considered is limited to 12 months from the date of signing the financial statements or whether it is longer. This rationale should include:
 - disclosure of the key assumptions on which the Board has based its assessment;
 - a clear exposition of the business model and the strategy;
 - an articulation of the key risks facing the business (these should be limited in number and should reflect the risk discussions of the Board);
- The significant judgements of the Board in producing its annual report and financial statements.

Much of this information will already be found in the annual report. The challenge we envisage will be to present this information as a logical story focusing on what is business critical – and thereby allowing the reader to identify the most important information.

The UK government department for Business, Innovation and Skills (BIS) recently issued a consultation on the future of narrative reporting¹⁷ and we believe that this offers an ideal opportunity to review the plethora of reporting requirements and bring the annual report into line with our recommendations.

¹⁶ The Companies Act 2006 requires that financial statements are “true and fair” (see s.393 at <http://www.legislation.gov.uk/ukpga/2006/46/section/393>). International Accounting Standard (IAS) 1 contains a similar requirement for the financial statements to be fairly presented. “Fair presentation” has been held by UK independent legal opinion to mean the same as “true and fair” (see <http://www.frc.org.uk/documents/pagemanager/frc/T&F%20Opinion%2021%20April%202008.pdf>)

¹⁷ BIS Department for Business, Innovation and Skills, Corporate Governance, The Future of Narrative Reporting: A Consultation, August 2010 (<http://www.bis.gov.uk/assets/biscore/business-law/docs/n/10-1057-future-narrative-reporting-consultation.pdf>)

6 The Audit Committee

BACKGROUND

The role of the audit committee has expanded in recent years. It has become fundamental to the corporate governance of public companies.

Enhanced disclosure

We believe that the current structure and remit of the audit committee, as an important sub-committee of the Board, should be retained and strengthened through enhanced transparency and disclosure. It is our view that an enhanced understanding of the function of the audit committee will contribute to greater confidence in reporting and assurance on that reporting. Greater transparency is also a critical driver for improving the quality of both reporting and assurance.

Our recommendations are premised on the existence of an effective audit committee and this effectiveness is dependent on the appointment of the right people. In particular, relevant and recent financial experience is critical to effective oversight of the financial statements and the associated assurance.

The current audit committee report is restricted to a short and bland statement. We believe that the audit committee should communicate to the user how they have discharged their duties. This should not simply be a generic high level description of a process but should explain the rationale for the audit committee's decisions – including its oversight of the external audit process.

The key areas of focus within this report should be:

- How the audit committee has satisfied itself that the Board has mitigated the key risks to the business;
- How the audit committee has satisfied itself of the quality and output of the assurance processes, both internal and external; and
- The issues raised by the external auditor, including the key areas of challenge and how those issues have been resolved.

Managing risks

The UK Corporate Governance Code¹⁸ requires that the audit committee (or a separate risk committee in the case of some entities) is responsible for reviewing the company's internal control and risk management systems. We recommend that the audit committee report should include a "Risk Matrix", mapping the key risks identified by the Board to the assurance processes used to mitigate those risks. Assurance processes are both internal and external to the company and such disclosure would enhance the user's understanding of the different forms of assurance. The "Risk Matrix" would, in particular aid the user's understanding of what the external auditor is responsible for – thus helping to reduce the so-called "expectations gap"¹⁹.

¹⁸ UK Corporate Governance Code (May 2010) Provision C.3.2 (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

¹⁹ The "expectations gap" is the gap between the expectations of the user of the external audit and what that audit actually delivers.

Effective governance and oversight

Our working group believes strongly in the value of the audit committee and its oversight of the assurance mechanisms, both internal and external. In particular, the audit committee is responsible for ensuring the independence, objectivity and effectiveness of the external auditor. We recommend that the audit committee report should allow the users to better understand that process. The independent external auditor should be accountable to the shareholder and it is one of the functions of the audit committee to ensure that the duties of the external auditor are properly discharged. The audit committee provides an important link between the shareholder and the external auditor.

An independent and objective auditor

The power and value of the external auditor's opinion is distinguished from internal assurance processes by the auditor's independence and objectivity.

The current model in the UK requires the audit committee to recommend the appointment of the external auditor to the Board²⁰, which is then voted on by the shareholders (there are limited circumstances where the Board can appoint the external auditor without shareholder approval)²¹. Greater transparency is needed around that process to allow the shareholders to make better informed decisions.

We believe the audit committee continues to be best placed to make the recommendation on the appointment of the external auditor.

How long is too long?

The appointment of the external auditor and, in particular the length of tenure of the external auditor of a FTSE 100 company, has been the subject of intense debate²² at the time of writing. In the UK the external auditor of a FTSE 100 company can, on average, expect to remain in appointment for several decades²³. So can the external auditor remain independent and objective for this length of time?

External auditors in the UK are bound by the Ethical Standards for Auditors²⁴ which set out the high professional requirements for auditors to maintain their independence and objectivity. These standards are in addition to the ethical codes enforced by the professional institutes such as ICAS²⁵ on all their members.

In the UK, the external audit report is signed by the Senior Statutory Auditor – normally the audit

20 UK Corporate Governance Code (May 2010) Provision C.3.2 (see The UK Corporate Governance Code, June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

21 UK Corporate Governance Code (May 2010) Provision C.3.2 (June 2010 (Financial Reporting Council) (see http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)

22 The European Commission has issued a Green Paper which proposes mandatory rotation of audit appointments (European Commission Green Paper Audit Policy: Lesson from the Crisis (Text with EEA Relevance), Brussels, 13.10.2010 COM(2010) 561 final – see in particular Question 18 (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf). The UK House of Lords Economic Affairs Committee is currently conducting an inquiry into audit market concentration and has asked similar questions. (See <http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/news/economic-affairs-committee-publishes-call-for-evidence/>)

23 See Oxera research prepared for the Department of Trade and Industry and the Financial Reporting Council in April 2006. (see <http://www.oxera.com/cmsDocuments/Reports/DTI%20Auditors%20executive%20summary.pdf>)

24 As issued by the Auditing Practices Board (APB) (see <http://www.frc.org.uk/apb/publications/ethical.cfm>)

25 For the ICAS Code of Ethics see <http://www.icas.org.uk/site/cms/contentcategoryview.asp?category=191>

partner. Under the Ethical Standards for Auditors²⁶, as issued by the Auditing Practices Board, the audit partner of a public company is required to rotate every 5 years (this may be extended in exceptional circumstances provided the appropriate safeguards are in place). There are also requirements for key audit team members to rotate. In reality staff development needs and natural staff turnover will result in significant change to the team throughout the period of appointment. Within the audited entity there will also be significant turnover of key personnel, in particular at the Board level²⁷.

A new audit firm will mean a brand new audit team, limited initial knowledge of the business and a steep learning curve. A change of external auditor can be expensive – both for the company issuing the tender and for the audit firms tendering for the appointment. It can, however bring the benefits of a fresh audit approach and an entirely new perspective on the entity.

In reality, the appointment of one audit firm for a considerable period of time may not be a risk to the quality of the audit. The audit firm may continue to perform a thorough and efficient audit – but a perception remains that the passage of time results in a gradual loss of independence and objectivity.

We believe that the audit committee is best placed to determine when it is appropriate to tender the external audit appointment. To aid the transparency of that decision, we recommend that the audit committee decides an appropriate timescale for the re-tendering of the external audit appointment and discloses that policy in its report. Focusing on the quality of the external audit and taking into account the particular circumstances of the company at that time, it should then comply with its own policy or explain why it has chosen not to. This policy should be disclosed alongside the date that the audit firm was first appointed and the date that the external audit appointment was last tendered.

Review of effectiveness

In the UK the audit committee should perform an annual review of the independence and effectiveness of the external auditor²⁸. We believe that this process is vital to ensuring audit quality. In addition, we recommend a more detailed review every 5 years, which would involve the audit committee actively engaging with the shareholders. The audit committee report would then include disclosure of the review processes to allow the user to understand how the audit committee has reviewed the external auditor's independence, objectivity and effectiveness; the desirability of continuing the engagement versus appointing a new firm; and the extent to which the shareholders have agreed or disagreed.

Resignation and dismissal of the auditor

The resignation or dismissal of an external auditor before the end of their term is an unusual occurrence and is potentially of particular concern to shareholders when it does happen. Company law provides for a statement of the circumstances of the resignation or dismissal to be provided to shareholders²⁹ but in practice this can shed little light on those circumstances. The audit committee report should disclose sufficient details of the circumstances to provide that understanding.

26 APB Ethical Standard 3 (Revised) Long Association with the Audit Engagement (see <http://www.frc.org.uk/images/uploaded/documents/ES3%20-%20v5%20clean.pdf>)

27 One study published by Cantos in 2005 suggested that the average life of appointment of a FTSE 100 chief executive is 4.6 years. (see <http://w3.cantos.com/05/imptob-507-kwohs/survey.pdf>)

28 Financial Reporting Council Guidance on Audit Committees (October 2008) 4.19 (see <http://www.frc.org.uk/images/uploaded/documents/Guidance%20on%20Audit%20Committees%20October%2020081.pdf>)

29 Companies Act 2006 s.520 (see <http://www.legislation.gov.uk/ukpga/2006/46/section/520>)

A transparent audit process

Research³⁰ suggests that users want to understand more about the external audit process – in particular, what were the areas of difficulty for the external auditor and how were these resolved. We believe that this transparency can be achieved through enhanced disclosure by the audit committee in their report. The audit committee should disclose the key areas discussed between it and the external auditor, including the areas of key audit challenge. This disclosure should allow the user to understand the degree of challenge exercised by the auditor and the key issues of discussion with the company.

The external auditor will then refer to this disclosure in their own report, thereby directing the user of the assurance report to where they can obtain more detailed information on the external audit process.

This transparency will also allow the shareholders to ask more targeted questions at the Annual General Meeting (AGM). We also believe that both the audit committee chair and the audit partner should appear together at the AGM. The audit committee chair should be willing to answer questions on the content of the audit committee report, in particular around the discussions with the external auditor, and the audit partner should answer questions arising from the enhanced disclosure achieved through the audit committee report.

Guidelines for enhanced disclosure

As the primary stakeholders – and therefore the addressee of the annual report and associated assurance reports – the needs of the investors are crucial to the development of our recommendations. In formulating the following recommendations we have drawn on the work of an independent working group comprising members of the Global Auditor Investor Dialogue³¹. The Convener of this group was also a Deputy Chair of our own working group. This group sought to develop guidelines for enhanced disclosure relating to accounting, audit and risk controls and their report provides a framework for improving the disclosure by audit committees.

Appraising your auditors

In 2003 (revised in 2007) ICAS published guidance entitled *Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors*³². This guidance remains highly relevant today and should assist audit committees in carrying out their duties.

Audit market concentration

Our report is written against a backdrop of fierce discussion and debate, in particular around one controversial question: does the current audit market for the largest companies present a systemic risk to the capital markets?³³ In the UK FTSE 350 the market is heavily concentrated in 4 audit firms³⁴ and many commentators are asking whether there needs to be action to widen the choice of firms.

³⁰ Meeting the Needs? User Views on External Assurance and Management Commentary, Fraser, Pierpoint, Collins and Henry, 2010 (The Institute of Chartered Accountants of Scotland) Chapter 6 (see http://www.icas.org.uk/site/cms/download/res/Fraser_Users_Report_April_2010.pdf)

³¹ Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners and Investors, Enhanced Disclosure Working Group (January 2009) (see http://www.enhanceddisclosure.org/view_the_guidelines.html)

³² Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors, Institute of Chartered Accountants of Scotland 2003 (Revised 2007) (see http://www.icas.org.uk/site/cms/Download/app_aud_2007.pdf)

³³ See for example Question 27 European Commission Green Paper Audit Policy: Lessons from the Crisis (Brussels 13.10.2010 COM (2010) 561 Final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

³⁴ The firms are: Deloitte, Ernst and Young, KPMG and PwC. See the Oxera research produced for the Department of Trade and Industry and the Financial Reporting Council in 2006 for further detail. (see <http://www.oxera.com/cmsDocuments/Reports/DTI%20Auditors%20executive%20summary.pdf>)

For the purposes of our report we have not specifically sought to address this question. The membership of our group is diverse and represents many different interests and perspectives – we felt it would simply not be possible to obtain consensus on this issue.

The quality of the external audit should always be the paramount consideration of the audit committee when recommending the appointment of the external auditor. As a general principle we believe that the choice of the external auditor should be left to the audit committee, reflecting the interests and wishes of the shareholders.

OUR RECOMMENDATIONS

The following guidance should be enshrined in the FRC's *UK Corporate Governance Code* and its associated *Guidance on Audit Committees*:

In relation to risk management the audit committee (or risk committee) report should include:

- Confirmation it has received sufficient, reliable and timely information from management to allow it to discharge its duties;
- How it has satisfied itself that the risk and control processes are operating effectively. This should include a matrix-style report which maps the key risks disclosed by the Board in the corporate report to the assurance processes used to gain comfort over those risks;
- Confirmation that action has been taken where appropriate to address any significant weaknesses in the risk and control framework;
- How it satisfied itself of the appropriateness of management's significant judgements – this should include a substantive discussion of those significant judgements (for example how the audit committee satisfied itself that the models used to value financial instruments are appropriate or how it determined that the value of a decommissioning provision was a reliable estimate of future costs).

In relation to the appointment of the external auditor the audit committee report should include:

- The date the audit firm was first appointed as the external auditor;
- The date the external audit appointment was last subject to a full tendering process;
- The policy on the expected timescale after which the company would normally expect to re-tender the audit appointment;
- Where the auditor has been subject to the normal annual review of effectiveness – the process by which the audit committee concluded that the external auditor was effective or otherwise and the conclusions of that review;
- Where the auditor has been subject to the extended 5 yearly review process – the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the conclusions of that review process;
- The reasons for any decision to re-tender the audit other than simply compliance with the policy;
- The circumstances of any resignation or dismissal of the external auditor before the end of their term.

In relation to the external audit process the audit committee report should include:

- Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

7 The External Assurance Process

BACKGROUND

Audit is valuable.

At the annual Aileen Beattie Memorial Event in April 2010, ICAS posed a controversial question: “Should the statutory audit be dropped and assurance needs left to the market?”³⁵ The motion naturally provoked a lively debate – with consensus on one point from the audience: external audit is important and has a vital role to play.

The European Commission, in their Green Paper³⁶ on audit issued in October 2010 asked a number of controversial questions - but their starting point is noteworthy:

“Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies.”

We believe that the external audit is fundamental to the effective operation of the global capital markets.

But what form should that external audit take? Have the expectations of the traditional statutory audit of the financial statements been stretched beyond what it is capable of delivering? Could the external auditor deliver further assurance that would be valuable to stakeholders?

Audit of the Financial Statements

Still true and fair?

Financial statements are predominantly historic in their nature. Although the application of accounting standards increasingly requires judgements and estimates made on forward-looking information, the financial statements state the company’s position at a particular point in time – a point in time in the past. For historical events there is a greater base of supporting evidence available than for future oriented information and therefore a high³⁷ level of assurance is possible over the financial statements.

We believe that the “true and fair” audit opinion remains the most useful for providing assurance on the financial statements as the concept is well established in law³⁸ and in the International Standards on Auditing (ISAs).

The meaning of “true and fair” has evolved over the years, developing alongside the financial reporting framework. Financial reporting requires judgement, sometimes based on assumptions about future

35 Held at Stationers Hall, London 28 April 2010. For the transcript see: http://www.icas.org.uk/site/cms/download/AEB_Event_2010_Transcript.pdf

36 European Commission Green Paper, Audit Policy: Lessons from the Crisis, Brussels, 13.10.2010 COM(2010) 561 final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)

37 International Standard on Auditing (UK and Ireland) 200 (paragraph 5) requires that the auditor obtains reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. Reasonable assurance is defined as a high level of assurance by the ISA. (See [http://www.frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20200%20\(final\).pdf](http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20200%20(final).pdf))

38 For the UK legal opinions on “true and fair” (see <http://www.frc.org.uk/about/trueandfair.cfm>).

events. “True and fair” has a meaning globally accepted, established in law and supported by the framework of International Financial Reporting Standards (IFRS)³⁹.

Auditing financial statements and the ISAs

The Board is responsible for preparing true and fair financial statements; the external auditor then opines on whether they agree that the financial statements are true and fair.

The external audit of the financial statements requires the application of the International Standards on Auditing⁴⁰. The external auditor assesses the key risks to the financial statements – the audit risks – and builds an audit approach to address those key risks. Auditors apply a concept of materiality – effectively assessing whether the presentation of the financial statements could mislead the user. The external audit will not, therefore identify every error in the financial statements but provides assurance that any errors are not material to the financial statements. The auditor is required to apply professional scepticism throughout the audit and obtain sufficient and appropriate audit evidence to substantiate the opinion on the financial statements.

The International Auditing and Assurance Standards Board (IAASB) has recently completed its “Clarity Project”. It has revised and clarified the existing standards to assist auditors in their application, while retaining the existing model. This project focused in particular on those areas known to be more difficult for auditors – for example the audit of groups of companies and the audit of fair values. The UK is one of the first jurisdictions to apply the new “clarified” ISAs although at the time of writing they were not yet in use. We believe that the new ISAs will improve the quality of external audits.

A quality audit

Audit quality is a difficult concept to define. At its most basic level audit quality is the delivery of the correct opinion. That opinion is based on a review of the evidence available at the time of the external audit – not what was only available with hindsight. Discussions of how to measure audit quality have been the subject of many papers – produced by regulators and academics – and we do not propose to repeat this work in our report.

We believe that an external audit conducted in accordance with the ISAs, taking into account the spirit of those standards – such as the overriding need for professional scepticism – and undertaken by individuals abiding by the Ethical Standards⁴¹ - should deliver a high quality audit with the correct opinion.

³⁹ Listed groups of companies in Europe are required to apply International Financial Reporting Standards (IFRS) as adopted by the European Union. Other companies in the UK apply UK Generally Accepted Accounting Practice or UK GAAP. “True and fair” is the terminology used in the UK Companies Act 2006 (see s.393 at <http://www.legislation.gov.uk/ukpga/2006/46/section/393>). International Accounting Standard (IAS) 1 uses the term “fair presentation” which has been determined by UK legal opinion to have the same meaning as “true and fair” (see <http://www.frc.org.uk/documents/pagemanager/frc/T&F%20Opinion%2021%20April%202008.pdf>)

⁴⁰ International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB), an operating body of the International Federation of Accountants (IFAC). In the UK audits are performed against ISAs (UK and Ireland) as issued by the Auditing Practices Board (APB) – which are effectively the ISAs applied alongside UK legislation. (See <http://www.frc.org.uk/apb/publications/isa/oct2009.cfm>)

⁴¹ Ethical Standards for Auditors, as issued by the Auditing Practices Board (APB) (see <http://www.frc.org.uk/apb/publications/ethical.cfm>). The standards are based on the Code of Ethics (see <http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics#code-of-ethics-for-professi-1>) developed by the International Ethics Standards Board for Accountants (IESBA), an operating body of the International Federation of Accountants (IFAC).

The power of an audit opinion

A qualified audit opinion is a rare occurrence in the UK – and the rarity of the qualification gives it power. A qualified external audit report sends an adverse signal to the market. The Board will want to avoid that qualification – which puts the external auditor in a strong position to persuade the Board to “get it right”. The rarity of audit qualifications suggests that Boards and external auditors normally reach a conclusion acceptable to both parties. An emphasis of matter is not a qualification but draws the user’s attention to a matter of fundamental importance – for example where the going concern status of the company is subject to doubt. We believe that the current use of these qualifications and emphases of matter is appropriate.

We accept that users want to understand more about the external audit process but a longer form audit report can confuse who is speaking to the user: is it the company or the auditor? We believe that an improved understanding of the audit process should be achieved through the enhanced audit committee report discussed above without diluting the power of the audit qualification.

Going concern

ISA 570⁴² requires that the external auditor reviews the Board’s going concern assessment. This is necessary to ensure that the financial statements have been prepared on the correct basis. We have discussed how the Board could better articulate, through the corporate report, the process by which it reached its decision and the assumptions underlying that decision.

We believe that the external auditor should explicitly state in the audit report that they have reviewed the Board’s assessment of going concern and whether they believe the Board’s conclusion was appropriate. Auditors cannot provide a guarantee that a company will not fail but enhanced reporting by the Board of their own rationale, coupled with an explicit opinion from the external auditor will enhance the user’s understanding of what assurance the auditor is providing.

Assurance on the Corporate Annual Report (Other than the Financial Statements)

Looking to the narrative

Stakeholders are increasingly relying on the narrative reporting in the “front half” of the annual report to enhance their understanding of the financial statements and the company’s performance and future prospects. The narrative includes many different types of information – including discussion of the future prospects of the business; reporting against Key Performance Indicators; and sustainability reporting – and presents a different challenge to the assurance provider. The information will often be more varied in nature, more forward looking and will be based on a number of assumptions.

We believe that the external auditor can meet this challenge and deliver assurance on the “front half” of the annual report.

The traditional ISA audit, as described above, could never be applied to narrative reporting. The model was developed to provide assurance on financial statements which are largely historical. We do, however believe that the external auditor could offer a different type of assurance. Currently the external auditor states in their opinion on the financial statements that the content of the annual report other than the financial statements is consistent with the audited financial statements. We believe

⁴² International Standard on Auditing 570 Going Concern (see [http://www.frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20570%20\(final\).pdf](http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20570%20(final).pdf))

that this opinion should remain as the link between the “front half” and the financial statements, but should be enhanced by a further separate assurance opinion.

Balanced and reasonable

We believe that the external auditor could deliver an opinion on the content of the annual report: that the Board has presented a balanced and reasonable review of the business. Our interpretation of “balanced and reasonable” starts with the ordinary meaning of the words

- “Balanced”: the annual report is not subject to “spin”; and
- “Reasonable”: based on the information available at the time (directly or indirectly through the audit of the financial statements or other information available in the public domain), a similarly skilled professional would have reached the same conclusion.

The external auditor has a unique and privileged access to a business during the course of the audit of the financial statements – the ISA model of audit is premised on the auditor understanding the business. The auditor: reviews the minutes of the Board and its sub-committees; reviews and tests the budgets and forecasts; and has unique access to the Board. This information provides the ideal basis for providing this additional assurance.

Qualifications and emphases of matter, similar to those used in the external audit of the financial statements, would need to be available to allow the new “front end” assurance opinion to be as meaningful as possible. Our vision of a “balanced and reasonable” assurance opinion is not intended to utilise the current assurance frameworks available⁴³ – a new framework will need to be developed. That framework will need to be supported by guidance and we acknowledge that the development of such a framework presents a challenge to the auditing profession – but we believe the profession can respond to such a challenge.

We also acknowledge that our recommendation will involve additional work and we understand that the work will come with a cost – but we believe that the benefits of this assurance will far outweigh any additional costs. We would encourage a constructive dialogue between the external auditor and the audit committee around the costs and benefits of this assurance.

The audit report

We believe that the three opinions proposed above – the “true and fair” opinion on the financial statements; the explicit going concern opinion; and the “balanced and reasonable” opinion on the front end of the annual report – could be presented in one assurance report.

This report should be prominently placed at the front of the annual report – following an explicit sign-off by the Board. We believe that this would be a powerful statement to the user: the responsibility for the preparation of the annual report and the financial statements rests with the Board and therefore its sign-off should be first. This would then be immediately followed by the assurance report.

Understanding the assurance process

We acknowledge that there is a desire from users to understand more about the external audit process. We do not believe that this should be achieved through the external auditor’s report. The

⁴³ The International Auditing and Assurance Standards Board (IAASB), in addition to issuing auditing standards, has developed frameworks for assurance engagements other than audit (International Standard on Assurance Engagement 3000 is one example. (see <http://www.ifac.org/IAASB/Pronouncements.php#Standards>.)

power of the audit opinion lies in its clarity and a longer form audit report could dilute that power. It is the responsibility of the company to speak to the user and the responsibility of the external auditor to provide assurance on that communication – a long form audit report could confuse those responsibilities.

The audit committee is responsible for overseeing the external audit process – we therefore recommend that this additional understanding should be achieved through the enhanced audit committee report. In particular, the audit committee would disclose in its report the key areas discussed between the audit committee and the external auditor – this would include the key areas of audit challenge. This would also extend to the additional assurance opinions recommended in this chapter.

The external audit report would then include an explicit reference to the audit committee's report and its discussion of the external audit and assurance process. This reference would draw the user's attention to where additional information can be obtained and ensure that the audit committee makes appropriate disclosure of those key issues.

In addition we envisage that the audit partner and the audit committee chair appear together at the company's Annual General Meeting (AGM) to answer questions arising from the enhanced disclosure achieved through the audit committee report. The improved transparency of the external audit and assurance process should encourage a better dialogue with the shareholders.

A new auditing profession?

We believe that our recommendations represent a challenge to the current auditing profession – but not an insurmountable challenge. External auditors combine their training as chartered accountants with heightened professional scepticism. The value of an auditor is not simply their financial reporting expertise – it is the questioning mind and the courage to challenge the decisions of others. This mindset can be transferred to assurance on narrative reporting.

The external auditor will build on the existing extensive knowledge gained through the audit of the financial statements. The challenge to the auditing profession is to exercise greater judgement. The scope for the exercise of judgement has arguably diminished with the increasing complexity of financial reporting standards and making a judgement against a new and developing framework requires courage. We recognise that this is a significant challenge but one we believe the profession can meet.

The importance of narrative reporting is growing. As a profession, accountants and auditors have demonstrated an ability to adapt with the times. Our recommendations should be seen as an opportunity for the profession – an opportunity to add value to business and its stakeholders.

The Audit Inspection Unit

The Audit Inspection Unit (AIU)⁴⁴ in the UK is responsible for ensuring the quality of audits of public interest entities through its inspection and reporting regime.

We believe that the AIU should be a line of last resort for the shareholder if they have concerns over the quality of the audit which have not been addressed by the company. The shareholder should be able to report such concerns and the AIU should have the power to investigate.

⁴⁴ The Audit Inspection Unit (AIU) is an operating body of the Financial Reporting Council (FRC), the UK regulator of the accountancy profession. The AIU has a remit to ensure the quality of audits of public interest entities – primarily listed companies – and undertakes an annual inspection regime. The decision on which audits to inspect is determined by a risk categorisation. The AIU reports on individual audits to the company and the audit firm. It also produces annual publicly available reports on each of the key audit firms auditing public interest entities. See <http://www.frc.org.uk/pob/>.

Liability concerns

Liability concerns everyone. Corporate and financial reporting is not an exact science – and audit and assurance is not a guarantee against the future.

We believe that there is a need to consider safe harbours⁴⁵ for directors – thereby allowing them the freedom to speak honestly, particularly about their expectations for the future.

Currently statutory external auditors are subject to unlimited liability in the UK⁴⁶. We believe that for auditors to provide further assurance, particularly around future-oriented narrative information, there is a need for a proportionate liability regime where external auditors are only liable for their portion of the fault.

OUR RECOMMENDATIONS

We believe that one report from the external auditor would be the most appropriate way forward.

Immediately following the statement from the Board that it believes that the annual report is prepared on a going concern basis and is balanced and reasonable and that the financial statements are true and fair and properly prepared, there would be a report from the external auditor.

The external audit and assurance report would include:

- An opinion on whether the financial statements are true and fair and properly prepared;
- An opinion on whether the annual report is consistent with the audited financial statements;
- A opinion that, following the review of the assumptions made by the Board in their assessment of the going concern, the conclusion is considered reasonable;
- An opinion that the annual report (excluding the financial statements) is balanced and reasonable; and
- A reference to the content of the audit committee report and confirmation that the audit committee report contains an appropriate reflection of the key issues discussed between the audit committee and the external auditor.

We envisage that the “balanced and reasonable” opinion would become an accepted part of the assurance framework. Initially this could be achieved through companies adopting the regime on a voluntary basis before being subsumed into the statutory assurance.

A framework and guidance will need to be developed to support the auditor in delivering the “balanced and reasonable” opinion.

We also recommend that the liability regime for directors and external auditors is carefully examined. To achieve our vision, there should be safe harbours for directors and a proportionate liability regime for external auditors.

⁴⁵ A safe harbour is a provision by statute or regulation which affords protection from liability under the law.

⁴⁶ The Companies Act 2006 s.534 allows for a Limitation of Liability Agreement – but this must be agreed to by the shareholders. At the time of writing this provision was not widely used. (see <http://www.legislation.gov.uk/ukpga/2006/46/section/534>.)

8 Engagement with Shareholders: Corporate Reporting and the External Assurance Process

BACKGROUND

Our recommendations are founded in the belief that shareholders and other stakeholders will engage with companies through better quality reporting, increased transparency and an improved assurance process.

Shareholders, as the primary stakeholders, are not a homogeneous group and have a diverse range of interests. Some shareholders may be interested in the long term sustainability of the company going forward several decades, while others may simply be looking to make a short term gain. Such is the nature of markets.

Stewards

We do not envisage that all shareholders will increase their level of engagement with companies – but those institutional investors who have signed up to the Financial Reporting Council’s UK Stewardship Code⁴⁷ have declared their intention to exercise a stewardship function – and we therefore recommend an additional principle and associated guidance to the Code.

OUR RECOMMENDATIONS

A principle should be added to the UK Stewardship Code:

Institutional investors should be willing to engage with their investee companies on the quality of their reporting and the assurance provided on that reporting.

Guidance on the principle

As part of this engagement institutional investors should:

- Seek to satisfy themselves that the reporting of the company is sufficient for their needs as investors;
- Where that reporting is not sufficient, seek to challenge the Board to improve its reporting;
- Seek to engage with the audit committee on the quality of the assurance provided on the annual report including the financial statements and any other assurance provided;
- Seek to engage with the audit committee where there is a formal review of the external audit appointment every 5 years;
- Seek to engage with the audit committee where there is a re-tendering of the external audit appointment;
- Challenge the audit committee and the Board where they have any concerns relating to the independence or objectivity of the external auditor - for example, there could be concern in respect of the re-tendering policy or non-compliance with that policy;;
- Notify the company of any concerns on the appointment of the external auditor; and
- As a last resort, be prepared to vote against the appointment of the external auditor if appropriate, explaining the reasoning to the company.

⁴⁷ Issued July 2010. As at 19 October 2010 a total of 68 institutional investors had signed up to the Code. (See <http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf>.)

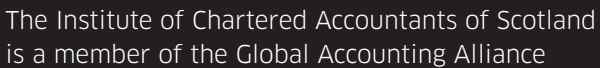
About ICAS

The Institute of Chartered Accountants of Scotland (ICAS) is the world's first professional body of accountants, receiving its Royal Charter in 1854. Since then, ICAS has played a leading role in the accountancy profession.

ICAS was the first to adopt the designation 'Chartered Accountant' and the designatory letters 'CA' are still an exclusive privilege in the UK for its 18,800 members. CAs hold key positions right across commerce and industry, the public sector and private practice.

There are currently 3,000 student members of ICAS, which is the only UK professional accountancy body to both educate and examine all of its students. The CA qualification is known around the world for consistency and high standards and ICAS enjoys a widely recognised reputation for providing the 'gold standard' in accountancy education.

The Institute's main objective is to uphold the integrity and standing of the profession of Chartered Accountancy in the interests of society and the membership through excellence in education, the development of accountancy, the enforcement of professional standards and service to members.



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