June 2019

ClientEarth

ClientEarth response to the independent review into the quality and effectiveness of audit

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1 Introduction

ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York and Beijing. ClientEarth's climate finance initiative conducts research and advocacy in relation to the legal implications of climate change-related financial risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.

In April 2019, the independent review into the quality and effectiveness of audit established by the Secretary of State for Business, Energy and Industrial Strategy (**BEIS**) and led by Sir Donald Brydon issued a call for views on the quality and effectiveness of audit (**Consultation**). This document provides ClientEarth's response to the Consultation, including our key messages and comments in relation to selected questions relevant to our expertise.

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2 Key messages

1. We are pleased to respond to this inquiry on the purpose, scope and quality of the statutory audit in the UK. ClientEarth has extensive experience in reviewing annual reports of UK companies for compliance with accounting and reporting requirements. Over the past ten years we have reported numerous companies to the Financial Reporting Council (**FRC**) and, more recently, the Financial Conduct Authority (**FCA**) for their failures to disclose material information about environmental and climate change-related trends and risks in their annual reports.[1] In 2018 we also sent public letters to each of the 'Big 4' audit firms to request information about how risks and impacts associated with climate change are taken into account in their audits.[2]

2. Despite wide-spread recognition that the financial risks and impacts associated with climate change and the zero carbon transition are some of the biggest mega-trends facing business today, we have observed a highly divergent and inconsistent approach taken by companies and their auditors in addressing these issues in the financial accounts, narrative reporting and audit reports. In light of the strong demand from investors, regulators, and other stakeholders for robust disclosures of the financial risks and impacts associated with climate change, we believe this current state of affairs is highly unsatisfactory.

3. Alongside our specific concerns about the reporting of risks and impacts associated with climate change and other environmental issues, our experience has also provided us with

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[1] See, eg, ClientEarth, EasyJet among companies reported to regulator by ClientEarth, https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/

[2] See, eg, ClientEarth, Letter to EY regarding audit of EnQuest plc, https://www.documents.clientearth.org/wp-content/uploads/library/2018-05-09-letter-to-ey-regarding-enquest-plc-audit-ce-en.pdf

significant insights into the broader dynamics of the UK's existing corporate governance and reporting framework, of which audit necessarily forms a key component. In our view the current framework, characterised by a blinkered view of shareholder primacy detached from practical reality and a troubling lack of meaningful accountability enforcement, is no longer fit for purpose. Reforms to address these issues and improve the overall quality, effectiveness and accountability of the UK's corporate reporting and governance framework, including audit, are essential. In addition to our responses to relevant questions contained in the Consultation, we would like to highlight following key messages:

- Existing accountability and enforcement mechanisms for corporate reporting and directors' duties are inadequate. Reforms to improve the quality and effectiveness of audit are important and necessary but unless they are made alongside reforms to improve both public and private oversight and enforcement of directors' duties for corporate governance and reporting, they will fail.[3]

- Auditors work in relation to 'other information' and principal risks and uncertainties facing a company is inconsistent and inadequate, even under existing requirements. Reforms to improve both public and private enforcement of auditors duties are necessary to ensure better quality audits.

- Reforms to improve the quality and effectiveness of audit must take into account evolving trends regarding investors' concerns about environmental, social and governance (ESG) risks and impacts, particularly in relation to climate change-related risks and impacts.

- Directors and auditors must be more accountable to all reasonable users of annual reports, including existing and potential shareholders and creditors (collectively AND individually), government regulators (eg. tax authorities and financial and prudential regulators), trustees of company pension funds (where applicable), customers, employees and broader stakeholders.

- Ultimately, auditors must be required to perform and provide opinions in relation to a fully integrated audit of the entire annual report.

4. Each of these key messages is elaborated on further in response to the questions below. Please note, we have not responded to questions which we believe fall outside of our particular experience and expertise.

3 Responses to questions

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

5. The statutory audit should be conducted for the benefit of *users* of information contained in the annual report. The determination of which actors or individuals constitute *users* of the report must be based on contemporary economic and social reality. Therefore, at a minimum this should include existing and potential shareholders and creditors (collectively AND individually), government regulators (eg. tax authorities and financial and prudential regulators), and trustees of company pension funds (where applicable). In certain

[3] Because this issue is not explicitly addressed by the questions contained in the call for views for the Consultation, we have included further details in a separate Annex at the end of our Submission.

circumstances users will also include employees, customers and civil society (representing the interests of broader stakeholders affected by the companies' actions).

6. All of these actors use the information contained in the annual report for the purpose of making decisions in a variety of circumstances. For example:

    - existing and potential shareholders and creditors (as well as their intermediaries) use the information in the annual report to inform their investment and stewardship decisions;

    - government regulators use the information to inform regulatory decisions (eg. tax rates and liabilities, capital adequacy calculations (for banks), prudential regulation (banks and insurers), solvency); and

    - trustees of company pension funds use the information to make decisions about the strength of the sponsoring company's covenant and contribution rates to the pension fund.

7. In some circumstances employees, customers and broader stakeholders may also use information in the annual report to make decisions about existing or potential employment, whether or not to purchase goods or services from a company or to support the company's social license to operate.

8. In our view, because companies are granted unique benefits of limited liability and legal personality, the quid-pro-quo is that they are required to provide detailed and accurate information to their stakeholders. Because there is a significant information asymmetry between a company and these stakeholders it is also important that this information is subject to an audit by an independent third party to provide all of these actors with confidence that the information is fair, balanced and reasonable.

9. Unless audit can provide this confidence to the users of annually reported company information then its value is limited, and may even be counterproductive in providing a form of liability shielding for the company and its directors who bear primary responsibility for the information disclosed by the company. Reforms to ensure that the reasonable expectations of all reasonable users of annual reports are met are therefore essential to ensure that an appropriate balance between expectations and quality is achieved.

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

10. Audit should be designed to enhance the confidence of users in all of the information included in the annual report. This should include the financial accounts as well as the 'other information' such as the strategic report, directors' report and corporate governance statement. If auditors are required to perform and opine a fully integrated audit on the entire annual report, this will have the benefit of also providing users with an enhanced view of the performance and prospects of the entity overall.

Q3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?

11. Yes. Currently there is significant legal uncertainty about the purpose of an audit and for who it is conducted. This severely undermines the utility of the audit and adds to the expectation gap about audit's purpose and who it is for.

12. The foundational case on the scope and purpose of the audit (Caparo v Dickman) is now nearly 30 years old. The findings in that case, that auditors owe a duty of care only to existing shareholders of a company as a body, now no longer reflects social and economic reality. This case was based on a previous version of the Companies Act and before IFRS accounting standards and International Standards for Audit (ISAs) were adopted. These developments all reflect a significant evolution in the purposes and audience of annual reporting and audit and indicate a significant expansion in the appropriate scope and duty of care owed by a company, and its directors and auditors for disclosed information.

13. The law should therefore clarify that the purpose of the audit is to enhance the degree of confidence of users of information contained in annual reports. As noted in question 1, the determination of which actors or individuals constitute users of the report must be based on contemporary economic and social reality and therefore include a broad range of stakeholders who reasonably use the information in annual reports for a variety of economic and other decision making.

Q4: Do respondents consider there is an expectation gap?

We are not responding to this question.

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

We are not responding to this question.

Q6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

14. Yes. We believe that there is a significant audit quality gap and that many auditors are systematically failing to address key legal requirements in the conduct of their audit. In particular, we are concerned that auditors are consistently failing to:

    - exercise professional scepticism and professional judgement in planning and performing the audit (ISA (UK) 200 [15], [16]);
    - to obtain an understanding of a company's objectives and strategies, and those related business risks (such as climate change and the low carbon transition) that may result in risks of material misstatement (ISA (UK) 315 [11], [15], [16]);
    - to obtain an understanding of the legal and regulatory requirements applicable to a company's strategic report and directors' report and how the company is complying with those legal and regulatory requirements (ISA (UK) 720 [12-1]); and
    - to perform procedures necessary to identify any material inconsistencies between a company's strategic report and directors' report and the auditor's knowledge obtained in the audit and to whether the strategic report and directors' report appear to be materially

misstated in the context of the auditor's understanding of the legal and regulatory requirements applicable to that information (ISA (UK) 720 [14-2], [15]).

15. In addition, we also agree with others' recent concerns that auditors are systematically failing to consider the adequacy of an entity's accounting records, and whether the accounts overall provide a 'true and fair view', including in relation to the capital maintenance requirements, and distributable reserves available for the payment of dividends.[4]

16. In our view these issues are closely linked to the auditors' professional judgments about how business risks and trends might affect risks of material misstatements in the accounts in relation to forward looking assumptions (such as those required for asset impairment tests, fair value calculations and contingent liabilities). These issues potentially have significant impacts on accounting treatments, and the overall performance and prospects of the entity, including in relation to core balance sheet items and calculations which have critical importance for determinations about solvency, future viability, tax liabilities, dividends payments and credit-worthiness.

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

17. In our view statutory audit and broader assurance should serve entirely different purposes. The term audit should be restricted to the form of mandatory assurance required by statute in order to serve the interests of users of annual reports and the broader public policy interest in enhancing confidence that company information is fair, balanced and reasonable. In order to avoid confusion, the standard for the entire statutory audit must be one of 'reasonable assurance'.

18. Assurance outside of the statutory audit should only refer to voluntary assurance arrangements that a company adopts in specific circumstances to support its direct commercial interests. In these circumstances it is appropriate to allow a company to determine the level of assurance to be provided (reasonable, limited, derivative) but this must communicated very clearly to users, in order not to be misleading

Q8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?

19. The current practice of allowing for different levels of assurance (reasonable, limited, derivative) over different parts of the annual report is very confusing and potentially misleading for users.

20. Going forward any audit required by statute must require a standard of 'reasonable assurance'. Due to their principles based nature, audit standards already provide flexibility and proportionality to allow for different approaches and levels of work in relation to different types of information in different contexts. This should not undermine the overall objective of an audit as a whole as being to provide users with 'reasonable assurance' in relation to the information contained in the annual report.

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

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[4] See, eg, Sarasin & Partners, ' Audit & Accounts' https://www.sarasinandpartners.com/global-home/responsible-stewardship/policy-outreach/audit-and-accounts

21. We are not responding to this question.

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

22. Because the internal auditor is not independent, it is not appropriate for external auditors to rely on evidence from work performed by internal auditors. The terms 'internal audit' is also somewhat misleading and suggests a level of independence which does not in fact exist. There should be a clear distinction between 'internal assurance', which the company performs for its own benefit, and external or statutory audit, which is performed for the benefit of users of company information and broader public policy objectives.

Q11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

23. We are not responding to this question.

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

24. Yes. In our experience reviewing company annual reports to assess the adequacy of risk disclosures around climate change impacts we see very problematic inconsistency in the quality of internal risk management procedures and risk disclosures by companies. These problems are also clearly not just restricted to disclosures around climate change risks and impacts.

25. Directors of all listed and large private companies should therefore be required to make an explicit statement about the adequacy of risk management and internal controls in the annual report, which they can then be held accountable to. Auditors must also be required to include this statement within the scope of their audit and carry out appropriate procedures in order to provide 'reasonable assurance' in relation to that statement.

26. Having said this, we also note that the Companies Act does already require the company director responsible for the Directors Report to make a statement in the Directors Report that:

    'so far as the director is aware, there is no relevant audit information of which the company's auditor is unaware, and he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditor is aware of that information.'

27. Arguably, this requirement on directors to provide auditors with all relevant information necessary to their work already requires directors to provide auditors with detailed information about internal controls and risk management practices as this is clearly necessary for auditors to properly consider the principal risks in the business relevant to the audit (as required by ISA 315; ISA 450).

28. Under section 496 of the Companies Act, and ISA 720 auditors are also required to provide an opinion on whether, *'in the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, he has identified material misstatements*

in the strategic report (if any) and the directors' report, and, if applicable, give an indication of the nature of each of the misstatements'.

29. In making this statement the auditor will necessarily need to consider whether the identification and disclosure of principal risks and the corporate governance statement appears to be materially misstated in the context of the auditor's understanding of the legal and regulatory requirements applicable to that information and the auditors knowledge about the company obtained in the audit (ISA (UK) 720 [14-2], [15]).

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

30. Yes. As noted above, we believe that the audit should cover the entire annual report to the standard of 'reasonable assurance'. This should include bringing the assessment of risk management practices and disclosures within the direct scope of the comprehensive audit.

Q14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

31. Yes. In addition the binary audit opinion, auditors should be required to publicly report their views on the adequacy of a company's risk management and internal controls as these issues are directly relevant to the reliability of the information provided by the company in its annual report.

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

32. No. However, in our view the most effective reform in this area would be to ensure better oversight and enforcement of the UK's insolvency regime, which we consider is currently inadequate. In particular, we consider it critical that the new entity proposed by the Kingman review to oversee accounting, reporting and audit also be combined with the Insolvency Service and Companies House to ensure that issues around going concern and insolvency can be overseen, monitored and enforced in a joined up way.

33. Only by making sure that the insolvency regime is properly and adequately resourced and enforced and that company directors and auditors are more appropriately held accountable will current failings be effectively addressed.

34. That being said, we also agree that auditors should be required to carry out additional work in relation to going concern as indicated by the FRC's proposed reforms to ISA (UK) 570.

Q16: Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?

35. We are not responding to this question.

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

36. We agree that the approach currently taken by companies to the viability statement is highly inadequate. Companies' disclosures are too often boilerplate with little visibility of any analysis that has been undertaken behind the scenes. Often, these statements are not in line with FRC guidance (e.g. too short-term).

37. In January 2016, we worked with a group of investors to write to the FRC to express concerns that to set out long-term investors' expectations that fossil fuel dependent companies (notably oil, gas and coal companies) should address climate-related risks in viability statements in their annual reports.

38. For fossil fuel companies, investment and planning periods can span several decades. For many fossil fuel companies the viability statement will therefore need to cover any foreseeable risks that they expect to face in the next 10 to 20 years. Despite this, the emerging practice is that most viability statements – from fossil fuel companies and other sectors of the economy – tend to cover a three-year period and to use highly boilerplate language. In its current form we consider that this provides only very limited value to users of the information.

39. The use of such boiler-plate language and inappropriate timelines for the viability statement is a result of inadequate accountability and enforcement, particularly by the FRC, and the voluntary nature of some of the guidance. If the viability statement is to be supplemented with a sustainability statement then detailed guidance and enforcement of compliance will be essential to ensure that it is useful and meaningful.

Q18: Should such a statement be subject to assurance?

40. Yes, if such a statement is included in the annual report then it must be included in the scope of the audit to the standard of reasonable assurance. Further guidance may therefore likely be required in relation to the performance of assurance over that information.

Q19: Who might be capable of giving such assurance?

41. Such assurance must only be provided by the statutory auditor. Audit firms are also the most likely actors to have expertise necessary to provide this assurance.

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

42. As we have noted above, going forward the audit must cover the entire annual report. The current practice of allowing for different levels of assurance (reasonable, limited, derivative) over different parts of the annual report is very confusing and misleading for users.

43. In our view the audit already requires the consideration significant forward looking elements. There is a pervasive mythology that financial accounts only present a backward looking view of the company. While this may have been the case historically, in light of changes to the Companies Act and the widespread adoption of IFRS accounting standards it can no longer be maintained, as more and more forward looking assumptions and estimates are used in the financial statements themselves. Among other things, this includes assumptions relating to:

    - the recognition of mineral resources and reserves (IFRS 6);

- fair value measurement of property plant and equipment (PP&E) (IFRS 13);
- impairments of PP&£, goodwill, mineral resources, agriculture (IAS 36, IFRS 6, IAS 41)
- depreciation methods and assumptions for PP&E (IAS 16)
- asset retirement obligations (IAS 16, IAS 37)
- financial instruments and financial disclosures relating to credit losses (IFRS 7, IFRS 9)
- pension liabilities (IAS 19).[5]

44. All of these accounting requirements will require the application of estimates and assumptions about the future. Accordingly, in order to provide an opinion on whether or not these assumptions are reasonable or might result in misstatement, auditors must already adopt a forward-looking lens. This will require auditors to have a detailed understanding of principal risks and uncertainties which might affect these estimates and assumptions.

45. In making assessments about the forward looking assumptions used in the financial accounts, auditors must also consider whether or not these are consistent with the information included by the company in other information in the annual report, including disclosures regarding principal risks and uncertainties. In our experience, companies are currently adopting inconsistent approaches to assumptions used in their financial accounts and broader information contained in the front half of the annual report. This is particularly evident when it comes transformative trends associated with climate change and the low carbon transition.

46. For example, in our work, we see frequent examples where companies in fossil fuel sectors adopt assumptions for future demand and prices for their products in their accounts which appear inconsistent and imprudent in light of disclosures about risks and uncertainties in other parts of their annual report.[6] The risks and uncertainties associated with these assumptions are also rarely adequately addressed in the notes to the accounts, despite increasing guidance from regulators indicating that this is necessary in order to provide a ‘true and fair view’.[7]

47. In our view, auditors are already required to consider these issues under their existing legal duties. To the extent that there is inadequate clarity about this, then further guidance and amendment of the audit standards should be a priority. In addition, going forward, auditors should be required to include the entire annual report in the scope of their audit, to the standard of ‘reasonable assurance’ (also discussed further in relation to the next question).

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

48. Yes. As noted above, we believe that all information included in the annual report should be subject to an integrated audit and audit opinion.

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[5] For a further discussion, see ClientEarth, Risky business: climate and and professional liablity risks for auditors’ (2017) https://www.documents.clientearth.org/library/download-info/risky-business-climate-change-and-professional-liability-risks-for-auditors/

[6] See, eg, Sarasin & Partners, ‘Are oil and gas companies overstating their position: A review of long-term oil price assumptions underpinning company balance sheets’ https://www.sarasinandpartners.com/docs/default-source/esg/are-oil-and-gas-companies-overstating-their-position.

[7] Recent guidance from other jurisidictions in relation to the same set of international accounting and audit standards makes this explicit. See, eg, AASB, ‘Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement’ https://www.auasb.gov.au/admin/file/content102/c3/AASB_AUASB_Joint_Bulletin_May2019.pdf

49. As is noted in the call for views for this Consultation, increasing weight is placed by investors and other stakeholders on both qualitative and quantitative information about risks and impacts facing a business (including KPIs, scenario analysis and stress testing results, and other targets). This now includes a wide range of information about environmental, social and governance (ESG) issues which investors consider financially material for their investment and stewardship decisions and necessary to substantiate their claims to consumers in relation to 'green' or 'sustainable' investment products. This information is also used by a wide range of other stakeholders to inform economic and regulatory decisions.

50. Currently there is a low level of confidence in the quality and reliability of much of this broader financial and non-financial information included in annual reports. From our observations there are currently significant problems with 'green washing' and 'bright-siding' in relation to this information, which means that it often conveys a misleading picture for users of annual reports or is otherwise very poor quality. As noted above there are also significant problems with inconsistency between the front end and the back end of annual reports.

51. Because of the extent to which this information is now relied on by investors, regulators and other stakeholders, we believe there is now a very strong case for it to be fully integrated into the overall audit. In our view this is essential to ensure that users have greater confidence that the information they are using to make decisions is fair, balanced and reasonable. It will also help address any perceived expectation gap in relation to the work which auditors are already required to do in relation to 'other information' contained in the annual report.

52. While we accept that there may be some challenges in extending the audit to cover the entirety of the annual report, legislative developments and existing audit standards are already moving in this direction (eg. ISA 720). The IAASB is currently working on developing new guidance in relation to ISAE 3000, which is potentially directly applicable to this issue and is aimed at addressing many of the potential challenges around providing assurance in relation to more qualitative and forward looking information, which might be contained outside of the financial statements[8].

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

53. For the reasons set out above, we believe that all information included in the Annual Report should be subject to an integrated audit and audit opinion.

Q23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

54. We are not answering this question.

Q24. Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgment?

55. We are not answering this question.

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[8] See IAASB, 'Consultation Paper, Extended External Reporting Assurance' https://www.ifac.org/publications-resources/consultation-paper-extended-external-reporting-assurance

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

56. In our view, the output from the audit should be a binary opinion covering the entire annual report, supported by additional information discussing key audit risks and uncertainties and additional information as necessary. This approach has the benefit of providing a clear high-level opinion for the majority of users, while providing more granular detail for those users interested to undertake more detailed analysis.

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

57. We are not answering this question.

Q27. What would prevent such disclosures becoming boiler plated?

58. We are not answering this question.

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

59. We are not answering this question.

Q29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

60. In our view, the combination of company law, case law and audit standards already require auditors to consider and form a view on whether or not the accounts have been prepared in accordance with the law and existing accounting requirements (Companies Act, Parts 15 and 16; ISA (UK) 250.). This clearly incudes critical issues relating to capital maintenance and dividend distribution, which materially affect the position and prospects of the company and information included in the financial statements.

61. As other have persuasively argued, the capital maintenance protections in particular, such as rules around dividend payments and related disclosures to shareholders underpin market confidence, the limited liability corporate system, and ultimately market stability and economic growth. It is imperative that these are properly enforced and that auditors adequately review and integrate these issues into their work and opinions.[9]

62. To the extent that companies and auditors currently adopt divergent practices in relation to these issues, in our view this reflects a severe failing in enforcement and accountability.

Q30. Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

[9] See further, Sarasin & Partners, ‘ Audit & Accounts’ https://www.sarasinandpartners.com/global-home/responsible-stewardship/policy-outreach/audit-and-accounts

63. It is widely recognised that IFRS account are not aligned with capital maintenance requirements, and therefore cannot provided a basis for determining distributable reserves.[10] This divergence between IFRS and the capital maintenance regime is the reason behind the ICAEW publishing guidance for calculating distributable profits as required by the Companies Act.[11]

64. In our view, the law is clear that auditors need to consider the legal requirements relating to the capital maintenance regime and distributable reserves, including the relevant ICAEW publications. Without having done so it is difficult to imagine how the auditors would be capable of providing an opinion that the accounts provide a true and fair view in accordance with the requirements of the Companies Act. However, to the extent that confusion remains on this point, this should be clarified and robustly enforced.

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

65. Yes. As others have noted, investors need to know what portion of a company's profit has been realised, and what portion has not. Understanding the level of unrealised profits is important to judging the reliability of a business's income stream. It is also a key ingredient in determining a company's true capital strength and ability to pay dividends: only accumulated realised profits (after accounting for foreseeable losses and liabilities) can legally be distributed to shareholders in the form of dividends. The law reflects the economic reality that if a 'profit' is not realised as cash or near cash, then any distribution based on such profits will actually be coming from other sources.[12]

66. Clearly, there is currently an unresolved legal question about what exactly the law requires in terms of disclosure of distributable reserves.[13] Whatever the current legal position, however, we believe that the disclosure of distributable profits and reserves at group level would help protect against insolvency and help strengthen long-term stewardship of companies in the interests of shareholders, as well as other stakeholders and the public interest. Going forward this information should be explicitly required to be disclosed as part of the audit annual report.

Q32. How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records? Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?

67. We are not responding to this question.

Q33. Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

[10] ICAEW, Implications of IFRS for Distributable Profits", 20th July 2005, https://www.icaew.com/-/media/corporate/files/technical/legal-and-regulatory/modernising-uk-company-law/implications-of-ifrs-for-distributable-profits.ashx
[11] ICAEW, 'Guidance for realised distributable profits under the companies act' (TECH 02/17BL) https://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-02-17-bl-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006.ashx
[12] See, eg, Sarasin & Partners, ' Audit & Accounts' https://www.sarasinandpartners.com/global-home/responsible-stewardship/policy-outreach/audit-and-accounts
[13] see further Martin Moore QC, 'The Financial Reporting Council: The True and Fair Requirement Revisited – Opinion (21 April 2008); George Bompas QC, 'International Financial Reporting Standards (Issues Arising in relation to the Companies Act 2006) – Opinion (8 April 2013); Martin Moore QC, 'The Financial Reporting Council: International Accounting Standards and the True and Fair View' (8 October 2013); George Bompas QC, 'International Financial Reporting Standards (Issues Arising in relation to the Companies Act 2006) – Further Opinion (14 August 2015).

68. Yes. We are supportive of this proposal. We believe that in addition to shareholders, other stakeholders with an interest in the performance, prospects and impacts of the company should also be permitted to attend. This should include, creditors, employees, regulators, and credible civil society organisations representing the broader public interest.

Q34. Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?

69. Yes, we believe greater transparency about key audit risks and judgments and how these were addressed with the audit committee would be beneficial to users of the annual report.

Q35. Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?

70. Yes. We believe that this would help users understand how and why some audit matters have been changed or resolved from year to year.

Q36. Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?

71. We are not responding to this question.

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

72. We are not responding to this question.

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

73. We are not responding to this question.

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

74. We are not responding to this question.

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

75. We are not responding to this question.

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

76. We are not responding to this question.

Q42. Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?

77. Yes. In our view, unless auditors are accountable to those who use the outputs of their work then there will be inadequate incentives for them to provide a high quality product that adequately meets users' needs. This issue must be addressed through improved mechanisms for both public and private accountability and oversight and an extension of the auditors remit to fully encompass the entire annual report in the audit.

78. As we set out in Annex 1, below, we believe that in order to improve the accuracy and quality of information subject to the audit, the first issue that needs to be addressed is the accountability and enforcement of corporate reporting and governance requirements against a company and its directors. Under the law currently, it is the company directors who bare primary responsibility for the information contained in the annual report. However, while this is the formal position, in practice there are significant procedural and practical hurdles standing in the way of adequate private and public accountability for breaches by directors of their duties by shareholders, let alone by broader stakeholders.

79. In this respect we believe that any changes to auditors liability or accountability exposure to broader stakeholders must be considered alongside equivalent changes in relation to enforcement and accountability in relation to company directors.

80. In relation to accountability and liability for the audit itself, in our view, the FRC's has not been effective in providing adequate regulatory incentives for high quality audits, even from a narrow shareholder interest perspective. Clear examples are evident in the spate of recent corporate governance failings (e.g. Carillion). As auditors are given increasing responsibility for providing assurance in relation to narrative disclosures (e.g. strategic report, corporate governance statements) it is critical that audit quality is ensured through a realistic threat of enforcement action for inadequate or deficient work.

81. In our view, this deficiency in regulatory oversight is also accentuated by broader structural accountability deficiencies in the UK's audit market. Based on the current orthodox position, the auditor's opinion is provided to the shareholders of the company as a body. However, currently there is minimal opportunity for shareholders to hold auditors accountable for the quality of their work. Successful shareholder votes against auditor reappointments are rare and under the current legal framework, successful litigation by shareholders against auditors for breaches of their duty of care is very difficult. In order to address these issues, legal reforms are necessary to ensure that shareholders and broader stakeholders can adequately hold auditors accountable for the quality of their work.

82. Where concerns persist about liability exposure threatening the audit business model, in our view, appropriate safeguards can be put in place to limit liability in specified circumstances to strike a balance between accountability and liability risks for audit firms.

Q43. How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

83. We are not responding to this question.

Q44. To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim

relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?

84. We are not responding to this question.

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

85. We are not responding to this question.

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

86. We are not responding to this question.

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

87. We are not responding to this question.

Q48. Given that a zero failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

88. We are not responding to this question.

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

89. We are not responding to this question.

Q50.How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?

90. We are not responding to this question.

Q51. What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

91. We are not responding to this question.

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

92. Yes. We believe that auditors should be required to consult stakeholders on their perceptions of key reporting and audit concerns and risks. This would help ensure that audits are more tailored to the needs and expectations of stakeholders and help to reduce the expectation gap.

Q53. How could shareholders express to auditors their ex ante anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

93. When determining scope and materiality for the audit, auditors should be required to consult a cross section of shareholders and other relevant stakeholders in order to assess key risks and issues for the conduct of the audit that are a priority for users of the Annual Report.

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

94. We are not responding to this question.

Q55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

95. We are not responding to this question.

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

96. We are not responding to this question.

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

97. We are not responding to this question.

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

98. We are not responding to this question.

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

99. We are not responding to this question.

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

100. We are not responding to this question.

Annex - Existing accountability and enforcement mechanisms for corporate reporting and directors' duties are inadequate

101. Recent high profile corporate governance scandals and ClientEarth's own experience have shown that accountability and enforcement of corporate reporting and governance laws in the UK are grossly inadequate. In this context, reforms to improve the quality and effectiveness of audit are important and necessary but unless they are pursued alongside reforms to improve both public and private oversight and enforcement of directors' duties for corporate governance and reporting, they will fail.

Public oversight and enforcement

102. Over a period of nearly ten years ClientEarth has repeatedly brought detailed evidence about failures by companies to comply with disclosure requirements to the attention of the UK's financial regulators.[14] The core issue at the heart of these complaints has been whether or not a company has properly disclosed 'material' information. In every case so far, the relevant regulator has failed even to communicate a decision about whether or not the report in question complies with the law – let alone to pursue any remedial actions or sanctions. As far as we are aware, the criminal sanction contained in the Companies Act in relation to failures regarding accounting and corporate reporting have almost never been enforced.

103. More generally, we note that the FRC, which has in the past taken on primary responsibility for reviewing corporate reporting, has taken an unusually permissive and conciliatory approach to correcting material errors in financial information. In 2016/17, for example, the FRC conducted just 203 reviews of corporate reporting, out of which no corrections were required and just three companies were required to publish details of the FRC's review.[15] This approach has been criticised directly by the European Securities and Markets Authority (**ESMA**) in its Peer Review Report on Enforcement of Financial Information, where it concludes that:

> *"the decisions taken by the FRC with regard to correcting material errors in financial statements are too weighted towards permitting those corrections to be made in future financial statements, rather than ensuring that the issuer makes the correction publicly and much earlier in a corrective note."*[16]

104. This overly permissive approach is also highly anomalous compared to other key jurisdictions. One clear example is the regular corporate reporting review and comment process undertaken by the US Securities and Exchange Commission (**SEC**). By statute, the SEC must review the corporate report of every issuer at least once every three years (though it typically reviews the reports of 50% of all issuers each year). Where it has questions about either the financial or narrative components of the corporate report, it provides issuers with a comment letter, describing its concerns and requesting a written response from the issuer. Issuers must then provide that response and the entire exchange is publically available. If the issuer's response satisfies the SEC's inquiry, the SEC issues a

[14] See, eg, ClientEarth, 'EasyJet among companies reported to regulator by ClientEarth', https://www.clientearth.org/easyjet-among-companies-reported-to-regulator-by-clientearth/
[15] See FRC, 'Annual Review of Corporate Reporting' (2016/17) https://www.frc.org.uk/getattachment/311af48c-bdfa-4484-8e7d-6de689fd8f4b/Annual-Review-of-Corporate-Reporting-2016-17.PDF
[16] ESMA, 'Peer Review on guidelines on Enforcement of Financial Information' (2017) [74] https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

formal letter acknowledging as much. If it does not, the SEC issues a restatement notice, which may require the issuer to amend the report.

105. In 2017, the SEC required 553 reissuance restatements for deficient financial reporting. As noted above, in the 2016/17 year, the FRC required zero corrections. We are also not aware of any action taken by the FCA in this regard to fulfil its own duties to oversee and enforce compliance with disclosure requirements for issuers under the FCA Handbook.

106. Similarly, in Australia, a strong public enforcement mechanism has been introduced for breaches of directors' duties, whereby, if a court is satisfied that a director has contravened a core directors' duty, it can impose a financial penalty, and disqualify the director. If a director breaches one of these duties and they are found to have been reckless or intentionally dishonest, they may also be found guilty of a criminal offence.

107. This regime is enforced by ASIC, which has been granted extensive powers to investigate suspected breaches of the law, require the production of information, issue infringement notices, seek civil penalties from the courts and, in some cases, to commence criminal prosecutions. ASIC has investigated, referred and prosecuted a significant number of cases where directors of Australian companies have breached their core duties. Evidence indicates that judicial proceedings brought by ASIC or referred to the Director for Public Prosecutions perform a significant role in the enforcement of directors' duties, constituting approximately half of all public and private proceedings involving breaches of directors' duties.[17]

108. We believe that the adoption of a similar regime in the UK would provide an effective means of ensuring that the statutory duties of UK company directors are enforced in alignment with the interests of investors, other stakeholders and the public interest.

109. For these reason, we strongly welcome the investigation and findings of Sir John Kingman's review of the FRC and we are encouraged by many of the proposed reforms, in particular the recommendation to introduce a new regulator with clear legislative footing and stronger powers. However, if this is to be effective, the new regulator must be properly resourced and empowered to hold company directors accountable for corporate reporting failures, as well as broader breaches of directors' duties. This must include oversight of the entire annual report and take into account the interests of broader users of the annual report, including creditors, employees, pension fund members, regulatory authorities, and wider stakeholders. It must also be joined up with the FCA's oversight of reporting by listed companies.

Private oversight and enforcement

110. Alongside reforms to the public oversight and enforcement of directors' duties in relation to corporate governance and reporting, avenues for private enforcement by shareholders and others must also be improved. Currently, the primary means by which directors can be held accountable by shareholders for breaching there duties is through the derivative action

[17] See Jasper Hedges et al. 'An Empirical Analysis of Public Enforcement of Directors' Duties in Australia', CIFR Paper No. 105/2016

scheme contained in the Companies Act (Part 11). Numerous commentators,[18] and government and government reports,[19] have identified that this scheme is inadequate.

111. The current scheme was intended to balance the need to provide shareholders with an effective private mechanism to enforce directors' compliance with their statutory duties, while ensuring that directors' proper activities are not inappropriately disrupted. As noted in the commentary cited above, we believe that the complexity of the derivative claim process tips this balance too far against the interests of shareholders, overly limiting any basis on which boards can be challenged and director's duties enforced.

112. We believe that this balance can be appropriately restored by strengthening the derivative action scheme by:

- broadening the range of applicants that can bring proceedings under the action to include shareholders, former shareholders and any other person who, in the discretion of a court, is a proper person to make an application;
- expanding the range of actions for which a derivative action can be brought;
- providing courts with discretion to order payments to current or former shareholders;
- requiring permission or leave from the court before settlement or discontinuation of an action, to prevent claimants being 'bought-off'; and
- removing shareholder ratification as a bar to the granting of leave for derivative action proceedings.[20]

113. Under the UK's current corporate reporting and governance framework, company directors are ultimately responsible for the performance of the company and its disclosures. Auditors undoubtedly play an essential role but unless directors themselves are held properly accountable through the public and private enforcement mechanisms described above, reforms to the audit sector alone will not be successful in addressing recent failings.

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[18] Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006', Journal of Corporate Law Studies 16 (2016) H. Hirt, The Enforcement of Directors' Duties in Britain and Germany (Peter Lang: Bern, 2004); D. Ahern, 'Directors' Duties: Broadening the Focus Beyond Content to Examine the Accountability Spectrum' (2011) 33 Dublin University Law Journal 116; R. Garratt, 'We Must Make Boards Better' Sunday Times, 9 January 2011; A. Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33 Civil Law Quarterly 76.

[19] Department for Business Innovation and Skills, Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business, Discussion Paper (Department for Business Innovation and Skills: London, 2013) para. 8.13

[20] See further, Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006', Journal of Corporate Law Studies 16 (2016).