

# *Internal controls reporting: sketching out the options*





Audit is currently undergoing an unprecedented level of public scrutiny around the world. The expectations of investors and other stakeholders – including employees, customers, suppliers and pension-holders – have increased in recent years, and the purpose, scope and practice of audit need to keep pace.

ICAEW's Audit and Assurance Faculty is developing a series of thought leadership essays that consider issues directly or indirectly relevant to the international debate about the future of audit. This series is intended to help directors, audit committees, shareholders, politicians, journalists and policymakers understand the key issues, and it will, among other things, help to inform the development and implementation of recommendations in the UK regarding audit, its regulation and the market for audit services.

The faculty has published a number of papers in the series, which are available to all at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit). Further papers will be issued in the coming months. If you have views on any of them, or experiences to share, we would very much like to hear from you. Please email your comments to [Nigel.Sleigh-Johnson@icaew.com](mailto:Nigel.Sleigh-Johnson@icaew.com)

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## *At a glance*

This essay follows our preliminary essay on the same subject, *Internal control effectiveness: who needs to know?* - published in August 2019. It is based on a series of interviews with members and chairs of audit committees and external auditors, conducted in late 2019, prior to the publication of the Brydon recommendations. We had further discussions with a number of those we interviewed after the publication of the Brydon recommendations. Those we interviewed are listed at the end of this publication.

Our interviewees were broadly in agreement in the six areas listed below:

1. Critical to the success of the reforms will be the quality of the reporting framework adopted and the guidance for management and external auditors. Everyone involved must understand what internal control effectiveness - and ineffectiveness - look like.
2. Whatever the framework adopted, the focus must first be on company reporting on the effectiveness of internal controls over financial reporting (ICFR), not on reporting by external auditors.
3. Enhanced public reporting of weaknesses in the UK represents a significant step forward for most companies and will require courage. Larger companies will be expected to set the standard.
4. The short-term focus must be on ICFR. Reporting on the broader controls framework is important but would be a step too far at this time.
5. The pace of change and scoping both matter. Some sort of phased implementation will be necessary, taking account of different types of company, as well as any external auditor involvement.
6. Many companies will need help from their external auditors with ICFR. However, the extent of external auditor involvement with public reporting by companies needs to be determined, at least initially, by companies themselves and the market.

We invite individuals and organisations to share with us in the coming months not only their comments on the analysis and suggestions in this essay but on their own experiences and ideas in relation to the challenges of internal controls reporting. These will help us to develop our contribution to the coming period of intense consultation and reflection that will determine the future of audit and reporting in the UK, and beyond.

## ***Foreword – COVID-19***

This essay was started in late 2019, before the implications of the COVID-19 pandemic became clear. As we approach the next financial reporting season, it seems clear that internal controls over financial reporting matter more than ever.

COVID-19 represents a wide-ranging, on-going set of risks affecting all businesses. These risks need to be assessed, managed and mitigated. Businesses will need to be able to demonstrate the strength of their internal control environment and their use of internal controls in responding to these risks.

As the nature of the heightened financial reporting risks associated with COVID-19 become clearer, investors are looking to companies for reassurance about the quality of financial reporting. They want to know how companies are mitigating the risks of fraud, error, management override of controls, and the re-emergence of big-bath accounting in a profoundly different control environment. These questions will be addressed, in practice, to audit committees and auditors, the very people we interviewed for the purposes of this publication.

In August 2019, we published *Internal control effectiveness: who needs to know?*, a thought leadership essay in our Future of Audit series, to help inform the debate on reporting on internal controls. It covered in some detail the UK position, compared it with what happens in the USA and elsewhere in the world, and set out the case for change.

We approached audit committee members, chairs and auditors with a track record of leadership in this area in late 2019 with a view to better understanding how they saw the development of reporting on internal controls in the UK, prior to the publication of the Brydon recommendations. We spoke to them again in early 2020, after those recommendations were published.

Those who agreed to be interviewed were asked what they thought about the reporting internal controls framework to be adopted. This also included questions on how well prepared companies currently are for reporting on internal controls, the responsibilities of audit committees, CEOs and CFOs, the nature and extent of external auditor involvement, as well as which companies should be required to report and what, if anything, companies should be doing now to prepare. Interviewees are listed at the end of this publication and we confirmed their views with them in April 2020. We are grateful to all of them for the time they took to talk to us. We are also grateful to a small number of other audit committee members, chairs and auditors who provided input, but asked not to be named.

**June 2020**

# *Introduction*

Reporting on the effectiveness of internal controls is a key feature of the current reviews of UK audit and regulation. At the time of publication, the reform agenda was overshadowed by the coronavirus (COVID-19) pandemic, but it still seems likely that policy decisions will be made, sooner or later, relating to public reporting on the effectiveness of internal controls in the UK.

The adverse consequences of ineffective internal controls are manifold and well-understood. They include the potential for corporate failure. While corporate failure can be seen as both inevitable and a necessary component of market economies, some of the reforms envisaged by Brydon and Kingman, including those relating to internal controls, are intended to reduce the scope for corporate failure and, in particular, disorderly, sudden or unexpected failure.

It seems unlikely that improvements to internal controls over financial reporting (ICFR) would, of themselves, have prevented any of the recent major corporate failures. Nevertheless, improvements to ICFR, and to internal controls more widely, would undoubtedly help avoid corporate crises by providing management and users of financial statements with better quality information, facilitating better quality communication and decision-making, and impeding those who seek to manipulate financial statements for personal gain, by making collusion and fraudulent financial reporting harder.

10 years ago, suggestions that UK companies and external auditors might report SOX-style on the effectiveness of ICFR were not taken very seriously. If the subject was raised, the idea was generally dismissed as a rules-based import from the USA - and not a particularly successful one at that - unsuited to the UK environment.

Discussions at EU level about the possibility of requiring some audit work on internal controls when the Audit Regulation and Directive were being revised were often described as 'bringing in Sarbanes-Oxley by the back door'.

Attitudes have changed. UK public limited companies and UK external auditors are nothing if not adaptable. The discussions that took place during the initial Brydon and Kingman consultations covered s302 style reporting by CEOs and CFOs in the context of the possibility of regulatory oversight of boards of larger listed companies, as well as s404 style reporting by external auditors.

The UK Code currently requires boards to oversee risk management and internal controls on an on-going basis, and for them to *review their effectiveness* at least annually, and to report that fact to shareholders. It is widely acknowledged that while this and other high-level principles of the UK Code are well-established, drilling down, the requirements that lie below those applying to the financial statements, such as those relating to the accounting records, are nothing like as detailed as those available to companies in the USA.<sup>1</sup> Uncertainty in the UK results in confusion and inconsistencies, and sometimes leads to unproductive haggling and negotiation both within companies, and between management and external auditors, about whether controls are, in fact, effective.

Responses to the Brydon review and the interviews we conducted in preparing this essay, show that stakeholders are agreed that work is needed on the foundations for the review of internal control effectiveness that is already required in the UK. There is also agreement that the focus of this work needs to be on companies, rather than external auditors, and that greater clarity is needed about who is responsible for internal controls within companies.

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<sup>1</sup> In the USA, companies apply COSO within the framework of the SOX legislation and related auditing requirements and other guidance covering documentation, evaluation and testing.

*'Audit committees report to the board and it's right that there should be more focus on board accountability. There's a strong case for strengthening controls - anything that enhances trust in business when we're all under pressure is worth considering - but what counts is the reporting framework.'*

**Robin Freestone**, Audit Committee Chair and Senior Independent Director, Smith and Nephew Plc and Chair, Moneysupermarket.com plc

Brydon recommended a s302 SOX-style reporting requirement for larger listed companies. While it is widely agreed that SOX in the USA entailed some long-overdue corporate housekeeping, and that it appears to have contributed to a reduction in the number of restatements made by companies, none of those we interviewed believed that the UK should go down exactly the same route for a number of reasons. But those we interviewed also acknowledged that there are important lessons to be learned from the USA's experience, and that we are at the beginning of an important journey. This essay is intended to sketch out how members and chairs of audit committees and external auditors currently see that journey unfolding.

## ***Reporting on internal controls over financial reporting, or controls more widely?***

Enhancing internal controls, and in particular internal controls over financial reporting (ICFR) is a means to an end, not an end in itself. The primary purpose of enhancing ICFR, is to improve the quality of financial reporting and confidence in the financial reporting process.

All of the members and chairs of audit committees and external auditors we interviewed supported better quality financial reporting unreservedly, and agreed that the primary responsibility for high-quality financial reporting lies with management. It irks auditors when the media blames them for poor quality financial reporting, as if they alone were responsible for the financial statements, as much as it irks management when it is assumed that nothing they prepare can be trusted unless external auditors have been involved.

There are, of course, different views about how best to enhance the quality of financial reporting and the underlying processes. Views differ about which controls management and external auditors should focus on, about the internal controls framework against which internal controls reporting should be measured, and about the nature and extent of external auditor involvement. In moving the debate forward, it is important to understand what enhancements to internal controls can and cannot be expected to do.

Those we interviewed agreed that while improved ICFR would reduce the risk of financial statement error, manipulation, collusion and fraudulent financial reporting, it cannot eliminate corporate failure. Better quality financial reporting can reduce the risk of poor quality decision-making by both management and users of financial statements, but it cannot prevent it.

‘We simply don’t know whether an improved controls framework would have helped with some of the collapses – the fundamental issues were about fraud and excess debt. But perceptions about the value of controls are important. If people don’t believe that controls are working, we need to do something about it.’

**Robin Freestone**

‘If investors get more from the cost of a new regime as a result of fewer companies going bust, fine. But it’s quite hard to demonstrate what this is going to prevent. I feel we already do a lot on this anyway as we take it seriously.’

**Kathryn Cearns**, Non-executive Director of a number of public and private sector bodies including Highways England

Would reporting on a wide range of controls – such as operational or compliance controls as well as controls over financial reporting – make any difference? Those we interviewed thought they probably would. Several cited the example of the need for better controls over the operational, compliance and liquidity risks associated with long-term construction contracts as non-financial controls that, with improvement, might have helped prevent one recent collapse. They emphasised the fact that investors look beyond the financial statements when considering corporate resilience, and that financial reporting controls will not compensate for the effects of weaknesses in other areas. Many of those we interviewed thought that asking companies to move to reporting on a wider range of controls would simply be a step too far at this time, not least because of the lack of established frameworks to report against. But others seemed more receptive to the idea that the scope of controls reporting might be usefully widened, in a controlled manner.



'The focus of controls could be more on business resilience or emerging risks - along the lines of the measures brought in by the PRA for stress testing.'

**Michelle Hinchliffe**, Partner and UK Chair of Audit at KPMG

The Brydon recommendations are confined to ICFR. While he noted 'some demand' for a wider reporting regime, 'such work would impinge upon the governance of risk management'. What he did recommend was that in fulfilling their existing duties under the UK Code to monitor risk management and internal control systems and review their effectiveness, so boards should make it clear 'what processes have been considered and reasons for their confidence in their effectiveness'. He suggested that a wider reporting regime might be something to consider in the future.

## ***The Framework: COSO, the UK Code – or something else?***

### **THE FRAMEWORK**

Those we interviewed agreed that audit committees and external auditors need better quality guidance on ICFR that goes into more depth, below the level of the financial statements. The UK Code and accounting records guidance are insufficiently clear or detailed for the purposes of internal or external reporting on ICFR.

Audit committees in particular need more ammunition in terms of good quality information and a clear framework for the reporting, documentation, evaluation and testing of ICFR, to challenge management and auditors effectively. The Brydon recommendations are seen as a good starting point for the development of a framework which, together with associated guidance, must result in a much clearer understanding than we have at present of the boundaries of the control framework, control objectives, which controls are to be tested and why.

Controls ‘relevant to the audit’ as required by external auditing standards have driven external auditor behaviour to date in this area. Under a new reporting regime with a focus on management and the risks facing the entity, such auditor-driven decisions should take a back seat, although auditors too should focus on the risks facing the entity. It remains important that everyone involved clearly understands what internal control effectiveness – and ineffectiveness – look like.

‘Audit committee chairs feel responsible for controls but there can be a challenge around transparency – such as a lack of documentation and detail in the reports they get – it’s not always easy for executive directors to execute their responsibilities for controls, either.’

**Michelle Hinchliffe**

### **THE BRYDON RECOMMENDATIONS**

The Brydon recommendations have been widely welcomed but those we interviewed noted that the devil will be in the detail. The recommendations include a mandatory ‘UK Internal Controls Statement’ consisting of an attestation that an evaluation of the effectiveness of the company’s ICFR has been completed, and a statement about whether ICFR were effective. The attestation should be addressed to the board, and signed by the CEO and CFO, as under s302(c) and (d) of SOX. The board should report to shareholders that it has received the attestation.

Brydon also recommended that the Audit Committee Chairs Independent Forum (ACCIF) should develop principles to be followed by CEOs and CFOs in making the effectiveness attestation, and that the principles should be endorsed by the new audit regulator, the Audit Regulatory and Governance Authority (ARGA). The establishment of ARGA on a timely basis is therefore key.

Those we interviewed were all expecting a recommendation for some form of internal controls reporting, but there were different takes on the framework against which internal control effectiveness should be measured.

Setting aside the merits of reporting against a framework extending beyond ICFR, and the challenges that would entail, Brydon recommended that the framework to be developed should be ‘based on a UK customised version of the Internal Control – Integrated Framework (2013)’. ie, COSO.

## COSO

It is difficult to argue that reporting on a COSO-style framework within a SOX-style regime, would not result in some improvement to the financial reporting process. Many believe that the reduction in the number of restatements in the USA since 2003 is almost certainly attributable - at least in part - to SOX. There is also widespread acknowledgement that SOX resulted in some much overdue housekeeping that in the long run, led to improvements, but that hasty implementation in the absence of proper guidance for directors was inefficient, excessively detailed, and led to disproportionate cost in the early years.

There is less agreement about whether COSO is the right starting point in the UK, and whether it is capable of proportionate application to smaller listed companies. Some of those we interviewed were clear that SOX was a part of a wider attempt to deal with a very different situation to that in which we find ourselves now in which, for example, there was no requirement for boards to approve financial statements and little regulation of loans to directors. Tightening up on ICFR was just one part of the story.

‘SOX came out of Enron almost two decades ago and we are much further down the road. We need something that isn’t quite such a blunt instrument.’

**Robin Freestone**

While audit committee chairs were less confident than external auditors about the merits of COSO, auditors were aware of its perceived shortcomings. Nevertheless, many we interviewed believed that COSO is the only practical way forward: the largest of listed companies with dual listings (24% of the FTSE 100) already report on compliance with COSO, and many other listed companies also do so, to a greater or lesser extent, internally. The largest global audit networks also have experience in this area.

## THE UK CODE

In the past, the UK Code has been used for SOX reporting in the USA by some UK companies listed there.<sup>2</sup> The use of COSO has never been mandated by SOX, but no company with a listing in the USA currently reports against anything other than COSO. Reporting against COSO under SOX undoubtedly improves robustness and many of those we interviewed commented on a controls ‘mind-set’ or ‘culture’ evident in companies that have been through the SOX reporting process.

COSO defines risk, a controls framework and a material weakness, and provides examples, which makes it clearer than frameworks that do not, including the UK Code. Some of those we interviewed were strongly of the view that it has the singular advantage of avoiding the need for UK companies with dual listings to report under two different regimes. But not all of those who favour COSO think it should necessarily be mandated in the UK because adaptations to some jurisdictions outside the USA have not worked well, and it would seem odd to mandate it in the UK, when it is not mandated in the USA.

<sup>2</sup> Precursors to the current UK Code include the 1992 Cadbury Code which was developed at the same time as the original COSO Framework. They were intended to be aligned.

Others again are adamant that COSO is *not* an appropriate starting point for the UK, that reporting under two regimes would only be necessary for a minority of large companies, and that the application of COSO – except at the very highest level perhaps – will result in a large number of companies needing to be exempted,<sup>3</sup> or to have reduced reporting requirements, as in the USA. They thought it would be better to have all listed companies – including smaller companies – report on something principles-based and less detailed, rather than replicate the current situation in the USA.

‘I am not a fan of the COSO framework, but we don’t want two regimes. We need something holistic, a consistent assessment of a homogenous set of controls across corporate Britain -- training and embedding understanding in one regime is hard enough. Right now, we don’t have that and whatever we introduce needs to be compatible with SOX even if not the exact same.’

**Mike McKeon**, Audit Committee Chair at National Express Group Plc, and a Board member of the Audit Committee Chairs Independent Forum (ACCIF)

### WHAT ARE THE ALTERNATIVES?

There are two issues to be addressed: do we want SOX-style legislation to require public reporting on ICFR effectiveness, and if so, what do we need in terms of guidance for reporting, documentation, evaluation and testing?

The 2016 EU Regulation on audit which applies to statutory audits of public interest entities already requires external auditors to report to the audit committee any significant deficiencies in the audited entity’s internal financial control system, and/or accounting system.

Some believe that the UK Code could, with some additional guidance, be sufficiently robust and granular for the purposes of reporting publicly on ICFR, perhaps borrowing from guidance on reporting on internal controls for those involved in IPOs.

Brydon’s recommendation can be read as an attempt to have the best of both worlds, and accommodate both camps. But can a framework ‘based on a UK customised version of COSO’, developed by the ACCIF and endorsed by ARGAs, succeed while avoiding multiple reporting regimes? One for the USA, one for larger UK listed companies and one for smaller ones? The right level of detail will be an important balance to achieve. Not enough detail, and differences of opinion will continue, and convergence with the USA will not be achieved. Too much, and the exercise ceases to be cost-effective, becomes burdensome, and results in exemptions.

‘There are already areas of commonality between the US and UK approaches - the FRC’s 2014 Guidance on Risk Management and Internal Controls was written with an eye to the 2013 revisions to COSO. Both are principles based and can be applied in a risk focussed way. But COSO is internationally recognised and, unlike the UK Code, includes detailed guidance and practical examples of what an effective internal control framework looks like.’

**Sonya Butters**, Partner in Audit & Assurance at Deloitte

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<sup>3</sup> Emerging Growth Companies (EGCs)

Those we interviewed told us that many had been 'scarred' by the implementation of SOX, and that memories are 'jaded'. Some said that it took over a decade to bed down. The initial absence of detailed guidance led to companies – fearing jail terms for CEOs and CFOs – doing too much. Different audit firms inevitably had different views and an excessively granular approach more widely often led to excess.

'The SOX Act was passed in July 2002 giving US companies just over 2 years to comply. The only guidance then available was COSO 1992. In the absence of time, practical experience and user-friendly guidance, everyone did too much.'

**Sonya Butters**

But there was no sense among those we interviewed that initial failures in the USA mean that there is no good way forward in the UK, only that it is important to get it right.

'We learned from SOX - things like defining key controls carefully and making sure they are genuinely key. Lots of companies defined far too many and there's been a massive exercise to refine this over time. We shouldn't need to go through all of that again.'

**Robin Freestone**

There are clear differences of opinion about the starting point for a UK Framework and about whether it needs to be compatible with SOX. Some of those we interviewed referred to existing requirements for listed companies to have adequate controls systems in place under the UK Code, and as part of the conditions for listing. They suggested that UK companies should be able to bring that level of detail into a principles-based controls framework. Doing so might help address a historical underinvestment in the external oversight of UK companies, and over-reliance on external auditors. Some noted the importance in the UK of moving towards a controls mind-set, and the need for better quality documentation and more granularity. Others warned that an excessive focus on controls can lead to a loss of focus on the risks that controls are intended to address.

## *Scope, timing, preparedness and skills*

### WHAT MIGHT BE THE SCOPE?

The Brydon recommendations make no specific reference to the types of company to which the ICFR reporting recommendations should apply. In general, they suggest that recommendations apply to PIEs, but that consideration should be given to applying some recommendations to the FTSE 350, at least initially, or some subset thereof. The recommendations related to ICFR seem likely candidates for this. Many of those we interviewed pointed out that all listed companies are already required to have effective ICFR.

'In the UK, the biggest bang for the ICFR buck will be the FTSE 50 downwards as most of the FTSE 50 either have to comply with SOX or have reasonably sophisticated controls. One idea would be to start lower down and work up.'

**Ken Williamson**, Professional Practice and Corporate Governance Partner at EY

Those we interviewed generally disagreed with the idea that reporting will be too difficult for smaller listed companies, particularly in the current climate. They pointed out that investing in listed companies involves commitment, and that it is important to demonstrate to investors that companies take their responsibilities seriously.

'Everyone should be doing all of this anyway - even if you're AIM listed - your controls should be working already - but we have to design a framework that isn't overly burdensome and works for everyone.'

**Robin Freestone**

'Smaller listed companies are raising public money exactly the same way as the bigger ones. A pound of the public's money is the same wherever it's invested and smaller companies need to invest in a proper finance and controls function.'

**Kathryn Cearns**

Nevertheless, many also thought that some sort of differentiation needs to be made between companies of different sizes and pointed out that there are significant differences between companies at the top and bottom end, even of the FTSE 350. There were real concerns about costs being prohibitive for smaller companies, about making the UK unattractive to investors, and memories of SOX resulting in de-listings.

'There's nothing wrong with differentiation on the basis of the business itself - you need more if a company is going to be FCA regulated - but 'I'm small, you mustn't make me do it' doesn't wash - you need a better argument on the basis of how much risk investors are being asked to take.'

**Kathryn Cearns**

'There's an appropriate balance to be struck that maintains both the trust and relative attractiveness of the capital markets here.'

**Alan Millings**, Partner and Capital Markets Leader at EY

## WHAT MIGHT BE AN ACCEPTABLE TIMEFRAME?

The pace of change matters. All of those we interviewed were concerned whether lessons from SOX were learned. External auditors in particular were clear that its excessively hasty introduction, in the absence of good quality guidance, contributed to unnecessarily high costs. All agreed that some sort of phased implementation would be necessary, with any auditor attestation following implementation rather than in parallel.

Some alluded to the possibility of introducing a new attestation regime on a phased basis in the early 2020s. Others were unconvinced, given the amount of work involved and the necessary lead-time for the development of good quality guidance. But significant concerns were also expressed about the risks associated with delay, and the possibility of momentum being lost as a result of new political priorities and/or the willingness and ability of government to drive a large, technically complex project forward.

## HOW PREPARED ARE COMPANIES?

External auditors were generally more guarded about company preparedness for a new reporting regime than members and chairs of audit committees, although all of those we interviewed acknowledged that things never operate quite the way they are supposed to.

'Another lesson SOX taught us was that some controls you assumed were working well weren't working quite as well as you thought. It was quite illuminating.'

**Robin Freestone**

External auditors expressed concerns about how even large companies will cope, although some thought that those in banking and financial services, applying something close to SOX already, would probably fare better.

This may be a function of the fact that external auditors and audit committees look at internal controls through different lenses: external auditors look to understand controls in order to assess risks relating to the financial statements. They then look at the design and implementation of controls relevant to the audit that they may be able to test, and finally test them and modify their substantive testing of transactions and balances accordingly. Audit committees look at internal controls through a much wider angled lens because their responsibilities are not confined to ICFR.

'It's a step up even for the most mature companies. Control effectiveness varies and a lot of companies don't know where they sit on the spectrum. It was the same with risk before the advent of proper risk management. Something turned up, you dealt with it. But the focus on controls is misplaced - it should be on risk.'

**Mike McKeon**

‘Companies are better at operating global ERP systems consistently than they were in 2001. It makes a big difference and it should make things easier than they were then, as should using third party service centres which happens more now.’

**Robin Freestone**

The different audit approaches adopted by different firms also colour their views. Some firms make use of internal controls wherever they can in their audit approach. Others, because of the variable quality of internal controls, sometimes take a primarily substantive audit approach, even to larger audits. That said, there is general agreement that the very largest audits with deeply embedded control systems have necessarily involved a great deal of work on controls for some time now, and that this is increasingly true of some smaller audits – although there is no clear cut-off point.

External auditors agreed that finance teams in the UK are used to, and respond positively, to being challenged. They agreed less about how UK companies with significant global operations might fare under a new regime. Some cited companies with good, integrated, global systems who believed it would be easy to ‘step into’ SOX, but found that it took much longer than they initially thought, cost considerably more, and presented significant challenges regarding documentation.

Members and chairs of audit committees noted the fact that to date, audit committees do not necessarily address risk through internal controls, particularly where that it is not perceived as an efficient approach. The introduction of a controls reporting regime may provide audit committees with the opportunity to reconsider their approach, and members and chairs were generally upbeat about the opportunity to drive greater consistency and discipline globally in ICFR. Many suggested that companies within the FTSE 100 probably already have the quality and depth of controls necessary for SOX, but that other listed companies would need to do more.

Some external auditors thought that companies need to take action now – particularly with regard to IT systems. They pointed to work that companies should already be doing under the UK Code relating to IT general controls. Some noted the opportunity that the current SAP migration provides to update companies’ understanding of these critical and often poorly understood controls. Some specifically noted cyber-security as a major and much underrated risk factor in relation to IT in its own right.

External auditors reported that presentations relating to internal controls and internal controls reporting they had made to groups of audit committee members and chairs were generally well-received. But some members and chairs we interviewed were far from convinced that work on controls is currently necessary, or even helpful at this stage, in the absence of a clear way forward.

‘Most companies have got too much to do to get too far ahead. And if we’ve been having audit reports and management letters from our auditors for years, how is it that we’re now being told we need more? I don’t need a comprehensive review from someone external, my director of assurance can do that.’

**Kathryn Cearns**



'We see a wide variety of approaches and rigour in addressing the UK Code's requirement for an 'annual review of the effectiveness of material controls.' Few UK businesses have a documented ICFR framework. Typically there will be a risk matrix which addresses the principal risks, including a small number of strategic financial risks. Rarely will there be a detailed financial or fraud risk assessment or testing of the controls that address those risks. We have been encouraging companies to look carefully at their risk and control frameworks to support their review of effectiveness under the Code as well as bringing the benefits of transparency to the Board on this topic.'

**Sonya Butters**

'We need to think hard about the boundaries of ICFR and whether we take in IT general controls, particularly access controls. Where you draw the boundary between a financial system and the controls around it is a moot point.'

**Robin Freestone**

## **WILL COMPANIES HAVE TO UPSKILL?**

Larger firms of external auditors and very large companies have the resources and skills to train their staff and some external auditors were open about bringing in resource from the USA, at least initially. But concerns were expressed about the ability of other firms to recruit, retain and develop sufficient people skilled in this area.

Expectations regarding accountability for internal controls have been heightened by the current debate and some external auditors expressed concerns about the pool of skills – particularly IT skills – available to companies, particularly smaller companies.

'As an audit firm, we're doing a lot of training internally. IFRS 9 has been a massive upskilling exercise in modelling and it will be the same for SOX in the UK – we will have to train people to do it. It will be a challenge for everyone to start with. We could learn from the US experience and adopt some sort of staggered implementation. But it's not a major concern for us and we have active secondment programs.'

**Michelle Hinchliffe**

'Some companies will definitely struggle for the right hires. Even in professional services firms we have SOX specialists and it is a different skills set.'

**Ken Williamson**

# Assurance

## THE BRYDON RECOMMENDATIONS

This essay was planned amid discussions about the need for some sort of SOX-style reporting in the UK to improve corporate discipline. One surprise, for some, was that s404-style external auditor involvement was not recommended. The reason given for this was its 'considerable cost'. The Brydon report cites research showing that about a third of total audit costs in the USA relate to ICFR. However, the absolute cost of the external audit is much less significant to companies – particularly larger companies – than the cost of the internal work needed for s302 attestation purposes – particularly when implementing a SOX style reporting regime for the first time.

Instead of recommending a s404-style regime in the UK, whereby external auditors report annually on internal control effectiveness, Brydon recommended that certain *failures* of ICFR, would result in a requirement for an audit of CEO and CFO attestations for up to three years.

He noted that the additional costs will therefore only be borne by those who have 'failed in their recent reporting', and of course that any board may choose to have the attestation audited. Some of those we interviewed believed that some larger companies will choose to have the attestation audited, but they also expressed concerns about companies most in need of external auditor involvement being among the least likely to be willing to pay for it.

Brydon also recommended that where weaknesses (and/or failures) in ICFR are reported, directors should be required to report the remedial actions taken, and their effectiveness. And 'where the same or any other material weakness persists over two reporting periods, boards should be obliged to have their attestations audited until the controls can be pronounced effective.'

These recommendations set a number of hares running.

Firstly, it will be important that the principles, guidance and standards to be developed do in fact equip boards – and auditors – to distinguish between 'weaknesses', 'material weaknesses', 'failures' and 'deficiencies' consistently. The differences are not just technical niceties. They are important because if the reporting bar is set too low, too much will be reported, if too high, not enough, and if the bar is unclear, there will be inconsistencies. A great deal of effort has been expended over the years in the USA in determining the difference between a 'deficiency', a 'significant deficiency' and a 'material weakness', simply because the latter is reportable, whereas the former two are not. The external auditors we interviewed had looked closely at these recommendations.

'The principles and guidance the regulator develops for boards and auditors – and for itself – are going to have to be robust enough to make sure that identification of a 'material weakness' is clear, meaningful and consistently applied so that everyone knows and agrees on what a failure looks like.'

**Jayne Kerr**, Director at PwC

These concerns echo those expressed by some members and chairs of audit committees we interviewed about the need for clarity with regard to what exactly internal control effectiveness looks like, to do away with disagreements over effectiveness between management, auditors and audit committees.

Secondly, the Brydon recommendations presuppose that weaknesses and failures will in fact be reported. Material weaknesses are reported in the USA, but relatively few. When SOX was first introduced some 15% of companies reported material weaknesses but that percentage (along with the number of companies making restatements) has fallen over the years as the regime has matured and the figures in recent years are between 3-5%.

Would there be a similar trajectory in the UK? The main drivers in the USA - the criminal penalties for non-compliance attaching personally to the CEO and CFO and the s404 annual external audit requirement - are not currently on the agenda in the UK. When taken with the UK's different corporate culture, the question arises as to what will incentivise audit committees and boards - particularly those outside the FTSE 100 - to self-report control failures or weaknesses. Members and chairs of audit committees were optimistic about larger companies leading the way and best practice spreading to other companies over time, and some UK companies already report voluntarily and publicly on controls issues.

The threat of external auditor involvement may well drive better behaviour but it might also motivate companies to avoid reporting internal control failure in the first place. Some external auditors noted that companies applying the UK Code are already effectively required to self-report material weaknesses under FRC guidance, but that a failure of enforcement means that such reporting is rarely seen by external auditors.

'Behaviourally, it would be a real problem if people starting thinking, 'if we report that, we'd have an audit burden for three years'. It's pointless, because it's after the event, and no use to me as an audit committee chair.'

**Kathryn Cearns**

Finally, and perhaps most importantly, some external auditors had significant concerns about recommendations for 'ad hoc' audits when controls are deemed to fail.

They told us that all audits involve a 'lead in and lead out' and that external auditors cannot just 'dip in and out of audits', particularly the largest and most complex, because it takes time for companies and auditors to develop robust documentation, evaluation and testing processes, and because virtually all audit relationships are predicated on the basis that the relationship will be ongoing.

Does that on-going relationship have to be an 'annual' relationship?

'There can be challenges with ad hoc assurance but this would be addressed by the annual refresh and approval of the audit and assurance policy concept put forward by Sir Donald Brydon. This recognises that audit committees need to own the level and nature of assurance to feel confident they are meeting their responsibilities. Assurance comes at a cost but provides confidence that systems are robust and effective. Audit committees have to get the balance between cost and benefit.'

**Sonya Butters**

Some external auditors noted that the COSO guidance is not a panacea, that it suffers from proportionality issues and that while there is a need for consistency, external auditors will need their own guidance for 'voluntary' audits of ICFR, and for audits where controls have failed. While Brydon did not recommend the s404-style annual involvement of external auditors, and the focus needs to be on good quality guidance for management, auditor behaviour will still drive company behaviour to an extent. In the USA, it was only when the auditing standard-setter - the PCAOB - developed the second iteration of its standard for external auditors that things started to settle down for companies.

### VOLUNTARY EXTERNAL ASSURANCE?

External auditors were understandably reticent about being seen to promote the need for external assurance. But some believed that the regime will lack credibility without external auditor involvement.

'Some form of assurance will be necessary to give confidence. It is important that everyone involved gets comfortable with the information they are relying on.'

**Michelle Hinchliffe**

'Operating internal controls is the duty of the directors and the board. Good external audit matches that and can add massive value - helping boards get there by assessing effectiveness - but it cannot and should not take away that prime responsibility.'

**Kathryn Cearns**

All of those we interviewed were clear though that a new reporting regime would inevitably involve at least some external auditor involvement, beyond the voluntary and control failure-driven involvement envisaged by Brydon.

'Many companies will need help from their auditors with ICFR but the extent of our involvement with public reporting by companies needs to be determined by company boards and investors.'

**Ken Williamson**

Some of those we interviewed were more concerned about how audit committees would satisfy themselves about the CEO and CFO attestations, and emphasised the need to focus on that process, and in particular on the involvement of internal audit.

'I'm not completely convinced that the additional assurance external audit might give would be useful. Boards are already looking for assurance from the audit committee and good companies are already making sure that internal controls in place are effective and operating.'

**Robin Freestone**

Members and chairs of audit committee suggested that where the internal audit function is genuinely independent, properly resourced and effective, there should be no need for mandatory external auditor involvement. They did not agree that external auditors always need to be involved for reporting to be credible. But they did want to reserve the right to have independent checks, and acknowledged that there would be situations in which commissioning an external auditor would be appropriate. They also suggested that investors generally prefer companies that have had auditor attestations, demonstrated by a lower cost of capital and higher valuations, and that these benefits offset the additional costs.

‘There is some evidence to suggest that investors place value on issuers subject to ICFR attestation.’

**Alan Millings**

## *Recommendations and next steps*

The members and chairs of audit committees and external auditors we interviewed were broadly in agreement in the six areas listed below. The main areas in which we noted divergence were in views on:

- the reporting framework to be adopted and how this will be translated into consistently measurable outcomes; and
- company preparedness for the changes to come and the step-up that will be needed globally for UK listed companies.

Areas in which there was broad agreement:

1. **Critical to the success of the reforms will be the quality of the reporting framework adopted and the guidance for management and external auditors.** Management, external auditors, audit committees and financial statement users all need more good quality information, and a clear framework for the reporting, documentation, evaluation and testing of ICFR, to challenge each other effectively. The Brydon recommendations are the starting point for the development of such a framework which must result in greater clarity about the boundaries of the control framework, control objectives, which controls are to be tested, and why. Everyone involved must understand what internal control effectiveness – and ineffectiveness – look like.
2. **Whatever the framework adopted, the focus must first be on company reporting on the effectiveness of ICFR, not on reporting by external auditors.** Those we interviewed were positive about Brydon's focus on management. That, more than anything else, reassured them that all stakeholders are at the right starting point for an important internal controls journey.
3. **Enhanced public reporting of weaknesses in the UK represents a significant step forward for most companies and will require courage.** Larger companies will be expected to set the standard. Many of those we interviewed noted a greater tolerance for failure in the USA.
4. **The short-term focus must be on ICFR. Reporting on the broader controls framework is important but would be a step too far at this time.** The audit of culture and ethical behaviour, for example, including determining what might constitute a reportable deficiency, would require a longer and different journey.
5. **The pace of change and scoping both matter. Some sort of phased implementation will be necessary, taking account of different types of company, as well as any external auditor involvement.** A balance needs to be struck between allowing sufficient time for the development of good quality guidance, and the risks associated with delay, including the loss of momentum arising from new political priorities and the challenges presented by such a large and technically complex project.
6. **Many companies will need help from their external auditors with ICFR.** However, the extent of external auditor involvement with public reporting by companies needs to be determined, at least initially, by companies themselves and the market.

Our extensive discussions with stakeholders on this topic, including those that took place in the preparation of this essay, have revealed that thinking is evolving rapidly. We have the opportunity now to make clear and decisive progress that has eluded those who have previously sought to effect change. We invite individuals and organisations to share with us in the coming months not only their comments on the observations and suggestions in this essay, but on their own experiences and ideas in relation to internal controls reporting. Please email your comments to [Nigel.Sleigh-Johnson@icaew.com](mailto:Nigel.Sleigh-Johnson@icaew.com). These will help us develop our approach in the coming period of consultation and reflection that will determine the future of auditing and reporting in the UK, and beyond.

## *Interviewees*

Robin Freestone is Audit Committee Chair and Senior Independent Director at Smith and Nephew Plc, Chair of Moneysupermarket.com plc, and Audit Chair at Capri Holdings Ltd. He is Chair of ICAEW's Corporate Governance Committee.

Kathryn Cearns OBE is a Non-executive Director of a number of public and private sector bodies including Highways England, and a member of the External Audit Committee of the International Monetary Fund.

Mike McKeon is Audit Committee Chair at National Express Group Plc, holds the same role at a private real estate company based in Prague, Czech Republic and is a Board member of the Audit Committee Chairs Independent Forum (ACCIF).

Michelle Hinchliffe is a Partner and UK Chair of Audit at KPMG.

Sonya Butters is a Partner in Audit & Assurance at Deloitte.

Ken Williamson is a Professional Practice and Corporate Governance Partner at EY.

Alan Millings is a Partner and Capital Markets Leader at EY.

Jayne Kerr is a Director at PwC.

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