Brydon Auditing Review (January 2020)

Just after the election, the Brydon Review was released. This follows the CMA and Kingman reviews. However, it is radical though the list of recommendations including the ones below are not as neat:

1) First, a separation of the audit and accounting professions into two distinct groups (a first for English speaking countries but more common in continental Europe). Included in this is the disclosure of annual pay for senior auditors together with a new attitude of suspicion and skepticism – existing professional skepticism was not enough. There is a new emphasis on forensic accounting and actions to prevent and detect 'material' fraud together with higher auditor remuneration and fees- but reported as profits from statutory work and audit work separately by the audit firms.
2) Second a change to what is audited and why. Essentially recommended a redefinition of audit that adds greater value to stakeholders than simply confirming and verifying financial statements. Auditor's opinion should be open and understandable and auditors should provide "greater granularity of information" about the estimates they use in the audit. He also wants shareholders to engage more with the audit team during the audit process and for them to be able to question the auditors at the AGM.
3) Third a renewed focus on the liability of directors and management of the company issuing any reports. The review recommends new reporting requirements for directors about resilience, public interest and audit policy, as well as an obligation to explain what they have done to prevent material fraud and to report on internal controls. This covers several issues expanded below:

- Significant new requirements for directors which includes a duty to declare actions they have taken each year to prevent and detect 'material' fraud.
- Directors might also have to present an annual 'public interest statement' to explain how the company they govern serves the wider public interest.
- The introduction of a British version of the Sarbanes-Oxley Act - the US law passed in 2002 after the collapse of Enron, WorldCom, and other high profile US cases. The US created such legislation to help protect shareholders, employees and the public from accounting errors and fraudulent financial practices. It has worked well in the US. Basically such an act formalises oversight bodies, auditor independence, directors' corporate responsibility, enhanced financial disclosures including off-balance sheets transactions, and other Brydon review recommendations.
- Such an act could ask CEOs and CFOs to vouch annually for the effectiveness of the company's internal controls.

In essence, Brydon has proposed changes to the law on the way auditors report to the public, and a new focus on providing assurance to users of accounts, strengthened standards for auditors, and a commitment to inform as well as check. The purpose of a company audit should help establish and maintain confidence in a company, in its directors and in the information for which they have responsibility to report. ARGA (the FRC replacement), should it come into existence, or else an enhanced FRC, should fill the training and certification role.

Judgement of whether there is a 'true and fair' view is to be modified to an equally vague term. The new term should be enshrining in law and places a requirement to assure that the accounts present a company's situation 'fairly in all material respects'. Of course, what is material is something that has caused auditors and directors many headaches over time – including the Tesco case (see https://www.fin-rep.org/which-book/financial-failuresscandals-from-enron-to-carillion/post-publication-discussion/

The Brydon review also contains new requirements for disclosures in company accounts: the “going concern” statement should be expanded into a “resilience statement” reviewing not only the near-term viability of the company but also including a wider stress test and statements regarding the long-term threats to the business. The report recommends replacing the existing going concern and viability statements with a resilience statement that incorporates a going concern opinion for the short term, a statement of resilience in the medium term, and a consideration of risks to resilience in the long term, such as climate change.

One retrograde step (in our view) by Sir Donald Brydon may be to question whether the idea that auditors cannot be expected to act as “bloodhounds” by sniffing out fraud at companies. That said his report does include a requirement for auditors to act on their suspicions if they do not believe directors are being candid with information. In addition, he recommended that a new panel should be created that would review frauds to see whether auditors were culpable.

Critique of Brydon

The whole question of intangibles is not appropriately discussed or tackled. Sure the recommendations may mean some of the issues are resolved but not all. Jonathan Ford of the FT makes this point[1]. A discrepancy can arise between the consolidated accounts and the parents company’s accounts. The importance of this this discrepancy between the consolidated accounts and the parent company accounts is that dividends are paid out of the parent company accounts.

Case A where the consolidated accounts balance sheet is much stronger than the parent company’s one. This can be created where a group’s subsidiaries could accumulate profits they do not pay to the parent as dividends. Hence, while the consolidated balance sheet enlarges, the parent might still prudently record its investment in subsidiaries at their historical cost, thus allowing a gap between them to develop.

Case B where the consolidated accounts balance sheet is much weaker than the parent company’s one. One example is, for instance, where the consolidated accounts are not impairing investments in lossmaking or liability-ridden subsidiaries (as in the case of Carillion and Thomas Cook). Over-valuing the intangible assets, (especially goodwill on brands taken over and subsidiary values), is a continuing and chronic issue in financial reporting.

Ford[2] cites another case that of GlaxoSmithKline (GSK). In the GSK case, the parent’s balance sheet grows much stronger than its consolidated counterpart does – this is another Case B where the consolidated is weaker than the parent accounts. In fact the GSK consolidated accounts show significant retained losses whilst the company accounts show large positive retained earnings. Substantial dividends were paid by the parent company despite the consolidated accounts showing a worse financial position. Of course, there are

[1] Ford, J., The opportunity missed by Donald Brydon’s audit review, Financial Times, 22 December 2019. Available at:
https://www.ft.com/content/a3df4cd6-2494-11ea-9a4f-963f0ec7e134
Accessed January 2020.

[2] Ibid.

many possible explanations.

As stated above, the reason why parent company balance sheets are important is that it is the parent company that pays dividends to shareholders out of its retained profits or distributable reserves. Overstate them, or fail to reflect foreseeable liabilities, and it becomes possible for companies to pay out unearned dividends and bonuses when the consolidated accounts show losses. And prudency would normally dictate that there is no plausible justification for such pay-outs.