

## **Appendix 3.07.3 Narrative solutions in the audit process**

### **Narrative Solutions**

We know that the FBU test is not working, and that the narrative section is heavily biased from the evidence provided in chapters 10 to 13, and from the evidence collected from over 100 interviews and over 1,000 separate pieces of evidence.

#### **FRC and ICAEW's solution**

The FRC must also have some inkling that all is not well for the their chairman to suggest that an external audit should encompass more of the report if not the whole report. This solution follows the Stephen Haddrill and FRC spokesperson augmented by what the ICAEW has stated:

Nigel Sleigh-Johnson, head of the financial reporting faculty at ICAEW, said, 'It is entirely possible for an auditor to give an opinion over the whole of an annual report. In 2013 we argued that since many people are asking what can be done to make business information more trusted, assurance on the annual report – going beyond the audit of the financial statements – is a vital part of the practical solution to this problem. We continue to believe this.'<sup>i</sup>

Here are the three authors' individual suggestions. We could not agree, but if the above solution fails then these might be evaluated.

#### **Professor Krish Bhaskar's solution**

##### **Change in the test for the entire narrative sections**

The FRC introduced a modification to the 'true and fair' view for the narrative sections. The test is fair, balanced and understandable. All the evidence points to a total failure of the word balanced. So it would seem that the test should return to 'fair and true' with the addition of 'understandable'. The FRC argued to us (in a series of meetings) that with forward looking information, balanced is a better test. However, we have found it is too subjective, too capable of being manipulated and too difficult for auditors to provide a valid and informative opinion, so we feel 'balanced' in the text has to go or if it remains, the word 'balanced' should be qualified to mean balanced to an independent observer with some knowledge of a) the industry/sector and b) financial reports and accounting rules. This alone may be sufficient to make an improvement, though the regulation for auditors should require them to read the narrative section and go way beyond looking for exemptions or checking for something that may be a material misstatement – that is just too weak.

##### **A mandatory independent comment on the entire narrative sections**

Krish also thinks that a more radical approach may be to have (via an act of parliament) a neutral person or authority to make an independent report on the narrative sections in an annual report and financials as a whole including the business model and strategy. Auditors are not neutral. Even a firm of auditors not undertaking any work may be in line for work in the future. So Krish would claim they are not independent. If there is not an industry or sector association or body, then business journalists might provide such a report. This might be through separate fees to each journalist or through an arrangement with the paper or magazine – bolstering their revenue stream at a time when online news is hitting the papers hard. Another independent

solution would be to create consultancies who specialise in providing balanced comment on the FTSE 350 and the larger private companies. Such a service would not undertake consultancy or audit work.

An alternative is to provide a set of press reports including at least two negative, if they exist.

### **Professor John Flower's solution**

It would be reasonable to expand the auditor's responsibility with respect to these reports – in differing degrees:

- 1) The auditor should be required to undertake work, whose sole purpose is to verify the accuracy of the reports. In the case of Carillion 2016, KPMG's opinion is 'based solely on the work required to be undertaken in the course of the audit of the financial statements'. One can envisage a case, where a material misstatement in the directors' report would not be covered by such an audit report – for example where the directors report that the company has contracts for future delivery when it has only expressions of interest. Hence the auditor's report should not be subject to such conditions as mentioned by KPMG.
- 2) The auditor should be required to report that the narrative reports give 'a true and fair view of the company's (current) financial position and performance'. Such a requirement raises very interesting points of principle: for example, is it possible to have more than one 'true and fair view'? It seems self-evident that financial statements prepared according to UK GAAP frequently do not give the truest and fairest view. Hence it would be perfectly reasonable for the view of the company's current financial position and performance given in the narrative reports to be thoroughly at odds with that presented in the financial statements. But John feels that the auditor should act as a brake on excessive and unjustified optimism on the directors' part. At the very least, the auditor should insist that, in the narrative reports, all significant differences with respect to the financial statements are flagged and backed up by rational arguments and/or evidence.
- 3) The auditor should report that the narrative reported gives 'a true and fair view of the company's current financial position and performance and prospects'. Although such a requirement would be logical and would provide stakeholders with extra information (i.e. a second opinion), John feels that it would be going too far. It would require the auditor becoming involved in management, as opposed to reporting on management.

### **Rod Sellers' solution**

Rod believes that the word 'balanced' is not always being seriously taken into account. So he believes in John's third point, that the responsibility of the auditor should be widened. Rod's solution is more towards that of the FRC/ICAEW solution.

At the very least, the auditor should insist that, in the narrative reports, all significant differences with respect to the financial statements are flagged and backed up by rational arguments and/or evidence. At the very least this would moderate any excessive statements by the directors.

The auditor should report that the narrative reported gives 'a true and fair view of the company's current financial position, performance and prospects'. Such a requirement would

be logical and would provide stakeholders with extra information (i.e. a second and more neutral opinion).

Rod raised the issue that auditors may say that they do not have the skill set to review commercial strategies. Though as we have pointed out their consultancy colleagues would. This might be charged separately and may require parliamentary approval to increase the scope of the audit for the larger listed companies. Or perhaps a simple redefinition by the FRC might be sufficient, but such fine tuning might require BEIS departmental and governmental approval – which the FRC claims has not been forthcoming.

### **An audit reviewer's suggestion**

Would you object to the marketing narrative if it were in a separate document away from the audited financial statements? In that way the auditors would never need to be associated with it at all. It would be clearly seen as statements from the board like any other trading announcement directors make. That might be the easiest solution.

I have seen many changes made to the narrative over the years and some quite strong debates about the nature of the content. Directors always have to be careful not to make misleading statements to the market or otherwise face FCA sanction.

So we have mentioned this now.

Another accountant made this comment about John's solution which is worth of reproducing here:

.... John's more than one true and fair view - absolutely there is more than one. Why else does the audit report say 'a' true and fair view? I have often pointed out the significance of the word 'a' in this context. It is not understood by the media or politicians. There are many true and fair views because judgement permeates the preparation and audit of accounts. There is no such thing as the truest and fairest.

One criticism is:

A difficulty with your independent comment is how does the neutral person gather the relevant information in the first place. A lot of information is presently gather via the audit process. There will be duplication of effort.

Analysts and the consulting division are used to do doing this. Often relying on third party sources and their own analysis. The three of us have frequently had to perform such tasks. We are sure that if the auditors cannot then the can be trained to or their consulting division personnel can undertake this task.

## Reviewer's comments

Other information expressions of interest: At present ISA720 requires the auditor to

*Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. If material that could well apply to these contracts.*

It then provides

*If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including:*

*(Ref: Para. A44–A44-2)*

*(a) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report (see paragraph 22(e)(ii)); or (Ref: Para. A45)*

*(b) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation. (Ref: Para. A46–A47)*

[https://www.frc.org.uk/getattachment/11b5e047-a2d7-4674-8281-cc57ec3d5e66/ISA-\(UK\)-720\\_Revised-June-2016.pdf](https://www.frc.org.uk/getattachment/11b5e047-a2d7-4674-8281-cc57ec3d5e66/ISA-(UK)-720_Revised-June-2016.pdf)

Which you might say is not strong enough...

As to John's item 2) more than one true and fair - absolutely yes. The phrase in the Act is to produce accounts that show A true and fair view. There is no such thing as THE true and fair view because of the judgment involved.

As to Item 3) I agree with John and not Rod for precisely the management point John makes. However, I agree with Rod on skill sets to evaluate business prospects.

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<sup>i</sup> <https://economia.icaew.com/en/news/april-2018/frc-seeks-to-expand-auditors-responsibilities>