BEIS Consultation

‘Restoring trust in audit and corporate governance’

September 2021

Summary of the PwC response

We have summarised our response to the BEIS consultation (the Consultation), focusing on the proposals we consider would have the most significant impact.

Contact us

Sotiris Kroustis
PwC UK Head of Public Policy
sotiris.kroustis@pwc.com

Jayne Kerr
Director, Public Policy
jayne.l.kerr@pwc.com

Introduction

As the UK recovers from the economic challenges of the pandemic, and navigates the new landscape outside of the European Union, ensuring that the UK remains a trusted, attractive and competitive destination for both foreign and domestic investment will be critical to the country’s success. Maintaining a dynamic business and regulatory environment where both public and private companies of all sizes and sectors can thrive is vital, as is building on the UK’s advantages as a recognised world leader in corporate governance and audit.

At PwC, we have made the case consistently that achieving the desired improvements to the quality of corporate governance, reporting and audit will require a holistic approach to reform across all of those involved: companies, directors, audit committees, auditors, investors and the regulator.

To be successful, any change needs to be proportionate and address the interdependencies and responsibilities of all relevant market participants together.

Reforms also need to be prioritised on those areas, across the system, where the greatest and most positive improvements can be made. By ensuring these reforms proceed together, there is more likely to be a sustainable improvement and lasting progress.

This matters because corporate failures – and the reasons for them – are often complex, even if a prevailing narrative of ‘negligent directors’ or ‘audit failure’ frequently emerges for each. A mature corporate governance and audit regime needs to acknowledge that failure remains a potential consequence of doing business, while maintaining its focus on minimising the impacts to employees, the economy and investor confidence. In such an environment, the regulator, audit firms, businesses and investors need to work together to shape and improve regulation as it practically evolves.

We support a great many of the proposals and believe they have the potential to increase confidence in the UK by improving standards for corporate governance and reporting.

In this summary we have focused on the proposals we think would have the most significant impact.

We have categorised the proposals as; i) those that we support but feel there needs to be careful design and implementation; ii) those we have more concerns about, although we believe a number of these concerns can be addressed; and iii) those we do not support.

Here is a summary of our categorisation (with the corresponding Consultation section):

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Proposals we support if designed and implemented properly

Stronger internal company controls (2.1)

We support proposals for a strengthened UK internal controls regime. The US experience over the past 15 years confirms that, once established and embedded, such a regime drives improvement in the quality of financial reporting and controls. It is vital that the changes make a real difference: the regime needs to be robust and applied to those organisations that would benefit most from the confidence an enhanced system would bring (that is, those organisations with a significant public interest and where there may be a more significant degree of separation between management and shareholders). We believe, as demonstrated by the US experience, that independent assurance will be critical to driving the desired level of strength and accountability in such a regime.

A strengthened internal controls regime in the UK will be a means of driving improvement in the quality of financial reporting and controls (as evidenced from the experience in the US market). In our view it would be sensible for the requirement to focus, at least initially, on internal controls over financial reporting (ICFR).

We also believe that proper design and implementation of a UK regime would represent an important, and positive, improvement in the UK governance environment. Today, premium listed companies are subject to requirements around risk management and internal control as part of their compliance with the principles of the UK Corporate Governance Code (the Code). However, in our experience, the processes in place to support these requirements vary significantly and for many companies are light touch, with a lack of formal structure and testing. There is also currently no specific requirement for directors to explicitly state that the internal controls are effective, which doesn't help drive rigour and formality in this area.

An important caution around the messaging about a strengthened framework is that strong internal controls cannot completely insulate a company against market forces that may cause it to fail (although it might encourage more transparent corporate reporting which could enable users/stakeholders to make better decisions in advance of corporate failure). Acceptance and clarity from the Government and policy setters that this is the case, is important in our view.

It is also important to recognise that a robust ICFR regime might reduce the risk of fraud and other similar inappropriate behaviour but can never eliminate that risk completely, particularly if collusion is involved.

Requirements of the strengthened regime

Of the options proposed by the Government, our preferred option is Option C, which is the requirement for a statement from the directors on the effectiveness of ICFR that is mandatorily assured. We believe in the value assurance will bring to the regime (see below for further comment).

Whether it is Option A (just the statement from the directors) or Option C, for the regime to really strengthen controls over financial reporting, the design and implementation of requirements for the directors' statement needs to be sufficiently rigorous and robust to avoid a situation that is not very different to what is in place today. We do not believe that the proposal, as outlined in the Consultation, is going far enough in this regard to make a substantial change and that more is needed in a number of areas, the most key being the following:

- **A clear public statement** – At the heart of a strengthened internal controls regime should be a clear, public statement from the directors as to the design and operating effectiveness of a company's internal controls, underpinned by a clearly communicated expectation of the level of diligence applied in making that statement. This would drive behavioural change and accountability at the board level and give users of accounts greater clarity on where responsibility lies. We are pleased that the Government is proposing a directors' statement that requires directors to specifically give their opinion on operating effectiveness of ICFR, but suggest that the wording of the statement needs to be more explicit in describing the work done by each of the CEO/CFO, and the Board, in support of the statement. Also, the statement should refer to **both** design effectiveness and operating effectiveness in order for there to be absolute clarity that both of these important elements must be considered. We note that the means of evaluating each of these elements is quite different.

- **Statement vs attestation** – There is some inconsistency in the Consultation as to whether the directors are making a "statement" on the effectiveness of internal controls or an "attestation". In our view there is a difference between these two concepts, with an attestation having a clearer legal status and the potential to confer accountability (as is the case with attestations that the FCA uses as a supervisory tool). Whatever term is used, it should have a clear legal meaning and be used consistently.

- **A two tier approach** – We suggest that a two tier approach be considered; the CEO and the CFO would make an attestation to the board and the board would then report to shareholders that this attestation had been received.

- **Clear guidance over process and evidence is needed to support the statement** – The UK regime would need to be supported by clear guidance for directors and management as to what they need to do to support their statement, including the expected level of evidence and testing. We've heard from a number of companies that, although there could be some resistance to an overly prescriptive approach, many feel it would be better to have more certainty about what exactly directors would be required to do to comply and a consistent and transparent framework to assess against. Further, even without a requirement for assurance, we believe that the directors' statement needs to be "auditable" and this would require robust documentation of the evidence and approach used to justify the statement. This would ensure consistency across all companies such that in situations where the regulator or stakeholders require it to be assured (or want to challenge the basis for the statement) there will be an evidence trail to assess.

Costs of the regime

In order for any ICFR regime to be rigorous and implemented consistently, it is inevitable that there will be cost and resource demands and in our view, a careful impact analysis needs to show that, when applied on a proportionate basis, the benefits of a new regime will clearly outweigh the inevitable incremental cost that many companies will experience. We believe that the cost estimates in the Government's Impact Assessment are understated. The Government has assessed the transitional costs associated with the directors' statement on ICFR, incurred over years 1-4, to be approximately £336k per company, and that annual compliance cost thereafter would be £60k per company. A recent study[1] of annual compliance costs under US SOx estimates that annual compliance costs per company (not including costs of assurance) ranged from $0.8m to $1.6m.

This might show that the Government's aspiration is to create a regime that is less onerous than US SOx or could simply be an overestimation of what companies already do today to meet existing requirements. Either way, there needs to be more clarity for companies as to what the potential cost is likely to be. The Government's Impact Assessment also does not quantify the benefits of introducing a new regime, which we believe is important.

A proportionate approach

We think that the additional cost associated with the strengthened regime is justifiable when compared to the benefits **if** applied to the **right** level of public interest entities (PIE). It is vital that the changes make a real difference: the regime needs to be robust and applied to those organisations that would benefit most from the confidence an enhanced system would bring (that is, those organisations with a significant public interest and where there may be a more significant degree of separation between management and shareholders). Also, as part of the Government's review of the PIE definition, we think there should be an assessment of whether all of the requirements of a PIE (existing requirements and the new proposals) should apply to all PIEs (see below). This would include requirements over the strengthened UK internal controls regime.

Independent assurance

We believe that independent assurance over the directors' statement should be mandatory, so our preferred option is Option C. However, it should also be proportionate and may not be needed for every company.

Based on experience in the US, the directors' certification and corresponding assurance have been fundamental to the increased reliability of financial statements. Assurance will also help ensure that rigour and consistency are properly embedded in the statement, further contributing to building confidence and trust in what will become a critical piece of corporate reporting.

Furthermore, it is not clear how failures or weaknesses in internal controls would be identified and evaluated if there is no independent assurance, and in the absence of a clear benchmark to make the assessment. There is a risk this could become overly reliant on self-attestation and self-regulation, which is unlikely to engender public confidence.

There may be a range of assurance providers who can provide assurance over the various disclosures in the front half of the annual report, and we are fully supportive of audit committees having a choice of assurance provider. However, for the directors' statement on ICFR in particular, our view is that in the majority of situations the statutory auditor would be the most logical and cost effective choice of assurance provider. This is because the supporting evidence for the directors' statement will be generated from systems and controls that, as part of the financial statement audit, would at a minimum have been understood and evaluated (although may not have been tested). In those situations, use of the statutory auditor to provide assurance on the directors' statement is also more likely to ensure the quality and consistency of the information reported.

[1] https://www.protiviti.com/sites/default/files/2020-sox-survey-protiviti.pdf

If the assurance over the directors' statement is provided by the statutory auditor but is not mandatory, we believe that the basis for the fee cap under the FRC's Ethical Standard para 5.40 will need to be rethought. In our view, it would be appropriate to include the provision of assurance by the statutory auditor in relation to ICFR in the denominator to the cap calculation (i.e. within the total audit fees). The additional assurance is by nature "audit" work, and will be performed on an integrated basis with the work required to underpin the statutory audit. Not to do so could mean that some companies would be unable to commission their statutory auditor to perform this work and would therefore be subject to a more costly and disruptive approach.

Enforcement against company directors (5.1)

We welcome proposals for increased director accountability. We support the proposals for the new Audit, Reporting and Governance Authority (ARGA) to have regulatory oversight of all directors on the boards of public interest entities (PIEs), as well as auditors, enabling the regulator to supervise coherently across the whole system. However, proportionality will not be achieved unless clear policies are developed on the threshold for enforcement and what constitutes a breach, with a balance needed between the powers to sanction directors and interventions that focus on improvement to address less serious failings.

At the moment the proposals are broadly drafted with significant details to be worked out as they are ultimately designed and implemented. One key example where more detail is needed is whether all directors are equally accountable for corporate reporting and the audit – recognising that there are directors who have a mainly operational focus. A further example is whether all directors would be equally responsible for the proposed new reporting requirements, such as the directors' statement over internal controls. The Government should consider whether there is a way to fairly reflect individual directors' skill sets and areas of focus with overall accountability without undermining the important unitary board concept.

We have held focus groups with a broad range of non-executive directors as part of the consultation process. Many participants voiced their support for the proposals in principle, believing that it would improve reporting and increase boards' interest in the detailed work of their audit committees. Several did highlight the complexity in relation to striking the right balance between executive and non-executive accountability, with many non-executives feeling that they will require more, or different, management information so they can have greater comfort to discharge their responsibilities under the proposals. There were questions as to whether this could lead to non-executive directors becoming more involved in the running of the business, impacting their independence by acting as a "quasi-executive".

There were also concerns raised about whether the proposals could significantly increase the risks associated with being a non-executive director, negatively impacting on the attractiveness of the role and reducing the talent pool.

The Audit and Assurance Policy (3.2)

We believe that introducing a requirement for premium listed entities to publish an annual Audit and Assurance Policy would provide transparency and enable companies to build trust with stakeholders. As part of making this proposal a success, the Government and regulator will need to work much more assertively with the larger institutional shareholders to ensure appropriate levels of engagement. If the Audit and Assurance Policy is brought into law, it must be sufficiently flexible that companies are able to update it annually in light of reporting developments and rapid changes in business operating models.

We support the proposal to introduce a requirement for an Audit and Assurance Policy which describes the company's approach to seeking assurance over its reported information. The Audit and Assurance Policy would provide transparency and enable companies to build trust with stakeholders, and we have heard from a number of non-executive directors that it would also be an important internal governance check for them. Stakeholder engagement will be critical for the Audit and Assurance Policy to be effective in ensuring that the needs of users of the information provided by companies are met. We would encourage the Government and regulator to work much more assertively with large institutional shareholders to ensure that they will engage.

We agree with what has been proposed as minimum content for the Audit and Assurance Policy, but there are a number of other areas where we think it would also be appropriate for directors to explain their approach to independent assurance (note that we are not saying these areas should have additional assurance, but that clarity over what assurance there already is would be useful). These would include KPIs that are related to, or influence, management and/or directors' remuneration and Alternative Performance Measures that cannot easily be reconciled back to audited financial statements, recognising the importance many investors place on these measures. Further areas of consideration potentially include TCFD and related ESG disclosures which are an increasingly important area for many stakeholders.

Any regulation to implement the Audit and Assurance Policy should be supplemented by detailed guidance around the elements of the Policy. This will ensure consistent application but will also be flexible enough to allow companies to design their own approach.

There may be a range of assurance providers who can provide services over the information outside the financial statements and we are supportive of audit committees having a choice of assurance provider, and, in fact, using this opportunity to get to know a wider selection of firms. In some cases, having the statutory auditor provide this assurance will be most efficient if the information is generated from systems and controls tested as part of the audit, and is more likely to ensure the quality and consistency of the information reported. Consideration will need to be given to how these services interact with the Ethical Standard rules in this area, which may need to be rethought.

Resilience Statement (3.1)

We agree that there is a need to improve current reporting over resilience and so we welcome the Government's focus on this area. Combining the going concern and viability statements into a much more robust single statement where the directors set out their business model and the key risks that would threaten it and are more robust in their description of the genuine long-term prospects facing the company and sensitivities around their assumptions, would be a clearer, more logical approach than having two separate disclosures.

One of the drivers of the proposals for the Resilience Statement is to increase the chances that potential corporate failure can be identified at an earlier stage, allowing stakeholders to make informed decisions about continuing their relationship with the company. We think it is first important to acknowledge that corporate failures are an inevitable and necessary part of a well-functioning economy that allocates capital efficiently. However, we agree that good corporate reporting should help investors and other providers of capital identify business model risks, and assess the likelihood of future failure. Armed with this information, they can make well-informed investment decisions.

As we noted in our response to Sir Donald Brydon's call for evidence in 2019, despite good intentions, the going concern statement and the viability statement could be improved in a number of ways. The viability statement, in particular, has become in many cases boilerplate and vague. The proposal for a Resilience Statement is broadly consistent with what would be good disclosure under these existing requirements so with the new proposal it will be crucial that this doesn't just become a repackaging of existing requirements under a new name.

Implementation of a new statutory requirement will be a good trigger for refreshed thinking and improvement and pulling this together into a single statement will increase coherence and user understanding. However, given the similarities to existing requirements, the Government will need to position the Resilience Statement as something new or different to today.

Tackling fraud (6.4)

We are committed to improving reporting and audit quality including, where necessary, as it relates to directors' and auditors' responsibilities with respect to fraud. Broadly, we agree with the Government's proposed response to the fraud recommendations from the Brydon review. However, we suggest there are areas where the proposed requirements could be strengthened or refined.

We feel that the requirement for the directors to disclose the steps they have taken to prevent and detect material fraud will help ensure that directors acknowledge their responsibilities around fraud, but it is only the first step and a more fundamental change in directors' mindset is also needed. To truly make a change in this area we think that as part of the proposal, there should be a requirement that directors perform a fraud risk assessment to support the disclosure.

From an audit perspective, we believe there are ways in which drawing on forensic skills can improve the audit approach and we have recently undertaken a number of initiatives to use forensic skills and experience to enhance the quality of our audit work around fraud. This includes specific training of all qualified staff in developing a forensic mindset, launching a repository of real-life fraud case studies to assist engagement teams in having more robust discussions around fraud risk, and piloting the increased involvement of forensic experts at the planning stage of certain engagements.

Audit committee - role and oversight (7.1)

We support a package of reforms that clarify the responsibilities and accountabilities of those involved in the corporate governance and reporting ecosystem – this includes audit committees.

The FRC has published guidance[2] on audit committees that promotes the consideration of audit quality as part of audit tendering and annual effectiveness assessments of the audit by the audit committee. We would support strengthening this guidance and should ARGA be given powers to set additional requirements, we believe that ARGA should consult on the details of the requirements to seek the views of audit committees and other stakeholders.

Importantly, audit committees must continue to be able to exercise discretion and professional judgement and not be disempowered in relation to the appointment and oversight of auditors. We believe that a risk based approach to monitoring compliance with the requirements is the most proportionate way to achieve this. Giving ARGA powers to take action to ensure effective compliance with any new requirements would likely lead to a higher rate of compliance.

[2] https://www.frc.org.uk/getattachment/68637e7a-8e28-484a-aec2-720544a172ba/Audit-Quality-Practice-Aid-for-Audit-Committees-2019.pdf

Proposals we have concerns about, although believe a number of these concerns can be addressed

Resetting the scope of regulation (expansion of the definition of public interest entities (PIEs)) (1.3)

We understand the objective of ensuring that the definition of a PIE includes a broader set of entities that have a significant public interest. However, we believe that it is not appropriate to take a regime that has been designed largely for listed companies with external investors and apply that to private companies. The proposals do not take into account the recent work by the Government, the FRC and private business, working together to design the Wates Principles and the concept of other entities of public interest (OEPI). Wide consultation meant that those changes were proportionate, and ensured the continued attractiveness of our economy for private equity and other forms of private ownership and investment. These changes need time to ensure they are working properly, as creating further change at this stage could undermine stability and confidence and could, although unintentionally, discourage entrepreneurship and investment, and through that, the creation of jobs.

Private companies

If the Government does decide that the PIE definition needs to be expanded then, in our view, it needs to reconsider the proposed thresholds used to determine which private companies are PIEs. Per the Consultation “The Government has sought to ensure that, as far as possible, the [PIE] definition is aligned with existing thresholds" (section 1.3.12) and this focus on applying existing thresholds is clearly evident within the large company options of the Consultation. However, another Government aim is to provide a "clear articulation of the public interest in any group of entities being added to scope", and it’s not clear how the proposed size thresholds achieve this.

We understand the desire for simplicity in the PIE definition by using pre-existing, well known thresholds. However, size is a blunt instrument and the quantitative thresholds being proposed risk capturing too many companies that, by their nature, do not have a material public interest. Rigid quantitative measures could also discourage growth as entrepreneurs will face a disincentive to grow their business and create jobs beyond these thresholds.

When thinking about the definition of a PIE, it's important to ask *why* an entity would be considered public interest. To properly consider this, the focus should not just be on size as other indicators of a genuine public interest could include: large pension schemes in deficit, the specific nature and activities of the company, or the company’s creditors or liquidity profile.

With regard to employees, we believe that the employee threshold being proposed under both options is too low and will result in a disproportionate number of entities. It fails to consider that the impact to employees of a company failure may be mitigated by subsequent restructuring or leveraged buyouts such that the failure might not have a material public interest. Furthermore, some employee services subsidiaries could be considered PIEs because they meet the employee threshold, but in reality these employees already work for other existing PIEs in the group.

Further consideration also needs to be given as to whether all PIE requirements should apply to all PIEs. If an appropriate expanded definition can be determined (see our comments above), for simplicity it would seem to make sense for all PIE requirements (current and proposed) to apply to all PIEs. This would make it easier for society to understand and avoid the creation of an expectation gap. However, this could lead to duplication and disproportionate effort where multiple PIEs are identified within a group. Clarification is, therefore, needed where there is more than one PIE in a group, how the individual requirements of a PIE should apply. Clarification is also needed of how the requirements would apply to PIEs that are subsidiaries of overseas parents that may already be subject to similar regulatory requirements. For example, the existing PIE regulations have resulted in situations where entities are subject to differing mandatory audit firm rotation requirements across an international group. An expanded PIE definition will make this more common.

Finally, to further ensure that the proposals are proportionate and do not lead to the UK becoming an unattractive place to do business, we believe that any expanded PIE definition should continue to apply the current dispensations available to private equity/venture capital structures which are themselves, or which control, OEPI entities. This would mean that such entities who invest in UK businesses are not themselves subject to restrictions as a result of their investment.

AIM companies

Any extension to the PIE definition should not impose a disproportionate burden on any entities brought into scope, whether it is to private companies, AIM companies or third sector entities (see below). Smaller AIM-listed entities, which are vital for UK growth, may be immature and, therefore, potentially cost and resource constrained. An extension of the restrictions and requirements of the UK PIE regime could impose a significant cost and administrative burden on these entities.

For simplicity, if the PIE definition is expanded for private companies, as discussed above, we suggest that the same threshold should be used for companies listed on AIM.

Third sector entities

Many third sector entities are subject to different regulatory requirements. For example, charities are regulated by the Charity Commission, providers of social housing are regulated by the Regulator of Social Housing and higher education entities are regulated by the Office for Students. Should the Government wish to improve the governance and reporting of third sector entities we believe that this should be done through reform of the applicable regulations.

Lloyd's Syndicates

We agree with the Government's view that expanding the PIE definition to include Lloyd's Syndicates would be disproportionate.

Impact on the audit market

It would be reasonable to expect that an expanded PIE definition will result in several additional audit firms undertaking PIE audits. The substantial incremental requirements associated with PIE audits need to be carefully considered to ensure that audit firms are equipped to address them to the requisite standards. Expanding the PIE definition is unlikely to be an effective lever to increase choice in the audit market and in fact has the potential to reduce the choice of auditor for companies, as a number of smaller audit firms may exit audits of entities caught by the new definition to avoid the additional regulatory scrutiny that comes with auditing PIEs. It could also drive disproportionate increases in overall costs of audit businesses, wage inflation and a "war" for talent.

Establishing the regulator (including strengthened powers of the regulator) (various sections)

If the strengthened corporate governance and audit regime is to work successfully, the regulator will need a clear remit to operate within. We support proposals for ARGA to have well-defined powers, underpinned by statute, and believe it is critical that there is appropriate independent oversight and accountability over the exercise of those powers. It is also essential that ARGA is set up to succeed: too many responsibilities, too early, could mean it is set up to fail. The UK business environment needs a regulator that has the appropriate capacity, works to clear principles and has a consistent approach to enforcement. The success of ARGA, in part, will be determined by its ability to both respond to the dynamic market environment and to drive improvement in audit quality and corporate governance.

In terms of the proposals in the Consultation, we believe ARGA should focus first on those proposals where it can have the most positive impact. Examples would be those we have expressed our support for above.

Very importantly, ARGA should position itself as an "improvement regulator" with a constructive approach to rules and enforcement (for directors and auditors alike). The FCA's "sandbox" concept whereby the regulator and business are able to work together to help companies understand and meet their regulatory requirements in a collaborative way is an approach we think the ARGA could mirror. Our experience has been that there is a reluctance by the FRC to provide formal advice or views on emerging accounting and auditing areas, for example, Cryptocurrencies.

It is important to note that, with a number of existing regimes in place (including FCA Listing Rules, FCA Disclosure Guidance and Transparency Rules and Market Abuse Regulation), there is potential for parallel investigations, duplication between the role of regulators and an overly complex combination of regimes, particularly in the listed company space. Careful consideration will be needed as to how the various regulatory regimes are to work together, and it will be important to ensure that duplication and complexity are avoided. As the proposals have the potential to increase overlapping powers, the need to ensure alignment between regulators will become even more important and will need to be managed to support effective regulation. We support the publication of the Memoranda Of Understanding (MOU) which is to be established between ARGA and the FCA (as is the case now with the MOU between the FRC and the FCA). To minimise the impact of overlapping powers and the risk of unintended consequences, the new MOU will need to be clear in terms of the roles, responsibilities and cooperation between the regulators, with clear criteria around the process to be followed in investigations.

Dividends and capital maintenance (2.2)

We believe that it is the right time to consider major change in this area and that the UK's capital maintenance regime should be subject to a more widespread review. We believe that the concept of capital maintenance should be based on the accounting rules actually applied by companies (i.e. IFRS or UK Accounting Standards, as appropriate), rather than being reliant on determining whether a profit is realised. But importantly this notion of capital maintenance needs to be underpinned by an explicit statutory obligation for a company to consider the impact of a proposed dividend on its solvency.

Should the Government decide not to pursue a more significant overhaul of the capital maintenance regime, we would nevertheless support actions that make it easier for company boards to identify whether transactions give rise to realised (and hence distributable) profits.

We do not support the introduction of a requirement to disclose the amount of a company's distributable reserves. We are unconvinced that disclosure of a single number which reveals that a company could, in accordance with the Companies Act's requirements, distribute, say, £100 provides useful information, when the dividend proposed is only £10. There are also various factors that contribute to the determination of a company's dividend policy (such as availability of resources after taking account of existing and potential liabilities, M&A activity, capital adequacy requirements, bank loan covenants, etc.) and these cannot be captured in the disclosure of a single number. We are also unconvinced that disclosure of a company's total distributable profits does anything to protect the interests of creditors, which is the principal objective of the capital maintenance rules under both the Companies Act and common law.

Attempting to disclose a group's distribution capacity would, in nearly all cases, be even more difficult. Even in a group of exclusively UK companies, aggregating the distributable profits positions of these companies would be unlikely to give a satisfactory result, and risks misleading rather than informing the reader.

While the proposed requirement for an explicit directors' statement about the legality of dividends and their effect on the future solvency of a company does little more than confirm existing legal obligations with which companies and their directors must comply, we support the proposal as a means of focusing the attention of boards and building stakeholder confidence.

Shareholder engagement with the audit (7.3)

We support the proposal to establish a formal mechanism for the audit committee to gather shareholder views on the auditor's audit plan and, overall, greater dialogue between auditors and shareholders. However, there are a number of areas we think need to be considered to make this increased engagement work effectively in practice.

Critically, in terms of the audit plan, we believe the auditor must retain the ability to exercise his or her professional judgement in determining the best approach to the audit. This will help ensure that individual shareholders who might provide input on areas of the audit that are burdensome, unnecessary or inappropriate do not unduly influence the audit, or the allocation of the audit team's resources, in areas that are not in the best interests of the company or its shareholders overall. Also, shareholders need to be willing and appropriately equipped to engage.

Our understanding from discussions with shareholders and investors is that, because of the number of companies they are invested in, they will engage when they have a concern but otherwise focus on other areas relevant to their investments. We suggest that more work needs to be done to understand how to provide the necessary tools and create an environment in which shareholders are incentivised to engage on audit matters in a meaningful way that helps audit committees and auditors understand their views.

Oversight and regulation of the actuarial profession (11.2)

We are broadly in favour of the direction set out in the proposals (i.e. the 5 principles for overseeing and regulating the actuarial profession), but have some significant questions regarding the scope and the details of application.

There are many fewer actuaries than auditors, but the breadth of objectives and types of actuarial work is great and members of the Institute & Faculty of Actuaries (IFoA) operate globally. Consequently, in our view ARGA's primary scope will need to be limited to actuaries working in UK regulated roles, or clearly defined roles with a specific UK public interest, all of which should require a practising certificate whether performed by a member of the IFoA or another body, such as a US actuary performing a regulated role in the UK.

The alternative risks IFoA members being replaced by unregulated individuals for many of the roles they currently perform, which would defeat the purpose of the proposals, damage the actuarial profession and work against the public interest.

The current standards for actuarial work are principles based, befitting the very wide range of services provided. We are not clear on the practical ramifications of making the standards legally binding, but we are concerned this may not be compatible with principles based standards. If the result is a move to standards which are more prescriptive and rules based then we do not believe this will be in the best interests of the actuarial profession or the users of actuarial advice.

It will be important to ensure that ARGA is appropriately resourced, allowing effective focus on the specific needs of the IFoA and actuaries in general. Measures formulated and implemented for the audit community are unlikely to be applicable to actuaries. There is a risk that actuarial issues will become overshadowed by much greater and more pervasive concerns relating to audit, corporate governance, and reporting.

Proposals we do not support

Market opening measures (managed shared audit) (8.1)

We understand the Government's aim to create more choice and resilience in the audit market. However, we do not support managed shared audits because, in our view, they could have an adverse impact on audit quality, and are likely to increase the cost of audits without securing commensurate benefits. In discussions that we have held with companies and non-executive directors over the past few months, we have observed a strong negative reaction, in part because of the increased cost involved, as well as the day-to-day practical challenges of managing multiple audit firms. Without the support of these communities, it's hard to see how this proposal could work. If the Government believes that there are too few audit market participants of scale, then tying them up in shared audit arrangements is likely to restrict choice further, especially when it is unclear whether the so-called "challenger" firms have the appetite to take on larger and more complex audit engagements.

We believe that the large company audit market is already changing and that more audit firms are beginning to compete successfully. Over recent years we have seen certain challenger firms compete successfully to win an increasing share of FTSE 350 and listed company audit mandates. In our view, the Government and the regulator should focus on supporting and maintaining the market changes that are already taking place.

In terms of increasing the resilience of the large company audit market, there are remedies, such as operational separation, that are already underway, and which have been designed, amongst other things, to increase the resilience of the largest audit firms. Also, the Audit Firm Governance Code, which is applied by the large audit firms, actually has the objective which those firms must regularly report against "to reduce the risk of firm failure, which in relation to the largest firms would be of systemic significance".

There are also a number of major practical difficulties with the proposed regime, including challenges with group structures that the Government itself recognises to some extent in it's Impact Assessment, which states that only 149 FTSE 350 companies are considered suitable for managed shared audit. There are also questions over the availability of suitable resources, primarily whether the challenger firms have or can recruit sufficient resources to take on up to 30% of the FTSE 350 audits (and potentially 100% of audits of Investment Trusts and other single legal entity audits).

An alternative approach

In our view, there are a number of other ways to drive increased choice and ultimately resilience in the large company statutory audit market, which, if brought together as a package of remedies, alongside the changes we are already seeing in the market as noted above, we believe would form a proposal which could be embraced by all parties.

- **Increasing choice through the Audit and Assurance Policy –** There has already been a shift in the FTSE 350 audit market as a result of recent regulatory changes and market sentiment. This has resulted in significant audit re-tendering and rotation, with an increased number of audits going to challenger firms. This level of change may be accelerated through the introduction of the Government's proposed Audit and Assurance Policy. We believe that this proposal will open the assurance market to the challenger firms, giving them more opportunities to build relationships and credibility with large company audit committees. We suggest that audit committees could consider having at least two external assurance suppliers included in their Audit and Assurance Policies, one of whom would be a challenger firm who would be given responsibility for a meaningful proportion of the assurance being commissioned. Some audit committees might choose to share the work involved in the financial statements audit under this approach, perhaps if their group structure made this practicable. Other audit committees might choose to carve out different areas of assurance and award those to a challenger firm. The key to this approach would be giving audit committees the responsibility to design a means of sharing the assurance effort in a way that was most appropriate for the company and ensured that high quality would be maintained.

- **Focusing on the role of audit committees –** The Government's proposal for minimum standards and increased scrutiny of FTSE 350 audit committees could include a specific requirement that FTSE 350 audit committees must give fair and explicit consideration to appointing a challenger firm as part of the audit tender process. Again, we believe this would help maintain and perhaps accelerate the change that is already taking place in this segment of the audit market.

- **Industry/sector specialisation –** The Government could focus on ways to help challenger firms make inroads into specific industries/ sectors where they could concentrate and grow a specialism, rather than taking such a broad view of the whole market.

Market share cap

We recognise that market share caps could lead to there being a greater number of audit firms appointed to audit the largest companies, as some of those companies would effectively be required to use challenger firms.

However, serious consideration would need to be given to the potential impact of such a remedy on the UK's competitiveness and attractiveness as a place to do business as having an auditor imposed on a company might make it rethink where it locates. Also, as we outlined in our response to the CMA's invitation to comment in 2018, we believe that there would be a number of significant issues involved in implementing such a cap, including making sure that audit quality and price are not adversely affected by the use of a cap, incentivising challenger firms to take up the audit appointments made available and ensuring that there is no "cherry-picking" from market participants – for example firms seeking to lose their highest risk and/or least profitable audits.

Because of these numerous issues, and because the imposition of a market share cap, by definition, would reduce choice of audit firm, we do not support the implementation of such an interventionist market remedy.

Fundamentally, as with the managed shared audit proposal, a market share cap will also not work unless there is clearly established appetite, capability and capacity in the challenger firms to audit the largest companies. Again, we would emphasise that an essential first step would be for the Government to establish that this appetite and capacity actually exists

The purpose of audit (auditors' responsibilities around wider information) (6.1)

We do not support the introduction of a statutory requirement for auditors to consider relevant director conduct and wider financial and other information, unless there is significantly more clarity about what this would involve.

It is proposed that statutory auditors should be required to consider "relevant director conduct" and "wider financial and other information" in reaching their judgements and that this would be a statutory requirement with detailed standards set by the regulator and enforceable against statutory auditors. The Government's expectations as to what constitutes "wider information" and "director conduct" are unclear and we do not support the introduction of a statutory requirement for auditors in this area without more consultation and significantly more clarity as to what might be considered "wider financial and other information" or "relevant director conduct".

A new professional body for corporate auditors (6.9)

Although we recognise that some elements of the proposal for a new professional body for corporate auditors may offer potential benefits, we do not support the establishment of such a body in the short to medium term.

We believe that a new professional body, as described in the Consultation, presents a significant risk of distraction, disruption and cost in order to be introduced effectively and with credibility. If this is attempted too quickly it may inadvertently fail to deliver its intended aim of improvements to the quality of audit and the attractiveness of the audit profession. The current UK model that encourages recruitment of diverse talent to develop skills within the accounting profession works well and makes a notable contribution to the UK labour market. Audit firms in the UK are leading recruiters of graduates and school leavers, and present an attractive option for young talent seeking to begin a broader career in business and finance. In addition, the rigour of the UK chartered accountancy qualifications is recognised and respected globally.

As a practical and realistic alternative, we believe that there are substantive improvements that can be made within the existing structures of the current UK professional bodies to improve the auditing profession. The specific question of a new professional body is one that we believe should be deferred and perhaps revisited in the future.

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