CFA Society
United Kingdom

8 July, 2021

The Rt. Hon. Kwasi Kwarteng MP
Secretary of State for Business, Energy & Industrial Secretary
Business, Energy & Industrial Strategy
1, Victoria Street
London, United Kingdom SW1H 0ET

Submitted by E-mail to: audit.consultation@beis.gov.uk

Dear Mr. Kwarteng,

CFA UK response to BEIS on their consultation on Restoring trust in audit and corporate governance

The CFA Society of the UK (CFA UK) welcomes the opportunity to support many of the proposals in this consultation (the "Consultation"). We have known for perhaps too long that the audit profession, its regulator and the audit market were in need of reform. The sheer scale of the exercise, reflected in the length of the Consultation, however, has limited the extent and pace of necessary changes.

By-and-large we support the government's approach as set out in the Consultation, including the majority of the detailed proposals. Along with other feedback endorsing this view, we would hope that the promised reforms will be implemented with some urgency under the new Audit, Reporting and Governance Authority.

CFA UK's mission is to help build a better investor profession for the ultimate benefit of society[1]. For the investment sector to do its job properly, it has to be able to rely on the accounts and corporate reporting it receives from the companies it invests in. As we said in our response to the Kingman Review in 2018:

> *"The investment profession relies on financial reporting. There can be no ambiguity on this point – investment professionals must be able to trust the financial reports that inform their investment decisions. It follows that the governance and regulation of the financial reporting industry has to be robust and that the auditing profession acts with integrity at all times."*

Access to robust, credible financial information about 'public interest entities' is important in maintaining a resilient economic and financial system. The public interest goes beyond the direct concerns of capital market participants, as is set out in section 172 of the UK Companies Act 2006, which states that directors should have regard to the business's impact on the environment, employees, suppliers and customers, and the communities in which they operate.

The replacement of the FRC with the ARGA is fundamental to the goal of restoring trust in business and audit, and in the regulator itself. The change in title from a council to an authority signals that this new statutory body should have the necessary powers not only to set standards but to enforce them and to hold those involved in corporate governance and audit to account.

[1] *A brief overview of both CFA UK and CFA Institute is provided in Appendix 1.*

The promotion of ethical standards for directors and other professionals within ARGA's remit is also a key part of the reforms. Higher personal and reporting standards will increase financial resilience generally and benefits will accrue to constituents outside those normally thought of as "investment professionals". This underpins the argument for extending the scope of the reforms to non-listed and non-commercial entities.

Our responses to the specific questions of the Consultation are provided in Appendix II. However, we thought it would be helpful to provide a short Executive Summary of the key points made within those detailed responses on the subjects most pertinent for investment.

Executive Summary

- **Scope**: we believe the UK government should define a PIE with a multi- and not a single-metric test that is not easily circumvented and is flexible enough to capture the dynamics of various business models ('employee-lite', 'balance-sheet lite' etc) prevalent in business today. In our view, implementation should be phased, as adding more than 1,000 additional PIEs will create capacity issues in the audit market. We do not think AIM-listed companies should automatically become PIEs.

- **Internal Controls**: we are strongly in favour of the adoption of a regime similar to Sarbanes-Oxley (SOX) in the US. Ultimately, such a regime will give both directors and investors greater confidence in and understanding of businesses, leading to a lower cost of capital. Whilst a large sum in its own right, we calculate that the estimated £2.3bn total cost over the next 10 years would represent less than half a basis point per annum (0.005%p.a.) on the £5.1 trillion market value of both the debt and equity of companies in the FTSE All-Share (and therefore excluding PIEs that are not listed). On this basis, arguments not to introduce such a reform on grounds of cost are clearly wide of the mark.

- **Dividends**: it is vitally important for investors to understand any constraints on dividend-paying capacity including limitations due to distributable reserves. Directors should already require this information before approving payment of a dividend (either intra-group up to a parent company or from the top-co out to shareholders). We agree that the regulator should have responsibility for defining distributable reserves, building on existing guidance and case law. It would need to take practicalities into account when deciding what should be done.

- **Resilience Statement**: we support both the replacement of the three-year Viability Statement with the proposed Resilience Statement and a longer, mandatory assessment period of five years. Requiring directors to consider matters listed in the recommendations will draw attention to their accountability for steps taken to strengthen the company's ability to survive adverse events. It will also help ensure that directors fulfil their responsibility to disclose all principal risks and existential threats. We endorse Brydon's suggestion that the Resilience Statement should have "a demonstrable link to the Risk Report," and agree with the inclusion of reverse stress testing scenarios.

- **Payment Practices:** we support the government's proposals but suggest they should be subject to a review for effectiveness after a few years. We would also welcome an additional requirement for companies to disclose their use of factoring and/or reverse factoring which can have the effect of masking the true extent of a company's financial liabilities.

- **Supervision of Corporate Reporting**: we support the government's proposals to increase ARGA's responsibilities in this specific area, namely to direct changes to reports and accounts, commission an expert review of an accounting application and publish correspondence relating to a CRR review. We also welcome the potential expansion of assurance to preliminary and interim results, and company presentations.

- **Enforcement against company directors:** we believe better use of existing powers should be made by a range of statutory bodies to properly punish directors for dishonest or negligent actions and misbehaviour. ARGA should also be invested with these same powers, enabling it to sanction directors as well as accountants.

- **Behavioural standards**: PIE directors should be required to act with honesty and integrity, and to have a duty of sincere cooperation with ARGA and other regulators. We believe ARGA would be well-served if it could introduce a regime of recognised (industry) codes of professional ethics for PIEs, similar to that recently introduced by the FCA for activities by regulated firms in markets outside its regulatory perimeter.

- **Audit Assurance Policy**: we are very supportive of this proposal from the government and hope it will foster greater engagement by investors on accounting issues. It should also raise the profile and importance of investors in the auditors' eyes and remind them that investors are their real client and not the company.

- **Corporate Auditor Profession:** we are of the view that establishing a distinct professional body for auditing will help ensure that the requirements of a refreshed and energised auditing profession are met. It would give the profession a new and redefined sense of purpose and ensure that audit professionals receive focused attention on their needs and recognition for achievements that encourage honesty, integrity and objectivity in the corporate world.

- **Shareholder Engagement:** we are supportive of proposals that will lead to improved shareholder engagement with companies on auditing issues. The precise mechanics of this are potentially complex and perhaps should be the subject of a further consultation. We have concerns about potential inside information leakage if conversations between auditors and investors are two-way, outside of the supervision of the Audit Committee and/or the company's investor relations professionals. We believe communication from investors to the auditor could be easily facilitated, as could the posing of questions to the auditor at the AGM.

- **Auditor Resignation/Dismissal**: existing Companies Act provisions are inadequate and we much prefer the line taken in the Brydon Review. In our eyes, the resignation or dismissal of an auditor should be assumed to be material, price sensitive news that requires immediate market disclosure with an abbreviated explanation (such as that provided in 7.3.14) as to why the appointment has been terminated.

- **Audit Market & Competition:** in their submission to the Brydon review[2], CFA Institute stated that audit quality, rather than providing a wider choice of auditor, is top of mind for investors. A wider choice that leads to more competition may encourage 'a race to the bottom' in terms of quality. We support the government's proposals to separate the audit arms from the other commercial businesses within accountancy groups.

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[2] Peters, Sandra J., Brydon Review response [letter to Sir Donald Brydon] (16 Aug. 2019) <https://www.cfainstitute.org/-/media/documents/comment-letter/2015-2019/20190816.ashx.

Thank you for considering our views. Should you have any questions or points of clarification regarding this letter, please contact Andrew Burton (aburton@cfauk.org) in the first instance.

Yours sincerely,

Will Goodhart
Chief Executive
CFA Society of the UK

Andrew Burton.
Professionalism Adviser
CFA Society of the UK

CFA UK set up a working group to respond to the Consultation. Its members were:

Jane Fuller, FSIP (Chair)
Oliver Gottlieb, CFA
Kunal Kothari, CFA
Andreea Lupea, CFA
Najia Mukhtar, CFA
Shane O'Rourke
Ben Reilly, CFA

Oversight of the submission was provided by CFA UK's Professionalism Steering Committee

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Appendix I: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behaviour in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.
- CFA Institute is planning to respond separately to this consultation.

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Appendix II: Responses to questions

Chapter 1 Approach (Q1-11)

Q1: Should large private companies be included within the definition of a Public Interest Entity (PIE)? Please give your reasons.

Yes. Please see Q1 of our earlier response to you in relation to mandatory TCFD reporting.[3]

Q2: What large private companies would you include in the PIE definition: Option 1, Option 2 or another? Please give your reasons.

In terms of the threshold itself, we agree reporting should be proportionate and concentrate initially on those companies that have (i) sizable operations, which make them a matter of public interest; and (ii) the ability and resources to be able to comply with the requirement.

CFA UK supports neither Option 1 nor Option 2:

- Option 1, based on the current threshold for the requirement to file a corporate governance report and the 'Wates principles' for private companies[4], immediately brings too many additional companies into scope for a new requirement with wide-ranging implications. It is unclear which of the two tests 'harvests' most of the 1,960 additional entities, but at first glance the £200m turnover figure for the second test looks low.
- Option 2 is based on the current 500-employee threshold for having to a produce non-financial information statement within the Strategic Report. Softened by the second additional turnover test, it captures 1,060 additional companies and seems to strike a better proportionate balance. However, we believe it could be too easily circumvented. We note that nowadays, with the opportunity to rapidly scale a business digitally, there is a wider range of business models. Some companies that might be considered large, or of public interest, might actually employ few staff.

If no other option were available, CFA UK would prefer Option 1, but suggest a phased implementation. Please see our response to question 11.

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[3] *As stated in our previous consultation response letter to you in relation to proposals on mandatory TCFD corporate reporting, we believe that collectively policy makers should seek to set the minimum bar for compliance with climate change disclosure requirements at the same level for all companies.*

Specifically, CFA UK does not wish to encourage companies to go private, or to avoid listing, or adopt some other ownership structure to avoid obligations like reporting under TCFD. Also, whether a company is listed, private or set up as a limited partnership is of no direct consequence to either its carbon footprint or its vulnerability to climate change. Many of our members invest in private equity and would welcome these disclosures, not least because public IPO is a key exit-option for many private equity investments.

Additionally, we would underline that, from an investment context, many climate change related risks cannot be diversified away and so become a systemic consideration applying to all companies. Hence, CFA UK believe that all companies should bear the responsibility of recording their contribution and vulnerability to those risks – subject to them meeting a minimum size threshold.

[4] ***Wates Corporate Governance Principles, 2018, p5**: https://www.frc.org.uk/getattachment/31dfb844-6d4b-4093-9bfe-19cee2c29cda/Wates-Corporate-Governance-Principles-for-LPC-Dec-2018.pdf*

We note the established precedents in the Companies Act 2006 for using an ‘any-two-from-three’ metric test to define both small (S.382 – <50 employees, <£10.2m turnover, <£5.1m balance sheet) and medium sized (S.465 – <250 employees, <£36m turnover, <£18m balance sheet) companies. It would, therefore, seem appropriate and logical for a PIE to be defined in a consistent way.

CFA UK suggests that the government seeks to structure a “two-from-three” metric test to define a PIE. This test should aim to capture a similar number of companies as under Option 2 but would have the benefits of (i) being internally consistent with other definitions in the Companies Act; (ii) reflecting the modern-day realities of digital businesses with low numbers of (or outsourced) employees; and (iii) not being easily circumvented by, for example, outsourcing labour to legal entities) outside the group.

Q3: Should AIM companies with market capitalisation exceeding €200m be included in the definition of a PIE? Please give your reasons.

No.

- Market capitalisation can be a volatile measure, particularly for small companies – far more so than employee numbers, turnover or balance sheet size: the AIM index fell 36% in one month during February/March last year, and many companies within it fell by more.
- The AIM market is specifically designed for those younger companies that seek the benefits of a public listing but wish to be free of some of the reporting requirements of the main market, although we note that some large companies also choose to list there for the same reasons.
- We note further that the investability of the AIM market also relies on constituents' AIM nominated advisors ("nomads") meeting their regulatory responsibilities to mitigate for these lower information reporting requirements.
- If the definition of a PIE is structured well, these companies will become PIEs once/if they grow to that size.

Q4: Should Government give newly listed companies a temporary exemption from some of the new reporting and attestation requirements being considered for Public Interest Entities?

Yes, if the temporary exemption is required because the company concerned is now listing and is not already a PIE and hence already required to meet them.

Q5: Should the Government seek to include Lloyd’s Syndicates in the definition of a PIE? Please give your reasons.

No comment.

Q6: Should the government seek to include large third sector entities as PIEs beyond those that would already be included in the definitions proposed for large companies? If so, what types of third sector entities should be included and why?

In principle, we believe the rules applying to commercial companies should apply equally to third-sector companies.

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***Q7:* What threshold for 'incoming resources' would you propose for the definition of 'large' for third sector entities? Is exceeding £100m too high, too low or just right?**

In principle, we believe the rules applying to commercial companies should apply equally to third-sector companies. We would not be in favour of a 'one-metric' test for the same reasons as provided in our response to question 2. The public interest test of many substantial third-sector entities may be better identified in their employee numbers or balance-sheets.

***Q8:* Should any other types of entity be classed as PIEs? Why should those entities be included?**

No comment.

***Q9:* How would an increase in the number of PIEs impact on the number of auditors in the PIE audit market?**

No comment.

***Q10:* Do you agree that the government should provide time for companies to prepare for the introduction of a new definition of PIE?**

Yes.

***Q11:* Do you agree that the Government should seek to offer a phased introduction for a new definition of PIE?**

Please see our response to question 2. If Option 1 were chosen, we have concerns about audit market capacity in the near-term, given the extent of the proposed reforms and a phased implementation period not adopted.

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Chapter 2: Directors' accountability for internal controls, dividends and capital maintenance

Stronger internal company controls

Q12:* *Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls?

Yes, we believe there is a strong case for strengthening the internal control frameworks for UK companies. The implementation of a similar regime under the US Sarbanes-Oxley Act (SOX) is generally perceived to have led to an improvement in the quality of control over key threats to accuracy and completeness of company financial statements and has rightly been used as the comparative benchmark in the Impact Assessment.

BENEFITS

From an investor perspective, given the centrality of the financial statements in determining the risk-benefit profile of a company, any reforms aimed at preserving and enhancing the integrity of financial reporting are welcome. While current guidance, such as the UK Corporate Governance Code and the Companies Act 2006, puts the onus on companies to have internal controls, we believe this has not provided a sufficient or consistent level of management focus on controls across UK companies. Reform is especially needed in the current environment of mistrust following recent accounting scandals and corporate failures, including Carillion and Thomas Cook Group.

A key difference between the proposed reforms and existing guidance is that the proposals would make company directors personally accountable for the effectiveness of controls. This would immediately direct management attention and resource towards an upfront and ongoing assessment of controls over financial reporting, to ensure these remain fit for purpose to mitigate key risks. Consequently, we fully agree with the benefits set out in the Impact Assessment, notably there should be a systematic improvement in the robustness of internal controls, reducing the risk of corporate failure and underpinning market stability, and thus enhancing investor confidence in UK business.

For companies the benefits of reassessing their internal controls are two-fold. Firstly, directors' statements and external auditor attestation (see our response to Q13) affirming the robustness of internal controls should raise confidence and attract investment, lowering the cost of capital. Secondly, the reforms present an opportunity to improve process efficiency, e.g. by automating repetitive controls, eliminating duplicate or non-key controls and building key control indicator dashboards to properly monitor the company's risk exposure and facilitate better management decision-making.

DISBENEFITS

A disbenefit of the reforms is the implementation costs for companies. The estimated range provided in the Impact Assessment is circa £1.5bn to £2.3bn over 10 years, with the biggest impact in the four-year transition period. However, we believe costs will ultimately be outweighed by the investor confidence – and with that a lower cost of capital – and wider public confidence, which benefits the UK's business environment as a whole.

Arguably, investment in re-evaluating the effectiveness of existing internal control frameworks is much needed in any case, given changes in key risks facing companies driven by new stakeholder imperatives such as ESG, digitisation and automation. There is an obvious need for risk and control frameworks to keep pace. If companies can demonstrate they have upscaled their risk management mechanisms, this should have a positive reputational impact, thus attracting investors while at the same time reducing the risk of financial loss and fraud.

Other non-monetised disbenefits mentioned in the Impact Assessment include a reduction in management focus on other non-financial risks (e.g. environmental & reputational). However, principal risk disclosures, new requirements for climate-related risk disclosures (e.g. under TCFD) and the proposed resilience statement should capture environmental risks and other as-yet unquantified risks, which should have a positive reputational impact. Overall, we feel that all key risks that affect a company's viability and commitments to stakeholders are interconnected and should be given due attention. Focusing on financial reporting controls does not preclude mitigation strategies for other types of risk, which could flesh out a range of issues affecting companies' risk profiles more broadly.

Finally, there may be a risk that UK listings drop due to the perceived regulatory burden. However, the reforms aim to increase investor confidence in individual companies and reduce the occurrence of corporate failure, thus attracting investment into the UK. Our position is corroborated by research suggesting that there was no significant decrease in the volume of large foreign firm listings on US stock exchanges in comparison to the London Stock Exchange after the enactment of Sarbanes-Oxley in 2002[5]. The same research suggests there may be a drop in the number of small companies listed on the LSE's Alternative Investment Market. In the case of smaller companies, please refer to our response to Q14 where we argue for a graduated approach with a focus on premium-listed PIEs in the first instance.

Q13:* *If the control framework were to be strengthened, would you support the Government's initial preferred option (Table 2)? Are there other options that you think Government should consider? Should external audit and assurance of the internal controls be mandatory?

We believe that emphasising the responsibility and accountability of a company's senior management and board for the effectiveness of internal controls and risk management is crucial to strengthening the framework. Tougher rules are needed to hold directors responsible for the accuracy of the financial statements.

The Government's proposed three options range from a directors' statement in the annual report to a fully vetted opinion from the external auditor as to the effectiveness of the company's internal controls. Only Option C is similar to the Sarbanes-Oxley Act in the US. We support implementation of the key Sarbanes-Oxley provisions. This would require directors of public companies to assess and report annually on the effectiveness of their company's internal control structure and procedures for financial reporting. The company's auditor would then be required to attest to and report on this assessment. ARGA needs to ensure that the regulation requires rigorous testing of the operational effectiveness of the controls. It would be a waste of money if this reform were not effective and there should be no risk of false assurance.

The £2.3bn cost (present value over 10 years) sounds high, but it is less than a tenth of a per cent of the £2.6tn market value of the FTSE All-Share. Arguably, since effective internal controls are just as important to providers of debt, a more appropriate benchmark is the £5.1tn enterprise value of the All-Share (making the cost less than 5bps). The estimated ongoing annual cost of £173.7m is less than 0.4bps. This is a small price to pay for improved internal controls and external attestation, and for a reduced risk of misstatements, misappropriation, corporate collapse and fraud.

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[5] **Piotroski, Joseph D., and Suraj Srinivasan. "Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings." Journal of Accounting Research, vol. 46, no. 2, 2008, pp. 383–425. JSTOR**, www.jstor.org/stable/40058099. Accessed 20 Apr. 2021.

While it is difficult to quantify the benefits of the SOX regime in the US, the Impact Assessment cites several of them (pars 571, 572 and 574). These include better prediction of financial performance (based on more reliable accounts) and a decrease in accounting fraud. It also aids regulatory scrutiny of both companies and audit firms. Among the wider benefits are: reduced cost of capital, improved capital allocation, better decision-making within companies and lower costs to society for corporate failure.

We believe that the day-to-day responsibility for a company's financial statements and internal controls over financial reporting lies firmly with the CEO and the CFO. These officers should acknowledge their responsibility for establishing and maintaining internal controls relating to financial reporting and that they have evaluated the effectiveness of these internal controls. To maintain collective responsibility, we support the model suggested on page 43 of the consultation: "A model encompassing a role for both the CEO and CFO and the board collectively could be designed under which the board could be required to consider and sign off an attestation by the CEO and CFO about the effectiveness of the internal control system."

External audit and assurance of internal controls over financial reporting should, we believe, be mandatory. It would enhance the accountability of the company directors and board members to users of accounts (improving their confidence in financial information), to the regulator and, ultimately, to the public, who have an interest in the honest operation of businesses and in fair and well-functioning capital markets.

Q14: If the framework were to be strengthened, which types of company should be within scope of the new requirements?

We support the implementation of a 'graduated approach', whereby the new requirements apply to premium listed companies, in the first instance, and then, potentially, would be extended to other PIEs later on.

Dividends & Capital Maintenance

Q15: Should the regulator have stronger responsibilities for defining what should be treated as realised profits and losses for the purposes of section 853 of the Companies Act 2006? Would you support either of the two options identified? Are there other options which should be considered? What should ARGA consider when determining what should be treated as realised profits and losses?

It is vitally important for investors to understand any constraints on dividend-paying capacity including limitations due to distributable reserves. As further set out in our answer to Q18, we welcome the work of the Financial Reporting Lab and support the recommendations of the Investment Association.

We agree that the regulator should have stronger responsibilities for defining what should be treated as realised profits and losses for the purposes of section 853 of the Companies Act 2006. Of the two options identified, we support the first - namely the creation of authoritative guidance rather than binding rules; we would interpret the latter as an unwelcome move toward a rules-based approach in UK corporate reporting. To an extent, the concept of 'realised', as interpreted by lawyers and the courts, has already promoted artificial structures designed to meet legal definitions rather than the underlying economics (e.g. 'cash box' transactions that create realised profits upon issuance of shares). Binding rules would risk increasing this artificiality.

We believe ARGA should build on the existing work of the ICAEW and ICAS and base the guidance on the accounting frameworks already in use. However, we are aware that there are areas of ambiguity within the current rules, especially in relation to intra-group transactions and fair-value gains and losses. These would need to be addressed before any disclosures could be prepared and so be of use. ARGA would need to carry out a separate consultation exercise on this due to the complexities involved.

There are other potential frameworks of rules that could be used. We support retaining a framework based on capital maintenance, but the necessary follow-on consultation should also include analysis and questions around the wider concept, including comparatives with other capital-maintenance-based jurisdictions.

***Q16**: Would the proposed new distributable profit reporting requirements provide useful information for investors and other users of accounts? Would the cost of preparing these disclosures be proportionate to the benefits? Should these requirements be limited to listed and AIM companies or extended to all PIEs?*

We believe that all information about constraints on dividend-paying capacity would provide useful information to investors. If new distributable reserve calculations and disclosures are to be required, however, it should only be to the extent that it is relevant to understand the constraints. Irrelevant information would just be clutter.

We note it is proposed that a 'not less than' figure should be permitted only when it is 'impossible to calculate the figure exactly'. We suggest that this be a permitted approach for all companies and could reduce the cost. ARGA will need to take practicalities into account when making its decision.

We note and agree that the government's proposals pertain only to the disclosures of the parent company of the group, but that any relevant information relating to subsidiaries' dividend-paying ability be also captured by commentary. This should help contain the cost of the new requirement and focus resource on the relevant areas.

We also note the argument that board directors (at all levels of a group) should already require this information before approving payment of a dividend (either intra-group up to a parent company or from the top-co out to shareholders). Therefore, the incremental cost of these new disclosure requirements should be limited.

This information would be useful for all companies where, as investors, we rely on financial statements to assess dividend-paying capacity. We believe that the requirements should apply to both fully listed and AIM companies (although not all companies that are listed or on AIM are UK incorporated, and the requirements will need to reflect that).

***Q17:** Would an explicit directors' statement about the legality of dividends and their effect on the future solvency of a company be effective in both ensuring that directors comply with their duties and in building external confidence in compliance with the dividend rules? Should these requirements be limited to listed and AIM companies or extended to all PIEs?*

There are already explicit rules about the legality of distributions. We are not convinced that a new requirement for an explicit directors' statement would be any more effective than simply enforcing the current rules. When the dividend payment is less than the disclosed reserves available for

distribution (as required under the new measures discussed in Q16), we would see an auditor's statement as unnecessary. However, if the payment from the topco were to exceed the disclosed distributable reserves figure (or the previous year's disclosed figure as a result of a restructuring of capital and reserves), then we believe an auditor's statement should be required.

Where illegal dividend payments have been made in the past, these have generally been part of much wider corporate and audit failings rather than an underlying cause. We note the wider proposals to give ARGA 'necessary powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors'[6]. We support these and believe that these wider enforcement powers, added to the new distributable reserves disclosures, will be more effective and appropriate than a narrowly focused new power.

To the extent that it is intended simply to increase the enforceability of current directors' duties, we would prefer a more direct approach as set out in answers to questions in Chapter 5.

Given that the mischief being aimed at is corporate failure, rather than just usefulness of information to investors, we do not see any reason why the requirements should not apply to all companies covered by the new wider definition of PIEs. This would ensure that it covers, for example, material subsidiaries of foreign groups and large private companies – protecting, among others, UK pensioners of those businesses.

Q18*: *Do you agree that the combination of recently introduced Companies Act section 172(1) reporting requirements along with encouragement from the investment community and ARGA will be enough to ensure that companies are sufficiently transparent about their distribution and capital allocation policies? Should a new reporting requirement be considered?

We welcome the work of the Financial Reporting Lab and support the recommendations of the Investment Association.

There are more constraints on a company's dividend-paying capacity than just distributable reserves. It is a Companies Act requirement only to pay dividends from distributable reserves, but this constraint applies to the legal entity only rather than the wider group. Listed companies are almost always part of a complex group in which the reserves situation in the parent entity may have little or no relationship to the circumstances of the wider group which it heads. We understand that, within complex groups, it is possible to 'create' distributable reserves in the parent company through internal corporate actions that do not change the fundamental economics of the group.

As such, information merely about legality of dividends is not enough. There are likely to be other considerations for dividend sustainability than the reserve situation within the parent company, which might include:

- regulatory capital requirements
- loan or bond covenants
- leverage: debt sustainability compared with e.g. EBITDA or net assets
- average debt levels and the high-low range
- risk appetite relating to holding company leverage
- commitments to pension fund trustees or pension regulators
- rating agency restrictions
- cash flow performance and forecasts

[6] 5.1.13

To make information on dividend-paying capacity more meaningful, we suggest that the recommendations of the Financial Reporting Lab are put on a statutory footing. The lab recommended that the board should disclose the company's dividend policy and that in so doing it should address the following overarching questions:

- Why this policy?
- What will the policy mean in practice?
- What are the risks and constraints associated with this policy?
- What was done in practice to deliver under the policy?

This is an area where the more proactive proposed approach of ARGA could result in real gains to investors. We recommend it be an area of focus for ARGA, which should engage with the investment community to discover (on a per-company or per-sector basis) what is thought to be useful. Using the proposed new powers this would likely to lead to significant improvements.

Stricter enforcement of existing rules on dividend distribution combined with better disclosure and the potential for ARGA to sanction directors would also improve incentives for directors to pay more attention to dividend-paying capacity and capital maintenance.

Chapter 3: New Corporate Reporting

Resilience statement

Q19: Do you agree that the above matters should be included by all companies in the Resilience Statement? If so, should they be addressed in the short- or medium-term sections of the Statement, or both? Should any other matters be addressed by all companies in the short- and medium-term sections of the Resilience Statement?

We agree that the short-term statement should incorporate companies' existing going concern statement. This includes disclosure of any material uncertainties considered by management during their going concern assessment, which were subsequently determined not to be material after the application of judgement and/or mitigating action. We note that such disclosures are currently required under international financial reporting standards in respect of the application of significant judgment.

A three-year term has become 'boilerplate' for the viability statement and we support both its replacement with the proposed Resilience Statement and a longer, mandatory assessment period of five years.

Existing and potential investors search for evidence of sustainable long-term value creation and transparent reporting on the resilience of future cash flows to inform their decision making. This includes sufficient and reliable information to understand both short and medium-term sensitivities to principal underlying risks. For example, to understand risk management strategies, investors want to know about any scenario analyses and/or stress testing models used to assess the probability of survival if risks materialise, along with a description of those risks and an explanation of any risk mitigation or acceptance.

Requiring directors to consider the matters listed in par 3.1.13 when preparing Resilience Statements will help address current weaknesses in reporting and draw attention to their accountability for steps taken to consider and strengthen their company's ability to survive adverse events. This will help ensure that directors fulfil their responsibility to disclose all principal risks and existential threats.

The first bullet point is applicable to all businesses: the Resilience Statement should capture "threats to liquidity, solvency and business continuity in response to a major disruptive event (such as a pandemic) which disrupts normal trading conditions". The second, on areas of significant business dependency such as supply chains, is also widely applicable. Some of the other points are addressed elsewhere, such as the sustainability of the company's dividend policy.

The Brydon report says: "The entire Resilience Statement would have a demonstrable link to the Risk Report." We endorse links to the Principal Risks and Uncertainties statement and we also agree with the inclusion of reverse stress testing scenarios in the Resilience Statement.

Retrospective assessments of the accuracy of information provided in prior Resilience Statements would be useful. This control could ensure the integrity of its preparation, implementation of resilience metrics and improvement over time.

There may be lessons from the PRA and FCA's requirements regarding operational resilience and third-party risk management. But while this might inform guidance, we would not recommend extending bank-style regulation wholesale to other sectors.

Q20: Should the Resilience Statement be a vehicle for TCFD reporting in whole or part?

We draw your attention to CFA UK's response (dated 5 May 2021) to the BEIS consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships. CFA UK has consistently encouraged policy makers to put in place a harmonised regime of climate-change disclosure obligations for all companies of a certain size, regardless of their ownership. It has also consistently advocated in favour of a speedy adoption of TCFD as the acknowledged global leading model for climate-related corporate reporting.

In principle, we welcome action by the Bank of England, the FCA and The Pensions Regulator to implement the UK government's 'roadmap towards mandatory climate-related disclosures', published in November. We note that this means that mandatory climate-related disclosures will be part of companies' reporting under both FCA listing rules (PS20/17) and BEIS regulation.

Our response of 5 May draws on a previous response to the FCA, which said that "not all of the 11 recommendations should be comply-or-explain and that 5 should be mandatory. Specifically, these are: i) Governance a), ii) Strategy a), iii) & iv) Risk Management a) & b) and v) Metrics & Targets a). We believe companies should be able to articulate the way they now perceive climate-change may impact their business and its markets in the future and, as a consequence, how they are beginning to govern, form strategy, risk manage and measure this."

CFA UK, therefore, supported the BEIS proposal that companies be "required to report against these same 5 recommendations (the first two in Risk Management and just the first in the other three categories), not through new but through existing statutory powers under the 2006 Companies Act".

We agree that the Strategic Report – in the principal risks and uncertainties section – is the best place for disclosure of climate-related information under the TCFD framework. These risk assessments should connect with numbers reported in the financial statements – in valuations, potential impairment of assets and decisions around asset lives, for example.

The most serious, or existential, threats would be escalated into the Resilience Statement, where additional disclosures including on stress tests would be most useful. This means that the Resilience Statement does not need to be a mandatory vehicle for TCFD reporting.

Q21: Do you agree with the proposed company coverage for the Resilience Statement, and the proposal to delay the introduction of the Statement in respect of non-premium listed PIEs for two years? Should recently listed companies be out of scope?

Yes, investors would welcome earlier adoption by premium listed companies followed by wider company coverage. Information on how a company manages principal risks/existential threats is of interest to a wide variety of stakeholders. For recently listed companies that were not previously defined as PIEs, the phase-in period should be a maximum of two years; no companies that would otherwise qualify should be permanently out of scope.

Audit & Assurance Policy

Q22: Do you agree with the proposed minimum content for the Audit and Assurance Policy? Should any other matters be addressed in the Policy by all companies in scope?

We support the concept of an Audit and Assurance Policy that provides a stronger framework for the audit committee's disclosures. It fits with the development of a 'wider audit' of information beyond that covered by the statutory audit of the financial statements and notes.

We welcome the opportunity for users of accounts to inform boards/audit committees about the areas they feel are most in need of external assurance. This will vary from sector to sector and between companies. This means it should be unnecessary to prescribe in regulation a long list of additional items that all companies should have audited. We support the user-informed approach referred to in Chapters 3 and 6 (6.2.6 and 7) of this consultation but have reservations about the detail.

Taking the bullet points in par 3.2.9 on minimum disclosures, we agree with the principle set out in the first: "An explanation of what independent assurance, if any, the company intends to obtain in the next three years in relation to the annual report and other company disclosures beyond required by statutory audit."

The point about the effectiveness of the company's internal controls framework has already been covered in our response to question 13, which is that we prefer Option C and that does entail external audit. Combined with the answer to Q12, this also covers the second bullet-point about a description of internal processes.

The policy on which services the company's auditor provides other than statutory audit should be set out clearly, as should the timetable for re-tendering the audit so that users of accounts can have an input into the selection criteria.

Regarding the Resilience Statement, the first part is covered by going concern requirements. Some companies may seek external assurance for the medium-term statement, or for parts of it such as stress tests. But this need not be a minimum requirement. The same applies to information ranging from carbon emissions to KPIs.

On alternative performance measures, we support the proposal in the IASB's exposure draft on the primary financial statements (general presentation and disclosures) that companies should be required to disclose information about management performance measures in the notes to the accounts, which means they would be audited. This is in addition to existing requirements to reconcile them to the statutory IFRS numbers.

We also agree with par 3.2.8 that assurance should be sought from bodies with the most relevant specialist knowledge and skills, i.e. not necessarily the statutory accounts auditors. The AAP would enable boards to explain their selection of external assurance providers – and allow users of accounts to suggest alternatives.

***Q23**: Should the Audit and Assurance Policy be published annually and subject to an annual advisory shareholder vote, or should it be published and voted on at least once every three years?*

It should be published and then voted on when it changes, or at least once every three years. Investors should have a formal opportunity to express concern about a lack of change as well as supporting the

evolution of the policy. We note that a 20% vote against would require the board to consider and respond to any objections. Giving shareholders a vote on remuneration has been effective in raising shareholder concerns and causing boards to rethink.

Brydon suggested that there should be an opportunity, before the audit committee has endorsed the AAP, for shareholders' views to be taken into account. In practice, shareholders would benefit from seeing a summary version of the AAP provided to the audit committee in order to make informed comment on it.

***Q24:* Do you agree with the proposed scope of coverage and method for implementing the Audit and Assurance Policy?**

We agree that the "consequences of unreliable reporting on matters of significant stakeholder and public interest can be as serious in the case of large private companies as with public companies". But we are also mindful of the need to avoid imposing additional regulatory burdens on relatively small and immature companies.

As well as the proposed phasing, we see no need for this to extend beyond the Companies Act 2006, section 414CA category which imposes NFR, or strategic reporting, requirements on companies with more than 500 employees.

Reporting on Payment Practices

***Q25:* In order to improve reporting on supplier payments, should larger companies be required to summarise their record on supplier payments over the previous 12 months as part of their annual Strategic Report (applying at a group level in the case of parent companies)? If so, what should the reporting summary include at a minimum? Do you have alternative suggestions on how to improve supplier payments reporting?**

We support the government's proposals in 3.3.5; we think its usefulness should be judged in an interim review.

***Q26*: To which companies should improvements in supplier payments reporting apply: companies which are PIEs and already report under the Payment Practices Reporting Duty, or PIEs with more than 500 employees?**

The Payment Practices Reporting Duty already applies to companies from medium size up (section 465 of the Companies Act 2006). However, they should also apply equally to third sector entities of equivalent size.

Reverse factoring has attracted attention in the UK because it is perceived to have played a part in obscuring the level of financial liabilities at Carillion before its collapse. We welcome the recent clarification by the interpretations committee of the International Accounting Standards Board on the presentation of these liabilities as trade payables or financial liabilities, emphasising that they should be presented separately when necessary to aid understanding of the company's financial position. It also gave some additional guidance on presentation in the cash flow statement and pointed to liquidity disclosure requirements under IFRS 7. This should help auditors (internal and external) and the FRC's corporate reporting inspectors to ensure that users of accounts are not misled about these liabilities.

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Some users of accounts remain uneasy, however.[7] [8] Because of timing issues, there is nervousness about the usefulness of information in the cash flow statement. We suggest that reverse factoring and receivables factoring should be explicitly disclosed in the annual report/payment practices statement in terms of the facility available and its utilisation. It would be helpful if the context for this – average debt level and high-low range over the period – were also reported so that any stresses and seasonality changes in the entity's overall financial position can be judged by users of accounts (see also answer to Q18 on dividend paying capacity).

Public Interest statement

Q27: Do you agree with the Government's proposal not to introduce a new statutory requirement at this time for directors to publish an annual public interest statement?

We note that the FRC recently consulted on the introduction of a new format of the company annual report and the creation of a Public Interest Report alongside the Business report and the Financial Statements[9]. Since the Public Interest Report is not a requirement at the current time, we are content to support the government's proposal not to introduce the statutory requirement for Public Interest Statement immediately.

However, if PIEs are to be required to produce a Public Interest Report then, surely as night follows day, they will be required to produce a Public Interest Statement within/at the front of it.

We would urge you to note that CFA UK responded to the FRC's consultation[10] and in doing so surveyed its members on the proposals. 82% of the respondents to the CFA UK membership survey agreed with FRC's proposal to split the corporate annual report into three separate documents and supported the creation of a Public Interest Report. As such, in the longer-term, CFA UK would support a statutory requirement on PIEs to produce a Public Interest Report and, within it, a Public Interest Statement.

[7] **European Finance Association Group letter to the IFRS Foundation 28.9.20:** https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F226%2FCL%2014%20-%20ICAEW%20-%20EFRAG%20DCL%20PFS%202019.pdf&AspxAutoDetectCookieSupport=1

[8] **Blog by Kazim Razvi, when director of financial reporting at CFA Institute**: https://blogs.cfainstitute.org/marketintegrity/2019/07/09/reverse-factoring-undisclosed-borrowing-to-smooth-operating-cashflows-volatility/

[9] **The Future of Financial Reporting**: https://www.frc.org.uk/news/october-2020/frc-publishes-future-of-corporate-reporting-discus

[10] **CFA UK Response to the FRC on the Future of Financial Reporting**: https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/future-of-corporate-reporting.pdf

Chapter 4: Supervision of Corporate Reporting

Q28: Do you have any comments on the Government's proposals for strengthening the regulator's corporate reporting review function set out in this chapter?

We welcome the following proposed powers, which would enable ARGA to:

- direct changes to reports and accounts;
- commission expert review of an accounting application; and
- publish correspondence from a CRR review.

We also support the proposal that the entire contents of the annual report should be brought within the CRR process.

We welcome work by the FRC and the FCA on the potential for strengthening supervision of a wider range of investor information, including preliminary results, interims and presentations to investors. Often pivotal information is included in these documents, not just for equity investors but for fixed investors around new issuances.

Chapter 5: Company Directors

Enforcement against company directors

Q29: *Are there any other arrangements the Government should consider to ensure that overlapping powers are managed effectively?*

Yes. The Government should require that ARGA establish memoranda of understanding with other relevant bodies, including the Insolvency Service, Companies House, SFO and National Crime Agency. In addition, there may be professional bodies outside accountancy (e.g. company secretaries) where coordination would be of value.

There should also be regular coordination between the bodies, as well as thematic discussions to ensure that differing expectations of roles do not lead to unexpected gaps in enforcement. The coordination should work both ways, and the Insolvency Service should be mandated to consider whether an ARGA or FCA report should result in criminal prosecution – or if not, why not. At present, there appears to be little enforcement when corporate scandals do not result in insolvency, which is not an acceptable situation for a high-quality corporate environment.

Companies House, the SFO, National Crime Agency and other bodies should be proactive in taking action against those responsible for financial crime, including against inappropriate nominee director arrangements, and those that trade through companies which are then dissolved without ever filing accounts. ARGA has a role to play in situations where those involved in such are also directors of PIEs. As elaborated on in our response to Q32 below, we believe ARGA would be well-served if it could introduce a regime of recognised codes similar to that recently introduced by the FCA for activities by regulated firms in markets outside of its regulatory perimeter[11] [12].

Q30: Are there any additional duties that you think should be in scope of the regulator's enforcement powers?

No, but it is important that all aspects of CA2006 section 386 (Duty to keep accounting records) are included, especially paragraph (5) in relation to subsidiary undertakings.

We welcome the proposal to cover those who are equivalent to directors at PIEs whatever their form (para 5.1.18). In addition, the Government should ensure that all requirements would apply to those exercising the responsibilities of directors (or equivalent) irrespective of whether they are recorded as such at Companies House or equivalent (i.e. 'shadow directors')[13].

Q31: Are there any existing or proposed directors' duties relating to corporate reporting and audit that you think should be specifically included or excluded from further elaboration for the purposes of the directors' enforcement regime?

No.

[11] https://www.fca.org.uk/about/recognised-industry-codes

[12] https://www.fca.org.uk/about/recognised-industry-codes-criteria-process

[13] A shadow director, as defined in section 251(1) of the Companies Act 2006, is: "a person in accordance with whose directions or instructions the directors of the company are accustomed to act".

***Q32**: Should directors of public interest entities (PIEs) be required to meet certain behavioural standards when carrying out their statutory duties relating to corporate reporting and audits? Should those standards be set by the regulator? What standards should directors have to meet in this context?*

Yes. PIE directors should be required to act with honesty and integrity. In addition, they should have a duty of sincere cooperation with ARGA and other relevant regulatory bodies. If a director is not willing to cooperate with investigation teams then they are not suitable to be a director of a PIE.

The standards should be set by the regulator, be subject to separate consultation and be regularly reviewed. To a very significant extent they can be based on what is already set out in the UK Corporate Governance Code. If Option 1 is chosen for the scope of PIEs, then all PIEs should already be subject to these requirements (or the Wates principles) on a comply-or-explain basis anyway. We would support this part of the UK Corporate Governance Code effectively becoming mandatory.

ARGA should also consider going one step further and adopting one of the FCA's recent reforms by mandating that each PIE has in place a code of professional ethics, either a standard one formulated by them, or one already established by a suitable body such as the IoD and approved by ARGA. This would mirror practice in many other professions, whereby breaches could lead to a company director's disqualification.

Just as the government proposes that directors' obligations specific to financial reporting should apply to all board members rather than just key individuals, regulators when exercising enforcement powers can apply the proportionality principle, taking into account each individual director's background and considering the size and complexity of the entity concerned.

The most important thing, at this juncture, and the essence of these reforms should be to rebuild the trust of investors and other stakeholders. If that can be achieved by putting best practice behaviour in place, then that can be a driver to attract the right kind of people into directors' role.

***Q33:** Should the Government's proposed enforcement powers be made available to the regulator in respect of breaches of directors' duties?*

Yes. ARGA should be provided with powers to gather information and investigate whether a director has breached a requirement and to impose sanctions in cases where a breach is found. The regime should provide a graduated range of civil sanctions that could be applied by the regulator. The civil standard of proof 'on the balance of probabilities' would apply when deciding disputed facts. Potential sanctions include reprimands, fines, orders to take action to mitigate the effect of a breach (or its recurrence), or to make declarations as to non-compliance. In the most serious of cases, there could be (temporary) prohibition on acting as a director of a public interest entity. Ultimately, the regulator would be required to apply sanctions in a proportionate manner according to the seriousness of the breach and risk posed by the director's conduct.

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Strengthening clawback and malus provisions in directors' remuneration arrangements

Q34:* *Are there other conditions that should be considered for the proposed minimum list of malus and clawback conditions? What legal and other considerations need to be taken into account to ensure that these conditions can be enforced in practice?

We believe that remuneration committees already have the necessary powers to adopt and enforce remuneration policies to ensure an adequate risk-reward balance, incentivise the right behaviour, eliminate the focus on short-term financial performance and so increase directors' accountability. Investors are increasingly engaging with remuneration committees and using their votes to push for outcomes that hold directors to account. There could be a role for ARGA in requiring the remuneration committee to revisit the policy or the awards where there are questions around the behaviour of the directors.

Chapter 6: Audit Purpose & Scope

Purpose

Q35: ***Do you agree that a new statutory requirement on auditors to consider wider information, amplified by detailed standards set out and enforced by the regulator, would help deliver the Government's aims to see audit become more trusted, more informative and hence more valuable to the UK?***

We agree that auditors should consider wider information than that obtained from the company in the course of the audit. International Standards on Auditing (ISAs) require auditors to obtain sufficient appropriate evidence, to take potential management bias into account, and to understand the entity's business model and risk, and its environment. While historically the emphasis has been on evidence obtained in the course of the audit, the latest revisions (e.g. ISA 540 on auditing accounting estimates) widen the perspective.

This has further to go and the FRC (ARGA in future) can and has proposed improvements to the UK versions of ISAs, such as ISA 240 on responsibilities relating to fraud. This consultation, following Brydon, rightly says that audits should be informed by external signals and consideration of director conduct, including whether any significant risks have been omitted from disclosures.

It is not clear that this needs to be a statutory requirement on auditors. Incentives for them to take wider information into account include the heavier sanctions being applied for failed audits and pressure to improve audit quality ratings. The FRC/ARGA is devoting much greater resources to supervision, its biggest single department.

If a combination of revised ISAs, more rigorous supervision and other proposed reforms to audit firm structure and practice do not result in improvements, ARGA could propose further remedies to BEIS.

Q36: ***In addition to any new statutory requirement on auditors to consider wider information, should a new purpose of audit be adopted by the regulator, or otherwise? How would you expect this to work?***

The objectives of audit are set out in ISA 200, the main point being: "To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error". Brydon proposed the following purpose, which we support:

"To help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements."

The point of these statements of principle is that they underpin the duties of both auditors and directors, and the regulator's duty to hold them to account.

Scope

Q37: ***Do you agree with the Government's approach of defining the wider auditing services which are subject to some oversight by the regulator via the Audit and Assurance Policy?***

See answer to Q22 on the AAP. Bearing in mind that this will extend audit well beyond the financial statements, it makes sense that the audit regulator's supervisory functions should extend to these

wider services and to those that provide them. The setting of audit standards is currently done at international level by the IAASB, which the FRC/ARGA should continue to influence. As users of accounts, we also support harmonised international standards, which aid cross-border investment decisions and corporate comparisons. This includes standards (ISA 600) governing component auditors.

FRC/ARGA's role already includes supervising group audits and their components. We note that other frameworks also exist for assurance of wider services, e.g. Service Organisation Control reports – independent assurance over the controls used by a third party designed to give stakeholders confidence. As noted in the answer to Q36, ARGA will also need to cover the wider assurance services commissioned under AAPs.

This is a complicated area and it would be helpful to users of accounts if ARGA would set out a) how it can apply existing standards to wider audit services and enforce them; b) where additional guidance is required for both auditors and other professional services firms carrying out assurance; and c) where it needs new powers. This may be the subject of a future consultation by ARGA.

Q38: ***Should the regulator's quality inspection regime for PIE audits be extended to corporate auditing? If not, how else should compliance with rules for wider audit services be assessed??***

Yes.

Q39: ***What role should ARGA have in regulating these wider auditing services? Should its role extend beyond setting, supervising and enforcing standards?***

See answer to Q38. The key is the function of the AAP (see answer to Q22), which is effectively an agreement between directors and shareholders. We are mindful that ARGA's immediate priority is to improve audit quality of the financial statements and of the annual report as a whole. In extending its jurisdiction for setting assurance standards, we would need to understand how ARGA would decide whether e.g. a carbon disclosure 'auditor' was credible. What sort of supervision regime could it run? Too rapid an expansion of its activities risks over-stretching its resources and skills.

ARGA and the UK more generally are not the only sources of laws and regulations governing the behaviour of companies and their directors. The FRC has historically been successful in influencing international standards on auditing, advocating for improvements while retaining alignment with international frameworks. In the longer term, ARGA (and the IAASB) will be setting standards for wider auditing services, just as the IFRS Foundation is expanding its remit by establishing an international sustainability standards board.

Proposals for a new corporate auditing profession are linked to the wider audit point. The body would include professionals who make key contributions to audit and assurance work but who are not accountants (see answers to Qs 48-51).

<u>Principles</u>

Q40: ***Would establishing new, enforceable principles of corporate auditing help to improve audit quality and achieve the Government's aims for audit? Do you agree that the principles suggested by the Brydon Review would be a good basis for the regulator to start from?***

Yes. See answer to Q36. These principles resemble the old Auditor's Code (issued by the Auditing Practices Board) that the FRC dropped because it felt that international standards on ethics (and other standards) covered all the bases. But there is merit in having a clear, concise summary that underpins auditors' duties and the regulator's ability to hold them to account. It is also important that audit service providers that are not statutory auditors are governed by the same principles.

Q41: Do you agree that new principles for all corporate auditors should be set by the regulator and that other applicable standards or requirements should be subject to those principles? What alternatives, mitigations or downsides should the Government consider?

Yes, but in the context of the international framework. It is important that ARGA works with other standard setters in the UK and internationally to avoid both conflicts and unnecessary duplication.

Tackling Fraud

Q42: Do you agree with the Government's proposed response to the package of reforms relating to fraud recommended by the Brydon Review? Please explain why.

As the consultation paper says (6.4.2), directors bear the primary responsibility for fraud prevention and detection. They have a duty to safeguard the company, its assets and its reputation, which includes taking steps to prevent both misappropriation and misstatements of accounts. We support the Government's proposal to legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud. We would note that fraud in its very nature often starts small, and, if undetected continues and grows. As such, it should be clear that directors are responsible for any and all fraud conducted within or by their business. Investors would value the additional assurance of an audit opinion on the directors' statement.

We welcome the FRC's tightening up of International Standard on Auditing (UK) 240: The auditor's responsibilities relating to fraud in an audit of financial statements. This makes clear the auditor's obligation to endeavour to detect fraud. Improvements to auditor education, notably by inculcating forensic skills, would also help. The FRC should use its influence to persuade the IAASB to incorporate these changes into ISA 240.

Fraud is the most commonly experienced crime in the UK, according to the National Crime Agency, which also estimates that fewer than 20% of incidents are reported. Whilst much relates to retail investment scams rather than corporate fraud we note that the Serious Fraud Office has had a patchy record in securing prosecutions. This suggests that fraud needs to be tackled much more effectively on every front in the UK, with companies and accountants/auditors playing an important part. Our answers to Q12-14 on strengthening internal controls are pertinent to this.

The need for auditors to be more proactive in identifying fraud is not limited to the UK. According to the Association of Certified Fraud Examiners (2020 'Report to the Nations'), financial statement fraud is the least common but most costly form of the crime, with a median loss of $954,000. One of the issues is that the amounts involved may fall below crude monetary measures of materiality, but qualitatively these acts of dishonesty are indicative of weaknesses – in internal controls or culture, for instance – that are highly relevant to stakeholders. Additionally, investors are aware of the behavioural incentive for companies that suffer fraud to try to hide it and so welcome effective audit countermeasures.

Auditor Reporting

Q43: ***Will the proposed duty to consider wider information be sufficient to encourage the more detailed consideration of i) risks and ii) director conduct, as set out in the section 172 statement? Please explain your answer.***

Yes, we believe the duty (which need not be statutory – see Q 35) will prompt improvements to the auditor's consideration of i) and ii). We will need to see how this is demonstrated in practice.

True & Fair View Requirement

Q44: ***Do you agree that auditors' judgements regarding the appropriateness of any departure from the financial reporting framework proposed by the directors should be informed by the proposed Principles of Corporate Auditing? What impact might this have on how both directors and auditors assess whether financial statements give a true and fair view?***

We are content with the current status of the true and fair view. We would naturally expect – and believe regulation already calls for this – that any departure from the financial framework or from individual rules should be disclosed and fully explained.

Audit of APMs and KPIs linked to Executive Remuneration

Q45: ***Do you agree that the need for specific assurance on APMs or KPIs, beyond the scope of the statutory audit, should be decided by companies and shareholders through the Audit and Assurance Policy process?***

See answer to *Q22*.

Auditor Liability

Q46: Why have companies generally not agreed LLAs with their statutory auditor? Have directors been concerned about being judged to be in breach of their duties by recommending an LLA? Or have other factors been more significant considerations for directors?

No comment.

Q47: ***Are auditors' concerns about their exposure to litigation likely to constrain audit innovation, such as more informative auditor reporting, the level of competition in the audit market (including new entrants) or auditors' willingness to embrace other proposals discussed in this consultation? If so, in what way and how might such obstacles be overcome?***

No comment.

A new professional body for corporate auditors

***Q48**: Do you agree that a new, distinct professional body for corporate auditors would help drive better audit? Please explain the reasons for your view.*

We believe it would be beneficial to establish a professional body for corporate auditors whose remit extends beyond that of the existing accountancy professional bodies. This body could cover the increasing range of entities that are involved in assurance, particularly of ESG issues.

We tend to agree with Brydon's recommendation that this will enhance the position of audit (statutory and corporate) as a distinct profession in a number of ways:

- producing relevant research and insights into key issues that are topical for auditors at any point in time;
- working with other relevant bodies (e.g. ARGA) to refresh and help embed a framework of principles and standards (e.g. ethical standards, minimum audit training and certification requirements etc.); and
- providing relevant professional training courses and materials.

Providing distinct opportunities for the development and recognition specific to auditing should help not only to draw in, but also to retain a larger number of capable professionals in the field of auditing.

Having a dedicated professional body for auditing should help ensure that the requirements of a refreshed and energised auditing profession, with a redefined purpose and scope of audit as previously discussed, is given the focussed attention and specific recognition it rightly deserves.

***Q49**: What would be the best way of establishing a new professional body for corporate auditors that helps deliver the Government's objectives for audit? What transitional arrangements would be needed for the new professional body to be successful?*

As noted by the government, the separation of audit and accountancy bodies would have an impact on the current designation of accountancy bodies as RQBs and RSBs for the auditing profession. However, we would expect that these arrangements could transition as part of the reform of the FRC as it becomes the ARGA.

It is likely that personnel and resources from existing bodies will move into new roles within the distinct professional body for auditing. In the transitional period, we would expect existing training, publication of insights etc. to continue.

We note that, in addition to the accountancy bodies, other professional bodies already cater to the training and certification requirements for wider corporate auditing (e.g. the Chartered Institute of Internal Auditors, the National Cyber Security Centre etc.) and these overlaps will need to be adequately disentangled, co-ordinated and aligned.

We would not expect the professional body for auditing initially to provide the full variety of specialist certifications and training that may be required for the expanded scope of corporate auditing. However, it may provide guidance and standards with regard to the minimum qualification/certification and ongoing professional training requirements in each of the key specialist areas (e.g. cyber security, data governance, climate risk).

Q50*: *Should corporate auditors be required to be members of, and to obtain qualifications from, professional bodies that are focused only on auditing?

Yes, we believe this would be helpful as discussed above. However, whilst we support the creation of a professional body that provides certification and training specifically focused on auditing, it may or may not be necessary also to have a specific professional qualification for auditors (who typically currently have accountancy and/or other relevant qualifications such as data security etc.) See our response to ***Q49*** above.

Q51: Do you agree that a new audit professional body should cover all corporate auditors, not just PIE auditors?

Yes, we agree. We are of the view that establishing a distinct professional body for auditing will enhance the skills and judgment of auditors and hence improve the quality of audit. We do not see why there should be a distinction between the quality of the audit provided to a PIE versus another company.

Moreover, many auditors will carry out work for PIEs as well as other entities and would need to be members of the new audit professional body in any case.

Chapter 7: Audit Committee Oversight & Engagement with Shareholders

Audit Committees – role & oversight

Q52: Do you agree that ARGA should be given the power to set additional requirements which will apply in relation to FTSE 350 audit committees?

Yes.

Q53: Would the proposed powers for ARGA go far enough to ensure effective compliance with these requirements? Is there anything further the Government would need to consider in taking forward this proposal?

No Comment.

Independent Auditor Appointment

Q54: Do you agree with Sir John Kingman's proposal to give the regulator the power to appoint auditors in specific, limited circumstances (i.e. when quality issues have been identified around the company's audit; when a company has parted with its auditor outside the normal rotation cycle; and when there has been a meaningful shareholder vote against an auditor appointment)?

No. We note the point made in par 7.2.5, so no further comment on *Q55-57*.

Shareholder Engagement with Audit

Q58: Do you agree with the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning? Are there further practical issues connected with the implementation of these proposals which should be considered?

Yes, we support the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning.

In terms of further practical issues to be considered, we would highlight the following:

- We believe that shareholder requests should be granted only to those entities or individuals who are invested in the company and who have voting rights.
- For the purposes of protecting sensitive information, there should be no non-public communication by the auditor to shareholders. We expect the audit committee to be the main conduit for investor engagement with audit planning. Shareholders with concerns that they do not believe are being adequately tackled by the board/management should have an opportunity to feed this to the auditor. This is for the purpose of raising red flags: we would advise against the auditor engaging in a discussion with shareholders at the planning stage.
- We believe that ARGA's engagement as outlined in 7.3.6 will be critical in the effective implementation of the proposals and we look forward to further consultation on these matters.

***Q59*: Do you agree with the proposed approach for ensuring greater audit committee chair and auditor participation at the AGM? How could this be improved?**

We do not agree with the proposed approach for ensuring greater audit committee chair and auditor participation at the AGM. We do not believe this proposal will lead to increased engagement.

We believe that these proposals can be improved by adopting the proposal outlined in the Brydon Review to require the senior auditor to attend the AGM and be prepared to answer questions through the addition of a standing item to AGM agendas: questions to the chair of the audit committee and to the auditor. This would, for instance, enable follow-up to questions raised in the planning process.

Q60: Do you believe that the existing Companies Act provisions covering the departure of an auditor from a PIE ensure adequate information is provided to shareholders about an auditor's departure? If you believe those provisions are inadequate, do you think that the Brydon Review recommendations will address concerns in this area? What else could be done to keep shareholders informed?

No, we do not believe that the existing Companies Act provisions ensure adequate information is provided to shareholders about an auditor's departure. We prefer the Brydon Review recommendations, which we believe will address our concerns in this area.

The resignation or dismissal of an auditor is material information and, therefore, should be made public along with the reasons for it. We do not see why this disclosure should not be immediate for quoted companies.

For private companies with bonds or other securities that trade on capital markets, prompt disclosure of an auditor's departure and the reasons for it are equally important. In many cases, the more concentrated ownership of private companies means that owners would tend to have immediate, direct knowledge of both the auditor's concerns and any problems with the relationship between the management and the auditor. Information about an auditor's departure is also of interest to other stakeholders, which suggests that it should be disclosed by PIEs as soon as possible.

CFA Society United Kingdom

Chapter 8: Competition, choice and resilience in the audit market

Introductory comment:
In previous submissions, we have stated that audit quality itself, rather than increasing the number of audit firms participating in the FTSE 350 market, is top of mind for investors. A wider choice that leads to more competition will not necessarily deliver better quality audits. The inability of investors – and other external stakeholders – to observe audit quality was rightly mentioned as an issue in the CMA's Audit Market Study. This highlights the importance of audit committee communication that links the choice of the best auditor(s) for the company to quality goals.

Market opening measures

Q61. Should the 'meaningful proportion' envisaged to be carried out by a Challenger be based on legal subsidiaries? How should the proportion be measured and what minimum percentage should be chosen under managed shared audit to encourage the most effective participation of Challenger firms and best increase choice?

No comment.

Q62. How could managed shared audit be designed to incentivise Challenger firms to invest in building their capability and capacity? What, if any, other measures, would be needed?

Before any changes, improvements must be made in how the work of each auditor would be communicated to investors. An opinion signed jointly by both firms, but not specific as to their responsibilities, would not be seen as an improvement and we opposed joint audit in submissions to the CMA. Shared audit, where one firm is appointed to lead the group audit and so bears overall liability (par 8.1.12), clarifies responsibility. However, the resulting duplication of effort, as the lead auditor checks the work of component auditors, is likely to increase cost while not necessarily improving audit quality.

In the US audit market, the PCAOB has introduced the reporting of work of other auditors to an audit engagement in the Auditor Search tool. In this tool, registered public accounting firms must report the percentage of audit work completed by other auditors on the engagement, including affiliated global network firms. If a shared audit regime is to be implemented in the UK, we advocate reporting similar to that in Auditor Search, if not on the face of the audit opinion.

In the context of shared audit, we see regulatory scrutiny of Audit Committees as the most likely way to improve audit quality by providing regulatory guardrails and improving communication with investors.

Q63: Do you have comments on the possible introduction in future of a managed market share cap, including on the outlined approach and principles? Are there other mechanisms that you think should be considered for introduction at a future date?

No comment.

Operational separation between audit and non-audit practices

Q64: Do you have any further comments on how the operational separation proposals should be designed, codified (in legislation and regulatory rules), and enforced in order to achieve the intended outcome of incentivising higher audit quality?

We note that the FRC is well advanced with providing guidance on these proposals and that audit firms have also taken considerable steps towards implementation. As investors, our primary concern is with audit quality and the implementation should be focused on this.

Q65: The Government proposes to require that all audit firms provide annual reports on their partner remuneration to the regulator. This will include pay, split of profits, and which audited entities they worked on. Do you have any comments on this approach?

We welcome the Government's proposals for separate profit and loss statements for audit practices. It is challenging to make any definitive conclusions without greater transparency on the profitability of each segment of the firm's business and related profit sharing.

To judge fee fairness relative to the disclosures in the auditor report and relative to peers, investors want greater detail and transparency on the economics and profitability of audit firms.

We support regulatory oversight of auditor remuneration designed to produce audit practices that provide incentives aligned with high-quality audits.

Q66: In the event that the Government wishes to go further than the existing operational split proposals in future and implement split profit pools in line with the CMA recommendation, do you have any comments on how these can be made to work effectively?

Any profit pool separation measures should be designed to promote pricing transparency.

Q67: The Government believes these proposals will meet its objectives. In the event that they prove insufficient to improve audit quality, and full separation of professional services firms is required, do you have any comments on how to make this work most effectively?

If the result were likely to be higher quality audits, investors would support an evidence-based decision for full structural separation.

Resilience of audit firms and the audit market

Q68: Do you have comments on the proposed measures? Are there any other measures the Government should consider taking forward to address the lack of resilience in the audit market?

We would support a regulatory plan for an orderly administration or liquidation of one of the firms – should red flags suggest it is necessary. Just as systemically important financial institutions must have a contingency plan, we believe it would be sensible to have such a framework in place for the audit industry. That said, we think firm partners should not be protected from loss of their partnership interests as we believe this risk provides an important behavioural incentive.

CFA Society United Kingdom

Chapter 9: Supervision of audit quality

Approval and registration of statutory auditors and PIEs

Q69: Do you agree with the Government's approach of allowing the FRC to reclaim the function of determining whether individuals and firms are eligible for appointment as statutory auditors of PIEs?

Yes.

Monitoring audit quality

Q70: What types of sensitive information within AQR reports on individual audits should be exempt from disclosure?

See our response to ***Q71***.

Q71: In addition to redacting sensitive information within AQR reports on individual audits, what other safeguards would be required to offer adequate protection to the entity being audited whilst maintaining co-operation with their auditors?

We recognise the trade-offs that might result from publishing AQR reports on individual audits, which in principle are likely to be of interest to users of accounts. Issues include delays to publication if there are arguments over sensitive material and potential inhibition of regulatory frankness.

We welcome the FRC's development of summary reports and believe that the power to publish without consent of the audited entity or the auditor should be part of the regulator's toolkit.

Regulating component audit work done outside the UK

Q72: Do you agree with the Government's approach to component audit work done outside the UK? How could it be improved?

Yes.

The application of legal professional privilege in the regulation of statutory audit

Q73: Do you agree that it is problematic if documents that the auditor reviewed as part of the audit are unavailable to the regulator because of the audited entity's legal professional privilege? If so, what could be done to solve or mitigate this issue while respecting the overall principle of legal professional privilege?

Yes. We agree that the regulator needs to be able to access the material on which an auditor has based its opinion (9.4.2). We also agree that any measures to address the problem would need to be targeted only at documents belonging to the audited entity that had already been shared with the auditor (9.4.6).

Chapter 10: A strengthened regulator

Establishing the regulator

The Government intends to legislate to give ARGA the following general objective which will apply when it is carrying out its policy-making functions:

> "to protect and promote the interests of investors, other users of corporate reporting and the wider public interest."

Q74: Do you agree with the proposed general objective for ARGA?

Yes, we agree with the proposed general objective and with the quality objective. We firmly believe that the quality objective should take precedence over the competition objective. Therefore, we do not agree with the following in 10.1.18: "the regulator may also need to promote effective competition where the importance of doing so may outweigh the need to promote quality".

Q75: Do you agree that ARGA should have regard to these regulatory principles when carrying out its policy-making functions? Are there any other regulatory principles which should be included?

We would expect the ARGA to follow the Regulator's Code.

Chapter 11: Additional changes in the regulator's responsibilities

Supervision: Accountants and their professional bodies

***Q76**: Should the scope of the regulator's oversight arrangements be initially confined to the chartered bodies and should they be required to comply with the arrangements?*

No comment.

Q77: What safeguards, if any, might be needed to ensure the power to compel compliance is used appropriately by the regulator?

No comment.

***Q78**: Should the regulator's enforcement powers initially be restricted to members of the professional accountancy bodies? Should the Government have the flexibility to extend the scope of these powers to other accountants, if evidence of an enforcement gap emerges in the future? What are your views on the suggested mechanisms for extending the scope of the enforcement powers to other accountants (if it is appropriate at a later stage?*

Where there is evidence of an enforcement gap, there would seem to be a strong case for having the scope to extend the regulator's powers. It is also important, as implied in 11.1.37, that the regulator should have the "power to compel third parties to provide relevant information required for an investigation".

Q79: Should the regulator be able to set and enforce a code of ethics which will apply to members of the chartered bodies in the course of professional activities? Should the regulator only be able to take action where a breach gives rise to issues affecting the public interest? What sanctions do you think should be available to the regulator?

Most professional bodies have codes of ethics and other standards of professional behaviour. The sanction for breaches includes exclusion from membership of those bodies, which should limit the individual's further engagement in activities that might harm the public. It might be helpful for the regulator to encourage standardisation; in any case, principles are often already similar.

Yes, the regulator should be able to take action where a breach affects the public interest.

Oversight & regulation of the actuarial profession

Q80-93: No comment.

CFA Society United Kingdom

Powers of the regulator in cases of serious concern

***Q94**: Are there others matters which PIE auditors should have to report to the regulator? Could this duty otherwise be improved to ensure that viability and other serious concerns are disclosed to the regulator in a timely way?*

If a crime is suspected, such as fraud, we would expect prompt reporting to the relevant authority. Another matter that we believe auditors should report to the regulator is when the PIE is withholding information essential to the audit, blocking attempts to investigate or failing to co-operate with the auditor.

Q95: Should auditors receive statutory protection from breach of duty claims in relation to relevant disclosures to the regulator? Would this encourage auditors to report viability and other concerns to the regulator?

Yes. Providing statutory protection for auditors of non-financial PIEs would extend a protection already available to those auditing FCA or PRA authorised. We believe this would encourage them to disclose serious concerns to the regulator.

***Q96**: How much time should be given to respond to a request for a rapid explanation?*

Responses to the regulator should be made with urgency.

Q97: Should the regulator be able to publish a summary of the expert reviewer's report where it considers it to be in the public interest?

Yes.

Q98: Are there any additional powers that you think the regulator should have available where an expert review identifies significant non-compliance by a company in relation to its corporate reporting and audits?

We would hope that existing and legislation and regulation, along with the reforms proposed in this consultation, would cover any misconduct identified by the expert review. We agree with the point made in 11.4.17 that giving the regulator much wider powers to intervene "would be a radical shift away from the UK's approach to corporate governance, in which best practice is encouraged through a principles-based approach and through disclosures to shareholders, rather than through regulation".

We support the current UK approach, but we believe that stricter enforcement of Company Law and other corporate regulations has a key part to play in tackling failings in corporate reporting and auditing.