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

1 July 2021

By email: audit.consultation@beis.gov.uk

Dear Secretary of State

Restoring trust in audit and corporate governance

Attached is the detailed submission by the Audit Committee Chairs' Independent Forum[1] ("ACCIF") in response to the UK Government's consultation document on the proposals for Restoring trust in audit and corporate governance, published in March 2021 by the Secretary of State for Business, Energy and Industrial Strategy. The submission focuses on those aspects of greatest relevance to Audit Committee Chairs ("ACCs"). ACCIF has been an active contributor to each of the three relevant reviews, the conclusions of which are consolidated in the document.

UK corporate governance is not broken (and nor is audit). In fact, it is highly respected and copied throughout the world. Requirements have progressively developed and evolved into the UK Corporate Governance Code (the "Code"), which sits alongside various legal responsibilities. While there are complexities, the overarching building block of the Code, namely "Comply or Explain", is well understood and respected and recognises that governance needs to be reflective of circumstances, which can be so wide and varied that it is not possible to define all situations in statute. ACCIF believes that this fundamental principle needs to be retained.

ACCIF Review Process

ACCIF formed a Steering Group of experienced ACCs to oversee and develop its response to the Government's proposals. The Steering Group identified the key areas that are of particular relevance to ACCs, with three of these being regarded as most significant. A questionnaire was prepared that invited responses from ACCIF members to the 30 questions in the consultation document relating to these key areas. There were over 50 completed questionnaires.

In addition, ACCIF has discussed the proposals in the consultation document with a wide range of stakeholder groups, including companies, investors, the FRC, government and

[1] ACCIF was formed in October 2015, has 178 members who sit on boards that represent 43% of the FTSE 100; one third of the FTSE 250; and many small caps, significant charities and public bodies.

auditors. The output from these discussions, together with the findings from the members' questionnaire, have been used by the Steering Group to develop our detailed response to the consultation document, which is attached.

The three areas identified by ACCIF members as being most significant to ACCs are the proposals relating to internal controls; the powers of ARGA and its regulation of directors and audit committees; and Managed Shared Audit ("MSA"). These were debated at a virtual ACCIF members' event to develop further the ACCIF response.

This transmittal letter sets out important overarching comments that ACCIF believes merit consideration to facilitate successful and proportionate achievement of the objectives of the proposals. Both the Steering Group and the ACCIF Board have approved this response.

The case for change

In your Foreword to the consultation document you stated "I want to ensure investors can get high-quality, focused and reliable information on UK companies so they can invest here with even greater confidence." ACCIF is totally aligned with this objective, and we agree with the principles that underlie the package of proposals. We agree that certain stakeholders lack confidence in elements of governance and question whether audit is functioning effectively. We accept that there is a desire to see a greater number of participants in the UK listed company audit market and that questions over audit quality, the level of engagement by investors in audit and reporting and the effectiveness of the regulator need to be addressed. We further acknowledge that there is scope to clarify the responsibility of directors and directors need to be seen to be taking responsibility for governance; blaming the auditors is in many cases not focusing on the root cause.

However, in its entirety the package of proposals is a disproportionate response to what has been, on all the evidence, a very small number of corporate failures related to either audit or corporate reporting.

Therefore, whilst a degree of change is necessary, it should not be at any cost. Our comments on the proposals:

- emphasise the need for proportionality and assess whether individual proposals are needed at all;
- consider the need for sufficient capacity within all parts of the governance eco-system (companies, investors, audit firms and the regulator) to absorb and deliver change; and
- recommend that proposals are implemented in phases so that the impact of the first phase can be assessed and, if necessary, adjustments made before moving to the next.

There are many aspects to proportionality. One critical area is equivalence and alignment. Many UK company Public Interest Entities are already subject to regulatory oversight in other jurisdictions and by other UK regimes. ACCIF believes that equivalence and alignment need to be designed in so that one process or attestation covers all substantively identical requirements.

As to the relationship between the resource impact of applying the proposals and the benefits they are expected to yield, when the final recommendations come forward, a

comparison with other capital markets needs to be undertaken in order to demonstrate that the additional requirements to be imposed on UK companies does not place UK PLC at a competitive disadvantage.

In order to achieve your stated objective there needs to be a measured approach to adoption and implementation over a number of years (and not just the next three or four). The risk is that the negative impacts of the proposals expand while the benefits become more difficult to capture. This will not be an easy undertaking to get right so that the UK remains attractive for investment.

Principles or Rules

Many of the current governance and audit-related responsibilities of directors and audit are embodied in the Code, which is built on the principle of 'comply or explain'.

The consultation document, understandably, seeks to clarify and in some cases extend director and audit committee responsibilities, by introducing new reporting requirements and applying an enforcement regime for all directors. However, it does not address the implications of the proposals for 'comply or explain', nor does it consider the implications that this will have for the design of regulatory oversight.

ACCIF believes that we need to continue to base UK governance on 'comply or explain' i.e. on principles not rules. This means that, for premium listed companies any detailed requirements (adapted as necessary for other Public Interest Entities) that flow from the proposals, e.g. on internal controls reporting, need to be designed into the architecture of the Code (and its broader remit) so that the integrity of the Code is retained while additional emphasis is placed on directors evidencing that their responsibilities are being fulfilled. ACCIF fully supports the proposals that would require directors to evidence the fulfilment of their responsibilities with regard to internal financial reporting controls.

Aligned to this, ARGA needs to be designed (and to therefore have the expertise necessary) to assess the adherence of directors to principles through the application of informed judgement and not by detailed box ticking.

Confidence in ARGA

The proposals will yield a new regulatory oversight regime for directors and audit committees for their responsibilities as they relate to governance and audit (and many will be subject to such oversight for the first time). ACCIF supports the formation of ARGA and recognises that ARGA should have oversight but with that comes responsibility too.

It is critical that the workings of ARGA are transparent, that independent and speedy appellate processes are built in and, overall, that the process of regulation is respected by and has the confidence of those it regulates. ARGA will need access to experience across a wide horizon if it is to successfully fulfil the role that is envisaged. ARGA will need to be thoughtful that shortcomings will be damaging to its reputation.

The consultation document understandably addresses ARGA's enforcement powers. It is disappointing, however, that it includes no discussion of proposals for ARGA to play an important role in sharing learning. Mistakes will not be eliminated, and corporate failure will certainly continue. Nevertheless, we will all perform our roles better if we can understand

how events have unfolded so that the learnings from them can be applied to our own circumstances. There will be more value to accrue to UK PLC, and its stakeholders, through continuous learning than through over-zealous enforcement.

Care also must be taken to ensure that the pursuit of regulation does not limit the diversity of those prepared to take on director and audit committee roles, just at a time when discernible progress is being made in this regard. It is also in all of our interests that those who already participate positively as directors will wish to continue to do so.

Audit quality

The consultation document does not tackle the definition of audit quality. This is a fundamental gap in the proposals as, until all interested parties are talking the same language and the regulator is assessing this, difficulty will persist. ACCIF is strongly of the view that the AQR reporting, which focusses on process, audit file contents and fault finding rather than outputs, needs to be fundamentally rethought.

Audit Market Participation

ACCIF has debated long and hard the proposals around Managed Shared Audit ('MSA'). We agree that there should be an intervention to tackle choice for the listed audit market and recognise that there will be a price to pay for this. But MSA is not the solution. We don't agree that the proposals will address audit quality or firm resilience. These require different mechanisms.

We consider that the MSA proposals are too complex and are not aligned to business organisation, operation and control structures and would prove too costly and inflexible for any benefit that might accrue. Far better to step back and define the outcome we are trying to achieve and over what timescale, then design a market share cap mechanism that can be monitored at, say, five year intervals: a well-designed mechanism should enable market forces to play their part over time to achieve the desired outcome of greater competition, although it has to be recognized that significant change will take a decade or more. The aim should be to achieve meaningful market shares for all participants that have the intent, capability, and capacity to perform in the industry sectors they serve. Quality should not be compromised, and it need not be.

We are naïve if we think we hold the solution to the resilience of the 'Big Four' audit firms in the UK. These are international businesses. If a problem was to arise with the UK operations, it would be the international business that determines the outcome. We should focus on what we can achieve effectively within the UK environment.

Investor Engagement

Audit and governance are essential elements of the framework for reporting on performance to investors. ACCIF agrees with the underlying thrust of the proposals that engagement with investors needs to improve. Various efforts have been made to achieve this over the past few years, including the introduction of expanded reporting by audit committees. The take-up of these changes in facilitating effective engagement has been minimal and there is a reluctance on the part of ACCs to expend more energy in this direction without confidence that investors will engage.

Several ideas have been put forward in the consultation document. ACCIF's view is that we should seek simplicity and build the ideas into one mechanism, namely the Audit and Assurance Policy ("AAP") and that this should be set out in the Annual Report and Accounts. This should not be subject to a voting regime. Rather its effectiveness as an engagement mechanism should be assessed after five years. Clarification will be needed so that the AAP (forward-looking) sits alongside the Audit Committee Report (backward-looking).

It needs to be recognised that not all investors are committing sufficient resources to take an informed engagement role. Those that do are to be commended. Much reliance is placed on proxy advisers who largely follow a tick-box approach. ARGA will need to be watchful in this regard as, if shareholder engagement is not based on an informed view of a company's specific circumstances (and consequently a tick- box approach is adopted), any potential for value through engagement will be lost and companies will have been subject to additional burden and cost with little benefit.

Roadmap and timeline – a priority

There is a real need for significantly greater momentum. It is clear that most of the proposals are currently concepts, not yet supported by any application guidance. For companies, detailed guidelines on the precise scope and operation of each reform will be critical. If the proposed reform is to succeed the crucial next step must be, therefore, the development of a comprehensive roadmap with clear timelines (including for the establishment of ARGA) followed by detailed guidelines soon thereafter and long before legislation or regulatory reform is to be implemented. A number of the proposals are inter-related and will need to be progressed together.

The development of the guidelines, which will be a significant undertaking, must involve the key stakeholders. A significantly extended timetable before the detailed proposals are developed will undermine the momentum and perceived necessity for change.

Conclusion

These are wide-ranging proposals. ACCIF supports the overall objective of the proposals and many of the proposed reforms but also believes that not all are needed to achieve the Government's objective. Some others should be modified. We should build on the many good aspects of UK corporate governance and be able to demonstrate that all adopted proposals will be applied proportionately and with a view to a measurable outcome.

ACCIF remains committed to supporting the achievement of the Government's objective and stands ready to assist in developing application guidance on any of the proposals that are taken forward.

Should you have any questions in relation to this submission, please contact me (jocklennox@gmail.com) and we can organise a call or meeting.

Yours sincerely

Jock Lennox – Chairman
On behalf of the ACCIF board

Members of the ACCIF Steering Group (and **their ACC roles** and board memberships**)**

Lucinda Bell	**Man Group, Derwent,** Crest Nicholson and member of the Advisory Board to Sir John Kingman's review of the FRC
Margaret Ewing	**ITV, International Airlines Group** and **ConvaTec Group** and member of the Advisory Board to Sir Donald Brydon's review into the quality and effectiveness of audit
Byron Grote	**Anglo American, Tesco** and Standard Chartered
Simon Henry	**Rio Tinto, Ministry of Defence,** PetroChina and Harbour Energy
Carl Hughes	**EnQuest** and **En+ Group**
Chris Jones	**Santander UK, LGIM** and Wellcome Trust
Rachel Kentleton	**Persimmon, Trustpilot Group** and Birmingham University
Jock Lennox (Chair)	**Barratt Developments** and Johnson Service Group
David Lindsell	**Cancer Research UK** (formerly **Drax** and **Premier Oil**)
Clare Thompson	**BUPA** and **M&G**
Kevin Thompson	**Spirax-Sarco Engineering** and **Great Ormond Street Hospital Charity**

Our detailed response to the consultation document focuses on the aspects of greatest relevance to audit committees. Those aspects are as follows:

Introductory note: The relationship between the proposals and the UK Corporate Governance Code

1. Stronger internal controls
2. The Resilience Statement
3. The Audit & Assurance Policy
4. Regulatory oversight of directors' duties
5. The purpose and scope of audit
6. Directors' responsibilities in relation to fraud
7. Regulatory oversight of audit committees
8. Shareholder engagement on risk and audit planning
9. Managed shared audit
10. The monitoring of audit quality
11. The role and powers of ARGA

To assist in the preparation of our response to the consultation document, the Steering Group invited ACCIF members to complete a detailed questionnaire. The questionnaire sought views on all the questions that we address below. 50 audit committee chairs completed the questionnaire and our responses to the questions take account of their views. Although the views they expressed were their own and not those of the companies of which they are audit committee chairs, the 50 are the audit committee chairs at 20 FTSE 100 companies, 35 FTSE 250 companies and 59 other companies. We have also held discussions with stakeholders – drawn from investors, companies, audit firms, the FRC and government - and considered their perspectives on the proposals in formulating our views.

Introductory note: The relationship between the proposals and the UK Corporate Governance Code

For almost 30 years, corporate governance practice in the UK has been governed by the UK Corporate Governance Code (the Code). The Code has been extremely effective in improving the quality of corporate governance in the UK and has been influential in the development of corporate governance elsewhere as well. It has successfully promoted high standards of corporate governance over many years through the concept of 'comply or explain'. As the FRC recently stated, "The Code offers flexibility through its 'comply or explain' approach, which is designed to encourage companies to develop governance processes and practices that are the most suitable for their particular circumstances and to report them in a meaningful way" [2].

The proposals in the consultation document step into the territory of the Code. These include the requirement for a directors' statement on the effectiveness of internal controls, additional audit committee responsibilities, behavioural standards of directors and the Resilience Statement.

To the extent that statutory compliance requirements, backed up by regulatory sanctions for non-compliance, are applied in areas currently covered by the Code, the continued application of the Code's 'comply or explain' approach could be threatened if not made redundant. In this regard, in some areas the consultation document proposes that Code

[2] FRC "Improving the quality of 'comply or explain' reporting", February 2021

might be used as a vehicle for guidance on compliance with new statutory requirements. This can only mean that the requirements will be backed up by detailed rules, in which case, in the absence of safeguards, regulatory enforcement of such requirements and rules would undoubtedly discourage companies from developing "governance processes and practices that are the most suitable for their particular circumstances".

We strongly believe that the 'comply or explain' approach should be retained and that to this end, any new statutory or other regulatory requirements should allow – and ideally encourage - companies to develop governance practices and processes having regard to their particular circumstances. The Government should, therefore, explain what it sees as the future role and status of the Code in the light of the proposals in the consultation document and should make it clear that the 'comply or explain' approach is being retained.

DETAILED RESPONSE TO CONSULTATION QUESTIONS

1. Stronger internal 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?

An explicit directors' statement about the effectiveness of the internal controls will increase the focus on internal controls and is to be supported, providing that the scope of the required statement and additional work necessary to support it are proportionate.

1.1 There is widespread support among audit committee chairs for strengthening *the reporting requirements* relating to internal controls but audit committee chairs take issue with the implication in the consultation document that there is a general need to strengthen the internal control systems of large companies.

1.2 The consultation document says that confidence in company reporting has been eroded by "high-profile firm failures where weak internal controls and poor risk management have been evident"[3].

1.3 In our view, very few failures have been due to internal control weaknesses or audit failure, as opposed to a non-viable business model and/or poor judgement in decision-making. It is essential, however, that directors assess regularly and methodically the effectiveness of internal controls.

1.4 The principal disbenefit of the proposed stronger regulation of internal control reporting will be the incremental cost of the work required to support the directors' statement. This will depend on the scope of the internal controls to be covered by the statement and the framework and guidance on how to apply it in order to enable the statement to contain all the required disclosures.

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 the Government should consider? Should external audit and assurance of the internal controls be mandatory?

We strongly support the Government's initial preferred option as set out in Table 2 in the consultation document. Since the central purpose of the proposals in the consultation document is to reinforce the reliability of corporate reporting[4], it is appropriate for the scope of the directors' statement to be limited to internal controls over financial reporting, and audit committee chairs would strongly oppose any proposal for the scope of the directors' statement to be wider than this.

It is in our view essential that rather than providing "certification", the directors should, as stated in Table 2, explain the basis for their statement as to whether the system of internal

[3] Introduction to chapter 2
[4] See page 14 Executive Summary, "The need for reform"

control over financial reporting has operated effectively, by describing what they have done to assure themselves that the statement is appropriate.

No third-party assurance should be required in relation to the directors' statement; any decision to obtain external assurance should be made by the audit committee.

1.5 We support the proposal that the statement is made by the board collectively (as opposed to the board reporting that it has received a formal attestation by the CEO and CFO).

1.6 The proposals will require boards to apply a "benchmark or standard of effectiveness against which the internal controls were being assessed"[5]. Very few UK companies other than those which are registered with the US SEC currently apply such a benchmark or standard in order to report on the effectiveness of internal controls as required by the Code – which, furthermore, is required to "cover all material controls, including financial, operational and compliance controls"[6]. This review of "all material controls" rarely takes the form of a discrete in-depth exercise carried out solely for this purpose and usually involves reviewing the internal control assurance activities carried out as part of day-to-day operations during the period and any significant internal control weaknesses that have come to light. The proposal that directors should use a benchmark system to assess the effectiveness of internal controls over financial reporting will therefore increase the compliance burden on most companies. However, if the scope of a statutory framework-based review of controls were to extend to all controls or even all financial controls, it would result in a far greater additional financial and compliance burden on companies, especially smaller PIEs. Such a broad scope would also be far more extensive than the reporting requirements of the Sarbanes-Oxley Act in the US and any similar requirements in other countries.

1.7 The document discusses whether directors should be required to use specified standards or whether they should make their own choice and explain why their chosen approach is appropriate to the entity's business model, perhaps underpinned by guidance on, for example, the matters that boards should consider when deciding which standard(s) to adopt. In our view, which we believe is shared by investors and audit firms, consistency of approach by companies subject to this reporting requirement is highly desirable. The issue is how to develop guidance on the application of a framework that enables it to be applied appropriately and in a proportionate manner across different business models and sectors but that is also sufficiently prescriptive to ensure consistency of approach and in the assessment of effectiveness (as well as in the identification of "deficiencies").

1.8 The best known and most comprehensive model used for testing and evaluating internal control and processes is the Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework and the COSO framework is generally

[5] Para 2.1.23
[6] Code Provision 29

applied by US companies as the basis for reporting management's assessment of internal controls as required by the Sarbanes-Oxley Act. However, it is widely believed that the application of the COSO framework would result in significantly more work and therefore a significantly greater compliance cost than would be necessary in most cases for the purpose of making the report as set out in Table 2. Moreover, if the COSO framework were to be generally applied for the purpose of the proposed directors' statement on the effectiveness of controls, it would be difficult to justify applying the framework in a different manner from the way it is applied for the purpose of complying with the Sarbanes-Oxley Act.

1.9 As the consultation document notes, the Audit Committee Chairs Independent Forum has developed a set of principles to support the proposed directors' statement[7] and would be pleased to assist the regulator, together with other interested parties, in developing appropriate guidance.

1.10 In our view, it should be possible to develop a framework based on the Listing Rule requirement for the directors of companies obtaining a premium listing in the UK to "have established procedures which provide a reasonable basis for them to make proper judgments on an ongoing basis as to the financial position and prospects of the applicant and its group"[8]. For the purpose of reporting on the effectiveness of internal controls over financial reporting, the framework would focus on the financial position aspects (and would therefore take account of forward-looking information to the extent that it is used to determine components of the financial statements). This would have the advantage of building on existing UK practice but would be less onerous than applying the COSO framework. Directors of UK companies that are subject to the requirements of the Sarbanes-Oxley Act would be able to identify the COSO framework as the benchmark system they have used to make their assessment of the effectiveness of internal controls over financial reporting.

1.11 The effectiveness statement would be required to disclose "deficiencies" that have been identified, and Table 2 also refers to "a serious and demonstrable failure of internal controls" and "material control weaknesses". These terms will need to be explained as the scope of the review of internal control effectiveness must be set by reference to the significance of deficiencies or weaknesses that would require the statement on effectiveness to be qualified.

1.12 Most audit committee chairs are of the view that no third-party assurance should be required in relation to the directors' statement (although several consider that material weaknesses in internal control over financial reporting should be detected by an effective audit of the financial statements) and that any decision to obtain external assurance should be made by the audit committee. In this regard, it is essential that rather than providing "certification", the directors should, as stated in Table 2 in the consultation document, explain the basis for their statement as to whether the system of internal control over financial reporting has operated

[7] Para 2.1.27
[8] Listing Rule 8.4.2(4)

effectively, by describing what they have done to assure themselves that the statement is appropriate.

1.13 However, UK companies that are SEC registrants might well choose to have their external auditor provide assurance since the auditor will have to perform the work required for this purpose in order to make their attestation report as required by the Sarbanes-Oxley Act. Some audit committee chairs are of the view that, party as a result of this, peer pressure would be applied on large groups to have external assurance. Others think it likely that their audit committee would be likely to seek external assurance on the internal controls effectiveness statement, particularly in the light of the proposed extension to all directors of the regulator's enforcement powers in relation to breaches of corporate reporting and audit-related responsibilities.

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

We agree that the new requirements should apply initially to premium listed companies and extended to other PIEs after two years.

1.14 We agree that the new requirements should apply initially to premium listed companies and extended to other PIEs after two years. In our view the requirements should not apply to a PIE that is a subsidiary of a UK-incorporated parent company, as the subsidiary will be covered by the statement in the parent's annual report, and the requirements should not apply to a UK subsidiary of an overseas-incorporated parent company which is subject to requirements that are determined by the regulator to be "equivalent" to UK internal control effectiveness reports.

1.15 We can see no justification for temporary exemptions for newly listed companies as, in order to obtain their listing, they must have met the requirements of LR 8.4.2(4), and the Listing Rule effectively requires directors to continue to maintain the procedures concerned.

2 The Resilience Statement

Q19 Do you agree that the above matters should be included by 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?

Although directors should be encouraged to consider the significance of each of the six matters in relation to the resilience of the company, they should not be required to include them in the Resilience Statement. The matters discussed in the Resilience Statement should be those the directors believe are the most relevant and material in relation to the resilience of their particular business.

2.1 In our view, if the inclusion in the Resilience Statement of specific matters were to be mandatory, it would almost certainly result in significant parts of the Resilience Statement becoming boilerplate – and all the more so if the same matters were required to be included in both the short- and the medium-term sections of the Statement. Companies are required to discuss their principal risks in their annual report and their risk framework should inform their Resilience Statement. It would be helpful if guidance on the implementation of the Resilience Statement were to suggest that directors should assess whether the significance of the risks associated with each of the six matters could threaten the viability of the company in the foreseeable future but it should be for the directors to decide which matters, on this basis, should be discussed in the Resilience Statement. Climate change, for example, is unlikely to represent a risk to a company's resilience within one year for many companies, and business investment needs within one year may not be significant.

2.2 Mandating the inclusion of specific matters might result in risks of greater relevance to some companies and/or in some circumstances being understated (or being thought by users to be less significant than is in fact the case) or even omitted.

2.3 The list of issues that the document suggests the Resilience Statement might be required to address includes threats arising from a major disruptive event such as a pandemic. The practicality of this proposal requires careful consideration. Firstly, the steps a company would need to take to continue as a going concern in the face of "a major disruptive event" would depend entirely on the nature of the event and the effect the particular event had on the company. In the case of COVID-19, prior to the pandemic and even well after it began it was impossible to foresee reliably what effect it would have on any individual company or even on the economy as a whole. One of the most significant disruptive events in the relatively recent past was the BP Deepwater Horizon well blow-out and oil spill. Even though oil spill risk arises directly from the business activity of an oil exploration company, BP could not have foreseen with any degree of reliability the likelihood that it would occur or what the effect of it would be on the company – indeed, the overall effect did not become clear until well after the event occurred. In our view, there would be no value to users in requiring companies to speculate about the impact on their resilience of possible so-called "black swan" events. It would have been more fruitful had the document discussed how the Resilience Statement relates to the discussion of principal risks and uncertainties in the annual report and whether a specific requirement to link the two should be developed.

2.4 We agree that reverse stress testing should be encouraged but are not convinced that a very brief explanation of reverse stress testing that has been carried out will provide information that is helpful to users of the annual report.

2.5 Views were expressed to the Brydon Review that "the current going concern assessment sets the bar too high for directors having to disclose any 'material uncertainties' relating to a company's ability to continue as a going concern, by allowing proposed mitigating action to be taken into account"[9] and concluded that material uncertainties should be disclosed "by reference to the Risk Report and, importantly, before any mitigating action"[10]. The consultation document arguably goes even further by proposing that the short-term section of the Resilience Statement (setting aside the fact that the Resilience Statement is to be made by the directors and not "management" as stated in the document) should include "disclosure of any material uncertainties considered by management during their going concern assessment, which were subsequently determined not to be material after the use of significant judgement and/or the introduction of mitigating action"[11].

2.6 It is necessary to keep in mind that only material uncertainties that would threaten the continued existence of a company as a going concern need to be considered. In order to make a judgement that a future event or change in conditions represents a "material uncertainty", the directors must first assess the potential impact of the event or change on the going concern status of the company, and the likelihood of it occurring. They must then assess the extent to which mitigating actions are readily identifiable, available and practicable. In our view it makes no sense to report something as a "material uncertainty" when, if it actually threatens to arise, it will definitely be either avoided or mitigated to the extent that it will not affect the company's ability to continue in operation as a going concern. In fact, such an item is not a "material uncertainty" at all. Accordingly, we do not support the proposal that material uncertainties should be disclosed in the going concern section of the Resilience Statement before any mitigating action.

2.7 Although the FRC *'Guidance on Risk Management Internal Control and Related Financial and Business Reporting'* points out that under section 463 of the Companies Act 2006 directors are only liable to the company if they knew that the statements were untrue or misleading or if they knew that the omission was a dishonest concealment of a material fact, there may be a case for a stronger safe harbour regime for Resilience Statements.

The proposed mandatory assessment period of five years

It is astonishing that the consultation document does not include any consultation question on what is the most controversial proposal in the document regarding the Resilience Statement, namely the proposed mandatory assessment period of five years. In our view, the length of the assessment period should be a matter for the directors to determine based on the appropriate business planning horizon of their business. The period should be a minimum of three years and the directors should justify their decision.

[9] Brydon Report para 18.0.4
[10] Brydon Report para 18.1.3.1
[11] Para 3.1.10

2.8 The document acknowledges that "most companies prepare viability statements on a three-year forward look"[12]. In fact it is more than "most" companies; it is the vast majority. There is no doubt that companies select a three-year assessment period for the purpose of their viability statement because it aligns with their business planning. The reason a particular business planning period is used for a business is that the reliability of projections beyond the timeframe selected, and in particular of assessments of the likelihood and impact of risks to the business, declines sharply. Whilst a longer period may be possible in some sectors, such as infrastructure-related businesses, even their ability to predict reliably the factors that might affect their resilience reduces significantly beyond three years ahead. The fundamental issue is that by definition the range of possible outcomes widens the further ahead one looks and the range is likely to be significantly greater in some sectors than in others. Retailing, for example, struggles with reliability even over three years. The length of the assessment period should therefore be a matter for the directors to determine, subject to a minimum of three years, and they should justify their decision.

2.9 This is not to say that companies should give no consideration to their future beyond three years ahead – it is likely that their corporate strategy will consider a longer period than three years – but identifying changes in the business environment to which they will need to respond in order to maintain resilience inevitably involves a high level of speculation, such that any assessment of longer term resilience is inherently unreliable and lengthy explanations of the limitations of the usefulness of published information would need to be provided. Further, if a mandatory assessment period of five years were to be introduced, the directors of companies whose business planning timeframe is, for sound reasons, less than five years could not be expected to state that they have a reasonable expectation that the company will continue to operate and meet its liabilities as they fall due over the assessment period, as is currently required by the provision 31 of the Code.

The long-term section of the Resilience Statement

We are sceptical about the usefulness of information that could be disclosed in the third part of the Resilience Statement that is recommended in the Brydon Report, i.e. "a statement from the directors about the long-term resilience of the business"[13].

2.10 The consultation document suggests that the long-term section of the Resilience Statement recommended in the Brydon Report "might include the impact of long-term changes in demographics, technology, consumer preferences and other identified trends on the company's long-term business model"[14]. In our view, little value is to be had from speculating about the impact on the company of socio-economic trends beyond five years in the future, the timing and impact of which are inherently highly uncertain and the response to them by the company concerned even more uncertain. The Brydon Report states "the directors would reference the sorts of threats that the company may face – climate change may provide a particularly good example – and describe either why they believe the company is resilient in the face of such threats or what processes are in place to enable the

[12] Para 3.1.8
[13] Brydon Report para 18.1.3.3
[14] Para 3.1.14

company to plan its reaction to these threats"[15]. However, for most companies, factors such as product life cycles and product innovation are likely to be more challenging issues than climate change but any description of "what processes are in place to enable the company to plan its reaction to these threats" is likely to be of little if any value.

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

In our view the Resilience Statement should not be used as a vehicle for TCFD reporting.

2.11 The purpose of the disclosures in annual reports recommended by the TCFD is "to help identify the information needed by investors, lenders, and insurance underwriters to appropriately assess and price climate-related risks and opportunities"[16] and consist of governance, strategy, risk management and metrics and targets. They are applicable to all companies and not only to companies for which climate change represents a significant threat to their resilience within the assessment period of the Statement, as the disclosures are not designed to highlight how resilient individual companies are to climate change risks.

2.12 Among the major unknown factors relating to the impact of client change on companies are the policies of governments, which are not consistent across the world, are evolving and therefore subject to change.

2.13 In these circumstances, an across-the-board requirement to address the impact of climate change in the Resilience Statement would be misplaced. A more appropriate place for TCFD information is the ESG report in the annual report, and duplication of information in the annual report should be avoided.

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?

We agree that the application of the Resilience Statement by non-premium listed companies should be deferred for two years. However, we do not agree that recently-listed companies should be out of scope, since resilience reporting is arguably more important in the case of these companies (which, having recently gone through a robust process to obtain a listing, should also find it relatively easy to prepare a Resilience Statement).

[15] Brydon Report para 18.1.3.3
[16] Ibid page iii

3 The Audit and 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 agree that the Audit and Assurance Policy should address all the matters listed in the consultation document but would go further: in our view the proposed minimum content should include details of planned internal audit activity. The Policy should distinguish clearly between information that will be subject to "audit" and information which will be subject to "assurance" and should explain the level of assurance that will be sought. (The use of the term "audit" is discussed in our response to Q37.)

3.1 In our view, as stated in the consultation document, the Audit and Assurance Policy should explain the assurance that the company intends to obtain in the next three years in relation to the annual report and other company disclosures beyond what is within the scope of the statutory audit. We agree that the Policy statement should address all the matters listed in the document. In order to manage expectations, however, it is essential that the Policy statement differentiates clearly between information that will be "audited" and information in respect of which "assurance" will be obtained and, in respect of the latter, the level of assurance that will be sought and whether the engagement concerned will be carried out in accordance with a generally accepted standard such as International Standard on Assurance Engagements (UK) 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information*.

3.2 The document proposes that the Policy should include "a description of the company's internal audit and assurance processes"[17]. In our view it should go further and include details of the programme of internal audit reviews planned for the next year and the provisional planned programmes for the following two years.

3.3 We do not think it would be appropriate for the Policy to refer to items or matters in respect of which the company does not intend to obtain any independent assurance.

3.4 The proposed minimum contents include an explanation of whether, and if so how, employee views have been taken into account in the formulation of the Plan. It is not clear to us why this is relevant to a Policy statement that is prepared in order to obtain feedback from shareholders. In any event, the level of interest of employees in and knowledge of audit and assurance matters is generally not high and we think the best way of seeking feedback on assurance requirements from employees is to do so as part of the wider employee engagement process and more specifically via employee engagement in the risk assessment process rather than via the Audit and Assurance Policy as a whole. In this regard, we note that each additional requirement that is imposed on companies will lead to a process and action for every entity that is subject the requirement, regardless of whether it adds value.

3.5 As noted above, it is important that the Policy explains clearly the level or degree of assurance that the company intends to seek. This may not be straightforward,

[17] Para 3.2.9

especially in such areas as ESG where there are no generally accepted assurance standards.

3.6 We note that the proposal that the Policy should cover a three-year period would enable a company to explain a multi-year cyclical approach to assurance in some areas, where relevant.

3.7 As is the case with other proposals in the document, no consideration is given to how the information in the Audit and Assurance Policy will overlap with or duplicate other information in the annual report, such as the audit committee report, and how the duplication is to be avoided (in this regard, see our response to Q23 below).

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

We agree that the Audit and Assurance Policy should be published annually but do not agree that it should be subject to an advisory shareholder vote, at least not at the outset. In our view, the Policy should be included in the annual report and accounts alongside the report of the audit committee.

3.8 While we agree that Brydon Report's recommendation that the Audit and Assurance Policy should be published annually, we are not convinced that the Audit and Assurance Policy would be successful in stimulating feedback from shareholders without a concerted campaign by companies and audit firms to stoke up interest in the Policy on the part of shareholders (noting that previous initiatives to arouse interest by asset managers in corporate reporting and audit, such as extended audit reports, have achieved little in this regard). Furthermore, echoing concerns referred to in the Brydon report about how well-qualified some investment managers may be to hold companies to account[18], many audit committee chairs question whether investors are sufficiently knowledgeable about the internal workings of companies to assess the need for or value of wider audit and assurance in specific areas. However, we accept the need to actively seek shareholder feedback.

3.9 We suggest, however, that rather than publish the Policy as a separate document, it is included in the annual report alongside the audit committee report. The audit committee report would provide the appropriate context for considering the Audit and Assurance Policy, the former being essentially backward-looking as regards assurance and the latter forward-looking. The timing would also be appropriate as shareholders would be able to put questions on the Policy to the company at or prior to the AGM.

3.10 In its report, the audit committee should be required to describe what they have done over the previous year to encourage and facilitate engagement with shareholders, and to discuss the matters raised by shareholders and the audit committee's response.

3.11 With regard to whether the Policy should be subject to an advisory vote, in our view it should not. A comparison of this proposal with the shareholder advisory vote on the Directors' Remuneration Report is instructive. The required contents of the

[18] Brydon Report para 8.3.4

Directors' Remuneration Report are factual (as opposed to judgemental or selective) in nature and are specified in Companies Act regulations. This results in consistent disclosures by individual companies from year to year and as between companies. The Report sets out in some detail the context in which remuneration committees make decisions regarding directors' remuneration. The subject matter of the Report is the remuneration of directors, which is a defined and, ultimately, quantitative, item. An Audit and Assurance Policy, by contrast, is by its nature selective and could not (other than at very great length) explain the context in which decisions about obtaining independent assurance are made and certainly could not discuss all areas in which the directors do not plan to obtain any such assurance.

3.12 For the outcome of a shareholder vote to be relevant and reliable, the information about the issue to be voted on must be sufficiently complete and must provide relevant information about the surrounding context. The shareholders must also be sufficiently knowledgeable about the subject matter concerned to enable them to make an informed judgement on the issue. We do not believe that either of these criteria would be met in the case of the Audit and Assurance Policy.

3.13 Until such time as practice is developed with regard to the Audit and Assurance Policy, in our view it would not be appropriate to make the Policy the subject of an advisory shareholder vote. In this connection, we are also concerned that if the Policy were to be subject to a shareholder vote, asset management firms might develop a house policy on how they will vote rather than base their vote on an informed analysis of individual policies that takes account of the particular circumstances of the company concerned. More concerning still is the likelihood that asset management firms would farm out voting decisions to proxy firms, who have no fiduciary duty to shareholders and no stake in the companies, and also that special interest groups would try to use the vote to advance their special interests.

Q24 Do you agree with the proposed scope of coverage and method for implementing the AAP?

We agree with the proposed scope of coverage and phased introduction of the AAP.

4 Regulatory oversight of directors' duties

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

No. Far from suggesting that the regulator's enforcement powers should be wider in scope than is proposed in the consultation document, we are concerned that the proposed powers could result in replacing the "comply or explain" approach to reporting on corporate governance matters in the UK with a statute-based "comply or be penalised" approach that, moreover, places too much power in the hands of the regulator.

4.1 The proposed new enforcement powers are very significant and the initiatives proposed in the consultation document will substantially expand the corporate governance processes and reporting-associated outputs in respect of which the regulator will monitor and enforce compliance. Far from suggesting that the regulator's enforcement powers should be wider in scope than is proposed in the consultation document, we are concerned that the proposed powers could result in replacing the "comply or explain" approach to reporting on corporate governance matters in the UK with a statute-based "comply or be penalised" approach that, moreover, places too much power in the hands of the regulator.

4.2 We agree that "where new statutory duties for directors are introduced into the regulatory regime for which the regulator is responsible, it should be able to enforce those duties under this regime"[19]. Our concern, however, is that the proposals include new statutory duties for directors that we do not believe are justified, such as the proposed additional requirements for audit committees.

4.3 The document states that the statutory duties relating to corporate reporting and audit may require further elaboration to provide greater clarity and certainty in order to enable the regulator to enforce them[20]. This is rather disturbing as it is surely the wrong way round – if greater clarity and certainty is required, it should be provided primarily in order to enable directors to understand how to fulfil their statutory duties. This is an example of the focus the consultation document places on the enforcement powers of the regulator and the lack of consideration given to the role of the regulator in fostering improvements in corporate governance and audit through the sharing of relevant information and 'lessons learnt'. In this regard it is surprising that three major reviews have been conducted and this entire consultation document prepared and published before any detailed and objective analysis has been made publicly available about the collapse of Carillion which, more than any other factor, caused all these reviews to be commissioned.

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 purpose of the directors' enforcement regime?

No but we are concerned the regulator will 1. Interpret the law; 2. Identify breaches of the law on the basis of its interpretation; and 3. Impose penalties for those breaches. It is of great concern that the document gives no indication of any checks and balances that will apply to the regulator in relation to the operation of the directors' enforcement regime.

[19] Para 5.1.22
[20] Para 5.1.23

A related and equally important issue is whether the "detailed requirements" will be broad principles or specific rules. We would prefer broad principles but such an approach can only be acceptable to those who are being regulated if they have confidence in the regulator to apply the requirements in a well-informed, proportionate and competent manner. We have no means of knowing whether that will be the case.

4.4 No but we are concerned as a matter of principle that, by giving the regulator the power to impose "more detailed requirements as to how certain statutory duties relating to corporate reporting and audit are to be met by directors" (a phrase we distrust because such requirements will interpret the law), the regulator will 1. Interpret the law; 2. Identify breaches of the law on the basis of its interpretation; and 3. Impose penalties for breaches (and therefore, as one audit committee chair has put it, will be parliament, police and judiciary). It is of great concern that the document gives no indication of any checks and balances that will apply to the regulator in relation to the operation of the directors' enforcement regime (see response to Q33).

4.5 A related and equally important issue is whether the "detailed requirements" will be broad principles or specific rules. We would prefer broad principles but such an approach can only be acceptable to those who are being regulated if they have confidence in the regulator to apply the requirements in a well-informed, proportionate and competent manner. This in turn requires the regulator to be led and managed by people who are peers of those they are regulating. This has not previously been the case with the FRC, which has based its modus operandi on monitoring compliance with a vast body of extremely detailed rules in the form of accounting standards, company law regulations and, in the case of auditors, auditing standards. We are aware that staff numbers at the FRC have been greatly increased and will continue to increase. Our concern, however, relates not to the volume of resource but to its quality, i.e. relevant experience and expertise. In this regard, we would urge the regulator to make use of expert advisory groups to support the regulator. Such advisory groups would need to be seen to have some real impact rather than sprinkling holy water on the regulator.

4.6 With regard to the duty to keep adequate accounting records, whether or not the regulator articulates what is required to comply with this requirement it will need to explain how the requirement relates to the directors' responsibilities for internal controls discussed in chapter 2 of the document.

Q32 Should directors of public interest entities 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?

We do not believe that the document makes the case for this proposal properly and we trust that there will be further consultation on how this proposal should be taken forward before any action is taken to implement it.

4.7 The justification given in the consultation document for the proposal that directors should be required to meet certain behavioural standards when carrying out their corporate reporting and audit duties seems weak – a layman would surely consider that the duties of directors to "exercise independent judgement….reasonable care,

skill, and diligence" and to avoid conflicts of interest could not be met by a director who acted dishonestly or lacked integrity. Principle B of the Code includes the statement "All directors must act with integrity, lead by example and promote the desired culture". Since the proposals will effectively bring other aspects of the Code into the enforcement regime, the proposal to introduce behavioural standards into the enforcement regime is not surprising.

4.8 However, we do not believe that the consultation document makes the case for this proposal properly and we trust that there will be further consultation on how this proposal should be taken forward before any action is taken to implement it. For example, a code of professional conduct similar in nature to the Senior Managers Conduct and Certification Regime might be considered rather than relying on abstract concepts such as integrity.

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

We agree with this proposal in principle provided that appropriate checks and balances are in place in order to constrain what would otherwise be an all-powerful regulator.

4.9 Although audit committee chairs agree with this proposal in principle, many have told us that their agreement is conditional on there being in place appropriate checks and balances in order to constrain a regulator who would otherwise be judge, jury and executioner. The checks and balances need to include the following:

- Appropriate controls to prevent conflicts of interest within the regulator
- Clear and detailed explanation of all requirements relating to directors and how compliance will be measured or assessed in each case by the regulator
- Details of the circumstances that would cause the regulator to believe that there is a breach of duties
- Details of the procedures the regulator will follow when it appears to the regulator that directors may have breached their duties relating to corporate reporting or audit
- Detailed explanation of how the regulator will determine the relative severity of cases and the sanctions it will apply
- An independent appeal process that is open and transparent so that any sanction process is seen to be fair
- Sanctions on directors to be determined on the civil standard of proof ("on the balance of probabilities")
- Proportionate sanctions to apply to all directors, including non-executive directors, but reflective of their specific roles and responsibilities

5 The purpose and scope of audit

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?

The document does not make the case for such a statutory duty: it does not explain what it means by "wider information", how this relates to the information that auditors are currently required by auditing standards to consider or, if that information needs to be expanded, why the matter could not be adequately dealt with by strengthening the relevant auditing standards.

5.1 The proposal to which this question relates is described in paragraph 6.1.10 of the consultation document as giving auditors "a specific responsibility to consider director conduct and wider financial or other information in reaching their judgements". It is said in the consultation document to be derived from the recommendations of the Brydon Review and "a judgement by the Review that not all auditors seem to be taking sufficient account of director conduct and wider financial or other information for their reports to be as informative and useful as they should ideally be"[21]. It is significant, however, that unlike almost all references in the consultation document to the Brydon Review, in this case no cross-reference to a specific statement in the Brydon Review report is given. The reason for this is that no such cross-reference is possible because no such judgement is expressed in the Brydon Review.

5.2 Contrary to what is implied in the consultation document, the Brydon review expresses no view whether auditors are "taking sufficient account of director conduct" and it is of concern that BEIS believes it is entitled to attribute to others judgements that they have not in fact expressed. Therefore, if the Government wishes to impose an explicit requirement on auditors to assess director conduct during their statutory audit, it has an obligation to explain exactly what it is proposing in terms of how auditors should be expected to go about making the assessment, including the sources of the evidence they would be required to use for that purpose. In this connection, we note that the auditing standard *ISA(UK) 540 Auditing Accounting Estimates and Disclosures* discusses how indicators of management bias should be identified and addressed by auditors. Before rushing to the conclusion that a responsibility for auditors to "consider relevant director conduct" needs to be enshrined in statute, the Government should consider the relevant existing requirements on auditing standards and explain, if the Government believes it to be the case, why the matter could not be adequately dealt with by strengthening the relevant auditing standards.

5.3 Similarly, the consultation document does not describe the nature or scope of the "wider financial or other information" which auditors would be required by law to consider. It is of great concern that the Government feels able to propose such a significant (and uniquely UK) statutory extension of the responsibilities of auditors without any discussion of how auditors would be expected to discharge the responsibility. In this case, there is at least a clue in the Brydon Review to what the

[21] Brydon Report para 6.1.2

Government may have in mind. The Review report recommends that "there should be an obligation on the auditors to report to both the audit committee and the shareholders on the extent to which their work has been influenced and informed (or not) by any external signals which might imply enhanced risk in the company whose financial statements are being audited"[22]. The Review lists 16 examples of "possible signals" such as extent of short selling, negative analyst report on viability, extended late payments and so on. If this is what constitutes the "wider financial or other information" referred to in the consultation document, we support the proposal to require auditors to consider such information and how it should affect their work but we do not understand why it could not be implemented by strengthening the relevant auditing standards rather than by imposing a separate statutory requirement (which in our view would be disproportionate). In this regard, we note that paragraph A5 of *ISA(UK) 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* refers to audit risk assessment procedures and gives as an example "reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications".

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?

In our view, the stated purpose of audit recommended by the Brydon Report, on which this question is based, is flawed. The purpose of an audit must continue to be to provide an independent opinion on the truth and fairness of financial statements based on a process of check and challenge of the information in them.

5.4 Whilst we support the intention underlying the purpose of audit that the Brydon Review recommends is adopted by the regulator, in our view the stated purpose as recommended by the Brydon Review and which the consultation document states that the Government is minded to ask the regulator to adopt is in fact not the purpose of audit but a desired consequence or outcome of an audit or, as the consultation paper describes it, "a broad ambition"[23]. The purpose of an audit is an independent opinion on the truth and fairness of financial statements. It is based on a process of check and challenge of information that is intended to be communicated to relevant third parties. This must remain the stated purpose of audit. However, we support the Government's proposal to adopt the Brydon Review's proposed "purpose" as a broad ambition for the Government's programme reforms and, importantly, for the regulator on a continuing basis. In view of the Government's proposal, we would have expected this "purpose" to be included in ARGA's objectives and regulatory principles as set out in paragraph 10.1.12 of the consultation document, certainly in relation to its oversight of audit but it could also be adapted to cover financial reporting as a whole. The objectives and principles set out in paragraph 10.1.12 relate largely to activity and not to achievement and the inclusion of an outcome-related objective would seem to be appropriate as it would provide an appropriate basis for assessing the effectiveness of the regulator.

[22] Brydon Report para 16.4
[23] Para 6.1.19

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?

This proposal appears to be based on the assumption that it is possible to develop professional standards that qualify as "audit" standards for a wide range of information. In our view this is not the case and developing the criteria to be applied to make this determination would involve the UK breaking new ground in an area where the existing distinction between "audit" and "assurance" engagements is accepted and shared internationally. In view of these complexities and the fact that wider audit services are not currently very significant relative to the audit of financial statements, we believe that the regulator should not for the time being oversee such wider services.

5.5 The consultation document proposes that the regulator should oversee assurance services set out in the published Audit and Assurance Policy to the extent that such services are described as "audit" services and "done to the relevant standards"[24] (on the basis that "if there is not yet a relevant audit standard, then the work cannot be audit"). The required content of the Audit and Assurance Policy described in paragraph 3.2.9 of the document would include details of what is described as "independent assurance" in relation to the annual report and other required disclosures beyond those within the scope of statutory audit, including the Resilience Statement and other disclosures relating to risk, and "a description of the company's internal auditing and assurance processes". Certain of these services might be conducted in accordance with relevant standards. However, it is not clear whether the standards governing "assurance engagements" such as those generally carried out by internal auditors would be regarded by the regulator as "audit standards". To do so would, however, depart from the internationally accepted framework in which audit is distinguished from other assurance engagements.

5.6 Furthermore, in this regard the Brydon Report says "In this new model there would also be different levels of assurance given by different auditors, depending on the field of activity concerned and the brief given to the auditor by the audit committee. The same principles would guide them all, but the same standards would not necessarily apply to all"[25]. If the regulator is to oversee wider audit services, the Audit and Assurance Policy would need to make clear which of the assurance services will be conducted in accordance with relevant standards and which will not (which could be done by making an 'assurance matrix' a required part of the Audit and Assurance Policy statement). It would also be incumbent on the regulator to ensure that the particular "level of assurance" that will be sought in every assurance engagement is made clear in the Audit and Assurance Policy. This would be a far from straightforward regulatory process. Since audit committees would be free to select the "level of assurance" they require, they might well set the level of assurance below the threshold for "audit", or might simply decide not to describe the service as an "audit" so that it does not fall within the remit of the regulator.

5.7 A more significant issue is the steps the regulator will need to take to be satisfied that a standard is of sufficient quality to justify describing assurance services conducted in accordance with it as "audit". An audit of financial statements in the UK is conducted in accordance with some 30 auditing standards amounting to many

[24] Para 6.2.6
[25] Brydon Report para 5.4.9

hundreds of pages, which have been developed over many years on an international basis by a long-established auditing profession. In the US they are known as "generally accepted auditing standards". In relation to other reports, multiple reporting frameworks may be available, as in the case of corporate social responsibility, or reporting frameworks may be relatively undeveloped and, since the information to be examined in an assurance engagement is not derived from a single integrated information framework as is the case with financial data, the degree of assurance that can be provided on reports may be inherently limited.

5.8 Furthermore, an "audit" is a process of checking whether relevant performance standards have been met. In the case of an audit of financial statements, the performance standards that the audited entity is required to meet are laid down in law and accounting standards. In most other areas, for example in so-called environmental audits, there are no "generally accepted" performance standards and the entity usually sets its own performance standards, which may be based simply on its own internal policies. If wider auditing services were to be made subject to oversight by the regulator, the regulator could not restrict its oversight to the standards of work by the "auditors" concerned. It would also have to address the appropriateness of the entity's performance standards in respect of which the "auditor" was engaged to verify the entity's performance.

5.9 For the regulator to have the competence to assess which assurance reports on information reported under such frameworks should be classified as "audits", it would have to recruit specialists with strong practical experience across a wide range of subject matter. These specialists would need to be managed effectively.

5.10 In view of these complexities and the fact that wider audit services are not currently very significant relative to the audit of financial statements, we believe that the regulator should not for the time being oversee such wider services but should focus its efforts on implementing and enforcing proposals in the consultation document relating to corporate financial reporting and audit, which are more pressing and will be far from straightforward to implement effectively.

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?

As stated in our response to Q37 above, in our view the regulator should not for the time being oversee wider audit services and therefore the regulator's quality inspection regime for PIE audits should not be extended to corporate auditing.

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

As stated in our response to Q37 above, in our view the regulator should not for the time being oversee wider audit services and therefore the regulator should have no role in regulating these wider audit services.

6 Directors' responsibilities in relation to 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.

We agree that directors of PIEs should be required to report on the steps they have taken to prevent and detect material fraud. The term "material fraud" will need to be defined.

We do not agree that auditors should be required to report on the work they have performed to conclude whether the proposed directors' statement is factually accurate; this could result in a very significant extension of their responsibilities because they would need to assure themselves that the steps taken by the directors were effective in preventing and detecting material fraud and not just factually correct.

We do not agree with the proposal to require auditors to report on the steps they took to detect material fraud and assess the effectiveness of relevant controls as in our view this is already addressed adequately by auditing standards and there is much evidence in audit reports that auditors are complying with the requirements of the standards.

6.1 We agree that directors of PIEs should be required to report on the steps they have taken to prevent and detect material fraud. Although the prevention and detection of fraud is one of the responsibilities referred to in the statement of directors' responsibilities in annual reports, which states that the directors are "responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities", it is not written into statute but is inferred from the directors' fiduciary responsibility to safeguard the assets of the company (which itself is not a specific statutory responsibility). The Code makes no reference to fraud and, perhaps more surprisingly, no reference to fraud is made in the FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Control, and there is no regulatory guidance on what constitute "reasonable steps" to be taken by directors to prevent and detect fraud and other irregularities.

6.2 The consultation document acknowledges the need for such guidance: it refers to the Code in this context, although we do not believe that it is appropriate to use the Code for detailed guidance on the application of requirements. Such guidance will need to define "material fraud". This is important as the steps taken by directors must be proportionate and cost effective. The guidance should also address the linkages between the directors' reporting on the steps they have taken to prevent and detect material fraud and the directors' statement in the annual report about the effectiveness of internal controls over financial reporting, and in our view the relationship between the two should be explained in the annual report.

6.3 A challenge in relation to reporting on the steps taken by the directors to prevent and detect fraud is how to do this in a brief but insightful manner as the steps are unlikely to change significantly from year to year and there is a danger that these reports will become yet more boilerplate.

6.4 The consultation document proposes that auditors should be required "to report on the steps they took to detect material fraud and assess the effectiveness of relevant

controls"[26] (which further points to a connection between the prevention and detection of fraud and the effectiveness of internal controls). The document says that this "complements the proposed obligation for directors to report on the actions they have taken". This raises the question of whether the steps taken by the directors and the steps taken by the auditors for the purpose of their audit cover the same ground. That is clearly not the case. The directors' responsibility to prevent and detect fraud arises from their duty to safeguard the company's assets. As regards the company's assets, the auditors' responsibility is to obtain sufficient assurance that the financial consequences of any fraud which materially affects the financial statements are reflected accurately in the company's financial statements. The two lenses are completely different.

6.5 The steps an auditor takes to detect misstatements in financial statements due to material fraud must depend on the auditor's assessment of the risk that such frauds will not be detected by the company's internal controls over financial reporting. Accordingly, the auditing standard ISA(UK) 700 *Forming an opinion and reporting on financial statements* requires the auditor's report to "explain to what extent the audit was considered capable of detecting irregularities, including fraud"[27], while ISA(UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report* requires the audit report to include "a description of the most significant assessed risks of material misstatement (whether or not due to fraud), a summary of the auditor's response to those risks, and where relevant, key observations arising with respect to those risks"[28] . It is relevant that these requirements are UK-specific: they have been added by the UK to the international auditing standards concerned, which suggests that the focus on fraud detection by auditors is already stronger in the UK than elsewhere. The consultation document's proposal that auditors should be required "to report on the steps they took to detect material fraud and assess the effectiveness of relevant controls" appears to ignore completely the fact that the scope of the steps taken by the auditors must be based on the auditors' assessment of the risk of misstatement. The proposal also ignores the existing the audit reporting requirements referred to above. In our view the reporting requirements in auditing standards already achieve the aims of the proposal in the document and there is much evidence in audit reports that auditors are complying with the requirements.

6.6 The document proposes that auditors should be required "to report on the work they performed to conclude that the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually correct" [29]. This would require auditors to extend their work beyond what is required for the purpose of the statutory audit and runs the risk of extending the auditors' responsibility. It is, in particular, difficult to see how auditors could report that the directors' statement is factually accurate without having satisfied themselves that the steps taken by the directors were effective in preventing and detecting material fraud. This would require the auditors to perform significant additional procedures, at significant additional cost. We therefore do not support this proposal, which in any event seems inconsistent with the proposal in the consultation document that decisions about whether the directors' internal control effectiveness statement should be

[26] Para 6.4.6
[27] ISA(UK) 700 para 29-1
[28] ISA(UK) 701 para 13-1
[29] Brydon Report para 6.4.5

subject to external audit assurance should be a matter for audit committees and shareholders.

6.7 We do, however, note that – as is recognised in auditing standards - material fraud very often involves senior management who have the knowledge and power to override or work around controls and this must be a, if not the, principal consideration for auditors in determining the steps they need to take as part of their audit to detect fraudulent reporting.

6.8 One of the more surprising features of the reviews of the audit market, audit and the FRC that have been carried out is the absence of information about the incidence of the problems the proposals are intended to address. Whilst the Brydon Report focuses on the expectation gap as regards the detection of material fraud by auditors, if it obtained any information about actual cases (other than Patisserie Valerie) it did not provide any information about their scale or frequency in its report. So, on the face of it, the Review made its recommendations on the basis of the expectation gap, i.e. on the basis of perception and not observed reality. This does not seem a satisfactory basis on which to propose that auditors should receive greater fraud awareness and forensic accounting training, or for the Government to endorse the proposal. However, if it is possible to create a case study register of corporate frauds, as suggested by the Brydon Report and supported by the Government[30], we agree that it could well be a useful education tool not only for auditors, as stated in the document, but also for directors.

6.9 Concern was expressed to the Brydon Review that "as the role of the auditor explicitly involves increased focus on fraud detection, failure to find fraud is judged in hindsight in a prejudicial manner"[31] and the Brydon Report therefore recommended establishing an independent panel along the lines of the Panel on Takeovers and Mergers[32]. This is rejected in the consultation document on the grounds that the FRC's Audit Enforcement Procedure already provides for an independent and impartial decision-making tribunal. The concern expressed to the Brydon Review, however, relates not to the status quo but arises from the increased focus on fraud detection proposed by the Brydon Review. It can be extremely difficult to avoid the use of hindsight in investigations carried long after the events being investigated occurred, and after their consequences have become clear. This problem might well be exacerbated once the standard-setting and proposed enforcement powers of the new regulator are put in place. It seems to us that steps should be taken to allay such concerns by issuing guidance to those sitting in judgement on auditors that emphasises the need for them to base their conclusions on what it is reasonable to believe the auditor should have known and done at the relevant time based on the circumstances then prevailing, and to assure themselves that their findings are free of hindsight bias.

[30] Brydon Report para 6.4.10
[31] Ibid para 14.5.1
[32] Ibid para 14.5.4

7 Regulatory oversight of audit committees

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

In our view the case for imposing additional requirements on audit committees of FTSE 350 companies in relation to the selection and oversight of auditors has not been made and we can see no justification for such additional requirements.

If, notwithstanding our views, the Government proceeds with the proposals, there is a real danger that the principles-based approach of the current regime (as reflected in the Code and the FCA Disclosure and Transparency Rules) will be replaced by detailed rules, the consequence of which could well be to change the criteria on which audit committees assessed the effectiveness of audits from the expertise applied by the auditors in identifying and responding to audit risk to compliance with a list of procedures. This would damage significantly the quality of oversight of auditors rather than improve it. The consultation document provides no information on how the regulator would in practice monitor compliance, other than that it would take a "risk-based approach… exercising its expert judgement", which is merely jargon. We do not think it is appropriate to ask consultees effectively to give the regulator a blank cheque as regards its powers to set requirements for audit committees.

7.1 We wish to register our strong concern that the consultation document justifies the proposals on the basis of a CMA market study that was in our view fundamentally flawed, being partial in its selection and superficial in its interpretation of evidence and employing backward reasoning to support pre-conceived conclusions. In our view, this is particularly the case with the CMA's conclusion, effectively repeated in the document, that "overall, while some Audit Committees are effective in overseeing the activities of auditors, the evidence suggests that there is significant variability among Audit Committees in the FTSE 350[33]".

7.2 The most important roles of audit committees are to monitor the integrity of the company's financial statements and the company's internal financial controls and internal control and risk management systems. Audit committees monitor the integrity of financial statements by reviewing the financial statements themselves and challenging management particularly on items in them requiring the application of judgement or which have a high inherent risk of error, and also by reviewing the performance of the auditors. Audit committees monitor financial controls and internal control and risk management systems by carrying out 'deep dives' into areas of the business, selected on the basis of their significance and the risks associated with them, and by overseeing the work of internal audit where the function exists, together with other relevant assurance work performed within the company.

7.3 The CMA study did not consider how well audit committees carried out either of its main roles but focused entirely on certain subsidiary procedural matters, notably the selection process for audit tenders and the oversight of auditors exercised by audit committees. Its conclusion that the selection process for audit tenders is in general insufficiently robust is based almost entirely on the fact that in all the audit

[33] CMA market study 3.65

tender-related documents it reviewed 'cultural fit', 'chemistry' or similar qualities were among the selection criteria. Solely on the basis of statements in company analyses of the results of the tender process such as the audit team "will fit with [the company's] culture", the CMA concluded "our review does not suggest that Audit Committees are consistently prioritising scepticism and challenge". The CMA made no attempt to assess, for example, whether 'cultural fit' was the only criterion among those considered by the audit committee concerned that separated the tenderers or to understand why audit committees regard 'cultural fit' as very important in ensuring the delivery of a high quality audit. Of greater concern to us, however, is the implicit rejection by the CMA of our evidence to its enquiry "that the number one factor in the selection of auditors is robustness of the audit, but that people have to work together and so have to get on with each other". Based on very limited evidence indeed, the CMA implied that it was very often the case that senior management were heavily involved in the auditor selection process and insinuated that they often exercise undue influence over auditor appointment. Indeed, the only evidence it provided to support this conclusion was derived from just one single audit tender.

7.4 In relation to the oversight of audit quality by audit committees, as noted above the CMA concluded that "overall, while some Audit Committees are effective in overseeing the activities of auditors, the evidence suggests that there is significant variability among Audit Committees in the FTSE 350"[34]. This conclusion was based almost entirely on very limited and superficial information from just 18 companies about the amount of time spent by audit committee members on external audit-related matters. It did not even give consideration to differences in time spent due to the size or complexity of the company concerned. The CMA preferred to base its conclusion on this data rather than evidence provided to it by us and by audit committee chairs to the BEIS Select Committee.

7.5 It is very disappointing that the flawed conclusions of the CMA market study as they relate to audit committees should have resulted in what in our view are highly disproportionate proposals for the regulation of audit committees. However, in case the Government decides to go ahead with its misconceived proposals relating to audit committees, we would hope that any additional requirements to be imposed on audit committees will be principles- rather than rules-based and practicable, and that the enforcement powers to be given to ARGA are exercised in a well-informed and measured manner by people with sufficient relevant experience to ensure that this is the case.

7.6 We assume that "additional" in the phrase "additional requirements …in relation to the appointment and oversight of auditors"[35] means in addition to the requirements in this regard of the FCA Disclosure and Transparency Rules (DTR) and the Code. In our view, as in relation to other proposals in the consultation document, the regulatory requirements that are relevant to a specific population such as audit committees should be brought together and enforced by a single regulator.

7.7 The requirements of DTR 7.1.3 and the Code span all the auditor appointment and oversight duties of the audit committee. They are drawn in broad terms and are very clear. Any "additional" requirements will therefore inevitably address how the

[34] CMA market study 3.65
[35] Introduction to Chapter 7

various duties must be discharged. This is reinforced by the statement in the consultation document that "the requirements set by the regulator will set minimum standards which audit committees will be free to exceed as they wish"[36]. Such a statement could not be made unless the standards concerned consisted of processes and procedures which are measurable (which, for all one knows and particularly in the light of the CMA's focus on it as an indicator of quality, might include the number of hours to be devoted to audit committee affairs, which is a crude input measure and not an outcome-related measure). There is a real danger that prescriptive requirements on how audit committees are to operate will reduce the incentive for audit committee members to base their approach to appraising the auditors on, for example, whether they have an excellent understanding of the business of the company concerned as a basis for the audit judgements they have to make, to be replaced by checklists of questions and tasks for audit committees to follow. This would damage significantly the quality of oversight of auditors rather than improve it. It would also in turn make serving on audit committees unattractive, especially for those with strong track records of corporate governance and business experience at senior levels, who – far more than governments or regulators – have contributed to what is described in the Executive Summary of the consultation document as "the UK's internationally-respected system of audit and corporate reporting"[37]. In our view, the Government and the regulator need to take great care that increasing the burden of regulation on audit committees in the manner proposed does not result in the very opposite of the objective to "strengthen the UK's audit and corporate governance framework", by replacing judgement founded on relevant experience and expertise with compliance checklists enforced by bureaucrats.

7.8 The consultation document states that the requirements to be imposed on audit committees "will cover the need for audit committees to continuously monitor audit quality"[38]. This compares with the Code requirement to "review[ing] the effectiveness of the external audit process, taking into consideration relevant UK professional and regulatory requirements"[39]. The only substantive difference between the statement in the consultation document and the Code requirement is the word "continuously". This is a somewhat strange requirement when the audit is not a continuous process and audit committees (other than in the case of very large companies) normally meet four or five times a year, only two or three of which take place when the audit plan is available and when the audit is in progress.

7.9 The consultation document states that "ARGA should take a risk-based approach to monitoring ongoing compliance, exercising its expert judgement"[40]. We have no idea what this means in relation to monitoring the requirements for audit committees relating to the appointment and oversight of auditors. What risks would the regulator consider? What public information could it use to assess risk? Would the regulator's decision criteria be published (we note that the Financial Reporting Review Panel used to publish the sectors it regarded as higher risk for the purpose of selecting annual reports for review)?

[36] Para 7.1.16
[37] Page 14 2nd para
[38] Para 7.1.15
[39] Code provision 25
[40] Para 7.1.17

7.10 It is unlikely that the audit committee report in the annual report would provide a basis for the risk assessment. It would not be appropriate to base the risk assessment on the biographies of audit committee members or the company's financial performance, and it is difficult to think of publicly available information that would indicate the risk that a particular audit committee is failing to meet regulatory requirements relating to the appointment and oversight of the company's auditors. It is difficult to see how the regulator could monitor the audit tender process on a real time basis (unless it intended effectively to supplant the audit committee). Since the audit committee is charged with monitoring audit quality, the regulator might conclude that an audit which has been subject to audit quality review and is found to require improvement is indicative of a breach of oversight requirements by the audit committee concerned. However, this would seem rather like double jeopardy and, indeed, raises questions about whether the regulator should be required to place Chinese walls between these activities.

7.11 We wonder whether adequate thought has been given to the practical implications of this proposal. To assess whether an audit committee is monitoring audit quality effectively is not just a matter of whether the audit committee is putting enough questions to the auditors on the audit plan, its execution and findings or of the amount of time the committee is spending on this. Of much more importance is how pertinent the committee's questions are and how well the auditors respond to those questions (since a poor response should result in further questions by the audit committee). Some insight into this process might be obtainable from minutes of audit committee meetings but it is very unlikely to provide sufficient insight to make a properly informed, fair assessment.

7.12 It seems to us that before taking these proposals further, the regulator should consider how long the likely time frame would be between initiating a case and arriving at a conclusion (other than in cases of downright negligence). Carrying out a properly informed, fair assessment of the audit committee's monitoring of the quality of the audit is likely to be time-consuming as it would require time to be spent in acquiring a good understanding of the company's business, the effectiveness of its financial internal control and risk management systems and areas of audit risk, which is the essential context in which the audit is planned and carried out.

7.13 With regard to the timing of effective enforcement, the proposals make no reference at all to the process of appointing auditors. Although the external audit tendering process can be lengthy for large companies, most FTSE 350 companies carry out the entire process within six months and in many cases significantly less than six months. The consultation document gives no indication of how, given these time frames, its proposals can be applied to monitoring the audit tender process operated by audit committees.

7.14 The possible "further steps" referred to in the consultation document[41], of public notices by the regulator detailing its findings or making direct statements to shareholders are logical regulatory responses to breaches but real-world reality needs to considered. It is one thing for the regulator to issue press releases that address a deficiency in a company's financial statements – these are usually seen as aberrations and not as symptomatic of wider reporting issues and therefore

[41] Para 7.1.18

generally do not cause any great reputation damage to the company concerned. It is quite another thing for a regulator to publish a statement that an audit committee has failed to comply with regulatory requirements as it will almost certainly undermine confidence in the company and result in the resignation of the audit committee chair and members of the committee. In our view it would therefore be essential to have in place an independent appeal process and to allow any appeal to take place before the regulator is permitted to make any public statement. Even then, however, damage to the company concerned is likely to result from a public statement by the regulator. We are not aware that any financial reporting regulator has been given the power to publish statements stating that an audit committee has failed to comply with its responsibilities. Furthermore, these "further steps" seem to us extremely presumptuous when no evidence has yet been published which points to significant failures by audit committees of companies that have collapsed.

7.15 In order for companies and their audit committees to have confidence in the regulator's willingness and ability to implement these proposals in an effective and proportionate manner, it will be essential for ARGA to recruit and retain people of sufficient calibre. In this regard we note that the document states that the regulator will exercise "its expert judgement" in "monitoring ongoing compliance". It is difficult to avoid the conclusion that in order to apply "expert judgement", this regulatory task will need to be carried out by people with relevant experience and expertise relating to the operation of effective audit committees in large companies. However, in the past the FRC has not sought or appeared to wish to recruit people with such experience in connection with its existing regulatory work, for example audit quality review.

7.16 Even if the regulator does succeed in recruiting people of sufficient calibre to review an audit committee's compliance with the regulator's audit oversight requirements, we do not agree with the proposal to give the regulator the power to place an observer on the audit committee. It is not clear from the consultation document whether the purpose of appointing an observer would be to acquire more evidence of non-compliance or to assist in remediation. As regards remediation, we cannot see how an observer would have sufficient knowledge to be better able to offer practical improvements than the audit committee itself, unless the audit committee members were so inept and lacking in relevant expertise and experience that their appointment should be terminated.

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?

This question cannot be answered without knowing how ARGA will implement the proposed powers, about which nothing is said in the consultation document.

7.17 In the - in our view unfortunate - event that the Government proceeds with proposals to impose additional requirements on audit committees, it is not possible to know from the consultation document whether the proposed powers will be sufficient to ensure effective compliance with the "additional requirements" without any information about what the additional requirements will consist of, how the regulator will apply a "risk-based approach to monitoring ongoing compliance", and what level of relevant expertise and experience the regulator will require in the staff

who will be engaged in the monitoring. Nevertheless, there is a real danger that if the regulator is to be given "powers to take action in relation to breaches of the new audit committee requirements", it will base its assessment of non-compliance on checklists of procedures (analogous to the approach currently taken to audit quality reviews by the regulator).

8 Shareholder engagement on risk and audit planning

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?

While we support the objective of securing greater shareholder engagement in matters relating to audit, we do not believe it is realistic to expect shareholders to be able to influence the audit plan appropriately and we cannot see how such engagement could be sought and obtained within the required timeframe each year. We suggest that thought is given to requiring the audit committee to discuss in its report the key features of the audit plan and of their dialogue with the auditors on the plan, and to include a request for shareholder feedback in the report.

8.1 The audit plan for a large group is complex, especially one with significant international operations. To develop the plan it is necessary to have an intimate knowledge of the group's business, its organisation structure, information systems, risk management and internal control systems, as well as a very good understanding of the requirements of auditing standards and how to apply them in the audit of a particular group's financial statements. However much companies and auditors were to encourage shareholders to set out their views on particular (audit) risks and other areas of emphasis that they would like the auditors to address, we question whether investors would give sufficient thought to this, especially on an annual basis. We also question whether investors have sufficiently detailed knowledge of the matters mentioned above in relation to the company to enable them to put forward suggestions that are sufficiently detailed, relevant and practicable to be incorporated into the plan for the statutory audit.

8.2 It is likely also that if the proposal were implemented, investors would delegate their responses to their corporate governance specialists whose understanding of the companies concerned is extremely limited. This would be likely to result in formulaic input or a box-ticking type of approach rather than responses that reflect the views of fund managers based on their evaluation of particular circumstances of individual companies.

8.3 As the audit plan is prepared each year, the proposals would require shareholder views to be sought each year. This raises significant questions of timing. Audit plans are rarely prepared earlier than well into the third quarter of the year and are often finalised in the fourth quarter because the auditors wish the plan to take account of events and operations during the year to the greatest extent possible. This leaves very little time in which to seek and obtain input from shareholders before significant audit work is performed. A comparison with shareholder engagement in remuneration policy changes is relevant – to seek shareholder input on the remuneration policy of a company with a 31 December accounting date in time for it to be considered before the annual report is finalised (normally six to ten weeks after the accounting date), it is usually necessary to request the input before the end of July. In order to give shareholders the opportunity to offer suggestions on the audit plan, the plan would have to be prepared far earlier than is currently done. This would mean that the plan would be subject to revision for changes in circumstances after it had been provided to shareholders for their feedback.

8.4 A further practical issue is that the accounting date of the majority of groups is 31 December. As a result, if this proposal were to be implemented, shareholders would be deluged with requests for their views on audit plans with similar deadlines for responses.

8.5 The proposals would also require audit committees to inform shareholders if there has been "a material change to the risks facing the company since those already disclosed in the last annual or interim report", although "where suggestions from shareholders go wider than issues that can be considered as part of the audit (for example business or strategic risks), these could be considered as part of the proposed Audit and Assurance Policy"[42]. The audit plan addresses specific areas of the company's business which give rise to the risk of error in a company's financial statements for the current year. The 'Principal Risks and Uncertainties' statement (Risk Report) in annual and interim reports address the operational risks arising from the company's business model and its strategy that might come about in the future and over an extended period. Whilst most business risks will have direct financial consequences should they eventuate, few of them are likely to come about in the form of specific events which have significant direct and immediate financial effects during the current financial year. It is also unusual for risks included in a company's Risk Report to change significantly from year to year, although the directors' assessment of their likelihood and impact may change. In view of the differences of scope and purpose as between the statement of Principal Risks and Uncertainties and areas of audit risk in the current year's financial statements, the usefulness of the Risk Report in enabling shareholders to comment meaningfully on the audit plan is questionable.

8.6 However, it is mainly in the light of the practical difficulties associated with gathering shareholder views on the audit plan in a timely manner that we do not support the proposals in the consultation document for giving shareholders a formal opportunity to engage with audit planning. We suggest that rather than pursue the proposals in the consultation document, thought is given to requiring the audit committee to discuss in the committee's report in the annual report and accounts the key features of the audit plan (for the period reported on in that annual report) and of their dialogue with the auditors on the plan, and to include a request for shareholder feedback. In conjunction with the Risk Report in the annual report (which is current at the date on which the annual report is published), the extensive information about the committee's review of the financial statements (set out in the audit committee's report) and about key audit matters in the auditors' report on the financial statements in the annual report, this would provide a very good basis for shareholders to raise questions about how the audit had addressed the particular financial statement risks and whether, based on the latest Risk Report, shareholders wished to suggest any changes in areas of audit emphasis for the next audit.

8.7 This would to some extent be a backwards-looking rather than a forward-looking exercise but, handled well and with an eye to the current year's audit, would enable shareholders to develop their views on areas of emphasis that they would like to feel confident the auditors would address in the forthcoming audit.

[42] Para 7.3.5

9 "Managed shared audit" – choice and resilience in the audit market

We strongly oppose the proposal to impose a managed shared audit requirement on FTSE 350 companies. In our view, it would have a negative effect on audit quality, impose administrative burdens on companies and their group auditors, and result in duplication of work. Managed shared audit would also not enable 'challenger firms' to develop the experience and expertise necessary to become the group auditor.
In our view managed shared audit would do very little to strengthen the resilience of the audit market in the UK. If the UK arm of a 'Big Four' firm were to fail, its global organisation would rescue it, as has happened several times in other countries.

9.1 We note that, despite the fact that 'shared audit' was not recommended by the CMA and that the concept of 'managed shared audit' makes its appearance for the very first time in the consultation document, the document does not seek views on whether the managed shared audit as proposed is workable or whether it would "deliver the desired improvements in quality" (or result in growing the competitor market or in improving resilience) as assessed by the CMA, with which the Government says it agrees[43]. Instead, the questions in section 8.1 of the consultation document assume that the Government will require all UK-registered FTSE 350 companies to implement managed shared audits and the consultation questions are limited to certain implementation mechanisms. This is a fundamentally unsatisfactory way to proceed. We therefore wish to make it clear that we strongly oppose the proposal for a number of reasons.

9.2 The proposal flows directly from the CMA's concern that market concentration has resulted in limited choice and a market that is not resilient. In relation to limited choice, as we pointed out to the CMA in November 2018, "the conflict rules prohibit the appointment as auditor of firms that provide relatively small amounts of prohibited non-audit services to a company or services that in practice would have no impact on the objectivity of the firm were it to be appointed as auditor. Changing the conflicts of interest rules would be a more practical way of increasing competition for audits than trying to bring smaller firms into the market"[44].

9.3 More important in relation to choice, the consultation document proposes to require the operational separation of the audit practices of the 'Big Four' firms in the UK from their non-audit practices. The proposal is based on a recommendation by the CMA in its market study report, the aim of which "is to ensure auditors' full focus is on conducting high quality audits, without their incentives being affected by the much greater revenue and profits from the non-audit side of the firm"[45]. Although "at this stage, the Government has decided not to take forward the CMA's proposal to introduce audit-practice profit pools"[46], it would require firms to strengthen the governance of their audit practices, to ensure that partner remuneration is linked to audit quality (with direct oversight by the regulator), and the publication of a separate profit and loss account for the audit practice with arm's length transfer pricing of transactions and arrangements between the audit practice and the rest of the firm.

[43] para 8.1.10
[44] Note of meeting on 19 November 2018 of a number of audit committee chairs, brought together by the ACCIF, with the CMA
[45] CMA Statutory audit services market study, page 187
[46] Para 8.2.14

9.4 Assuming this proposal is implemented (and the large firms are reported to be working on its implementation), there would be good grounds for reducing the restrictions on the non-audit services that a firm can provide to its audit clients. This would in turn help to address the CMA's concern that in some audit tenders, due to the restrictions on non-audit services that the company's auditor is allowed to provide to it, the number of tenderers for the audit is too low. We acknowledge that since the ethical standards of the UK auditing profession largely mirror international standards and practice and in other countries audit practices are generally not required to be operationally separate from their non-audit practices, the reduction in the restrictions on non-audit services would apply only to non-audit services provided to the UK operations of companies. However, a reduction of restrictions in the UK might nevertheless result in an increase in the number of tenderers for many audits.

9.5 As well as the limited choice of auditors resulting from the ethical standards governing the auditing profession, the CMA concluded that "while the risk of one of the [Big Four] firms failing was small, there would be significant adverse impacts were it to happen"[47]. Unfortunately, the CMA did not give appropriate consideration to the global nature of the Big Four firms in assessing the likelihood that the UK arm of one of them will fail. The CMA referred to two claims against Big Four firms neither of which was significant in financial terms or even, in one of the two cases, in terms of reputation damage resulting in a loss of clients. It focused on the collapse of Arthur Andersen in the US in the wake of the collapse of Enron. The CMA report does not discuss the events that precipitated the collapse of Arthur Andersen but they are instructive. Firstly, the federal prosecutors went after Arthur Andersen long before they brought charges against the officers of Enron. And, when the partner in charge of the audit was found to have ordered the wholesale shredding of Enron documents, rather than bringing charges against him the prosecutors sought to indict the whole firm, which effectively destroyed the firm's reputation in the US. There have been other life-threatening situations for Big Four practices in particular countries, such as South Africa and Japan. In such cases, the national arm of the Big Four firm concerned has been bailed out by the global firm of which it is part. As the Arthur Andersen case shows, a Big Four firm will only fail (or, as in the case of Arthur Andersen, implode) internationally if its US arm – by far the largest component of all Big Four global firms – fails. In our view, the risk of this happening is not sufficiently great to justify the authoritarian overriding of market mechanisms in relation to the choice of auditors unless it is virtually certain that the intervention would achieve the intended increase in competition within a reasonably short period without any risk of reducing the quality of audit or impeding efforts by auditors and the regulator to improve audit quality.

9.6 However, we do not believe that there is any likelihood that that would be the case with the managed shared audit regime proposed in the consultation paper. To reduce the risk of substandard auditing it would be necessary to restrict shared audits to certain industry sectors for which auditors do not require specialist expertise and experience and to exclude the very largest companies from the shared audit regime. However, the result would be that the 'challenger firms' would not achieve a significant audit market share for many, many years and even then may well not have developed the necessary capability to be the group auditors of large companies. We note that the impact assessment published with the consultation

[47] CP 8.3.5

document models the share of the FTSE 350 audit market that challenger firms could achieve after ten years and suggests that those firms could achieve the share of FTSE 350 audit fees of between 9.1% and 12%. The model assumes that the challenger firms will receive 20% of the total audit fees of UK-incorporated companies that have UK subsidiaries which individually account for between 20% and 60% of group turnover or group total assets. No companies are excluded based on industry. Accordingly, the model implicitly assumes that challenger firms would be appointed as (shared) auditors of banking and insurance companies and other sectors for which auditors require specialist experience and expertise in order to perform high quality audits. To take on the additional work expected to go to challengers in the model, the impact assessment states that the combined audit fee income of the five largest challengers would need to grow at an annualised rate in the range 1.7-2.7%.

9.7 The audit fee income of the five largest challenger firms in 2018 was £430m. The UK audit fee income of the Big Four firms totalled £2.3bn. On the basis of the model, if an annual growth rate of 2.5% for the challenger firms is assumed, their audit fee income would be £550m in 2027. If the fee income of the Big Four firms' audit practices did not grow at all in the years to 2027, the combined income of the five challenger firms would be less than the fee income of any the Big Four.

9.8 The assumptions in the BEIS model do not appear unreasonable except that they assume the current group audit fee would not increase if managed shared audit was imposed on them, whereas it most certainly will, although not by as much as would be the case with joint audit. The consultation document draws attention to the need for challenger firms to "invest heavily in resources and expertise to effectively compete in the FTSE 350 audit market" and notes that they "will need confidence in their revenue streams in order to make this investment"[i48]. However, the model indicates that after ten years the challenger firms are likely to remain subordinate to the Big Four firms and that the fee income they will generate from the FTSE 350 will not be sufficient to enable them to make sufficient investments to develop the capacity and capability necessary to compete successfully with the Big Four firms on an open market basis. It therefore does not seem to us that the proposed managed shared audit regime will achieve the stated objective of increasing choice in the audit market or the resilience of the market.

9.9 The consultation document states that companies would be required to appoint a challenger firm as the auditor of "no less than 10%....and preferably closer to 30%" of the group's statutory audits", based on criteria such as the total audit fee, group revenues, profits and assets. It is not clear from the consultation document whether these proportions refer to UK subsidiaries (which is the assumption made by BEIS in its impact assessment) or whether it refers to all the subsidiaries of a group wherever they are located. Since a substantial proportion, in fact a majority, of the operations of most FTSE 100 and many FTSE 250 companies are overseas, even a 30% share of the UK subsidiaries of a group could represent a very small proportion of the group as a whole. If, on the other hand, the 10% to 30% range is based on the group as a whole, where the majority of a group's revenues or assets are outside the UK it would clearly not be appropriate for the challenger firm to audit substantially all the group's UK subsidiaries. Therefore, to achieve the 10% to 30% share it would be necessary in many cases for overseas arms of challenger firms to be appointed as

[48] para 8.1.11

auditors of certain subsidiaries. The consultation document emphasises the need for challenger firms to "invest heavily in resources and expertise in order to effectively compete in the FTSE 350 audit market". The appointment of challenger firms as auditors of overseas subsidiaries would do nothing to increase the capacity or capability of challenger firms in the UK and would do nothing to strengthen the resilience of the UK audit market.

9.10 The consultation document implies not only that managed shared audit will result in greater choice in the audit market and greater resilience in the market but that it will "deliver the desired improvements in quality"[49]. As noted above, we cannot see how this will be the case. In our view, the imposition of shared audits would give rise to a real risk of lower quality audits, especially in relation to the audit of financial services operations and other sectors with industry-specific accounting practices and accounting estimates, due to the lack of relevant experience and expertise in the challenger firms. Audit committees would therefore be likely to appoint challenger firms as auditors of subsidiaries whose financial statements have the lowest audit risks and that require the least specialist capability in the audit team. Again, this would do little to increase the capability of challenger firms or to "build their reputations and credibility with audit committees as being able to conduct complicated and large-scale audits"[50].

9.11 The consultation document states that "the challenger firm would have access to, and engagement with, the FTSE 350 company's main (group) audit committee". The only justification the consultation document provides for this requirement is that it "aims to mitigate the CMA's concern that the audit committee would only engage meaningfully with the group auditor"[51]. This appears to relate to one of the reasons given by the CMA for rejecting shared audit, as follows: "A shared audit with a challenger firm reporting directly to a Big Four firm would do nothing to change audit committee perceptions. It would achieve the opposite, and reinforce the idea that any auditor outside of the Big Four must be less capable"[52].

9.12 Since audit committees are generally concerned only with the group financial statements and, for example, weaknesses in risk management and internal control systems that are significant in the context of the company as a whole, and since responsibility for the audit report on the group accounts lies solely with the group auditor, there is no reason for them to engage directly with the auditors of subsidiary companies in carrying out their duties to monitor the integrity of the company's financial statements or to review the effectiveness of the audit – especially where subsidiaries audited by firms other than the group auditor account for a relatively insignificant proportion of the group's revenues and assets. Requiring audit committees to engage with subsidiary auditors would be a totally unnecessary distraction, and it is difficult to see how a regulatory requirement for audit committees to engage directly with subsidiary auditors would in practice provide any real benefit either to audit committees or the subsidiary auditors – the challenger firm will not develop the experience and expertise necessary to become the group auditor based on artificial processes such as requiring the shared auditor

[49] para 8.1.10
[50] CP 8.1.12
[51] CP 8.1.17
[52] CMA ibid para 6.18(a) page 152

to have access to the audit committee. The requirement would therefore simply be a pointless regulatory burden.

9.13 The challenger firms are a relatively unknown quantity to many audit committees and their experience of auditing operations of FTSE 350, and certainly FTSE 100 groups, is limited. Audit committee chairs are therefore concerned that they would be held responsible for an appointment they would not necessarily make of their own volition. If the proposed shared audit regime is proceeded with, they will seek assurance from the regulator on the capability and capacity of a challenger firm before making an appointment.

9.14 Finally, the imposition of the managed shared audit proposal would be addressing a service provider market issue by forcing purchasers to use and pay for an unsuitable service provider. What is the justification for requiring the purchaser to pay for such a service?

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?

Since the statutory entity structure of groups is usually determined more by historical transactions and historical tax positions than by the current business model or structure of management and control, basing the "proportion" of audit work to be performed by a challenger firm on legal entities would result in duplication of work by both management and auditors. However, we do not see any practical alternative to basing the 'meaningful proportion' on legal subsidiaries

9.15 Matrix operating models and shared service centres, among other factors, would make it inefficient to base challenger firm participation on legal entities, which are often structured on the basis of tax positions or historical transactions such as acquisitions and not on the current business model or structure of management and control. However, if audit work was not allocated on the basis of the financial statements of an identifiable entity there would be difficulties in defining the precise boundaries of the work for which different auditors are responsible, to whom the auditor concerned would report and what form the "audit" report would take. Even though it would be likely to result in significant duplication of work by management and the (two) auditors, we do not see any practical alternative to basing the 'meaningful proportion' on legal subsidiaries.

9.16 We have explained above why we do not support the imposition on companies of a managed shared audit requirement. We do not wish to offer suggestions about the scope of an arrangement in respect of which there is no compelling evidence that it will result in the outcomes of greater choice in and resilience of the audit market and improvements in the quality of audit that are posited in the consultation document. We would observe that based on the model applied by BEIS in its impact assessment, the challenger firms would have to carry out a significantly greater proportion of the audit work in FTSE 350 companies than is assumed in the model, which would increase our concerns about their capacity and capability to perform the work and the likelihood that, far from improving, the quality of audit work overall would deteriorate.

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?

As we state above, we strongly oppose the proposal to impose a managed shared audit requirement on FTSE 350 companies. In our view, it would have a negative effect on audit quality, impose administrative burdens on companies and their group auditors, and result in duplication of work. Managed shared audit would also not enable 'challenger firms' to develop the experience and expertise necessary to become the group auditor.
We discuss other mechanisms below in response to Q63.

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?

We accept that a way needs to be found of increasing the opportunities for challenger firms to grow their share of the UK audit market while minimising the risk to audit quality. We doubt that a significant increase in the challenger firms' share of the statutory audit market could be brought about other than by means of some form of market share cap. The challenge would be how to define the population to which the cap would apply in such a way as to ensure that challenger firms appointed as a company's auditors had the capacity and capability to execute an audit of high quality that would also help them develop their expertise further. It would take a number of years for the challenger firms to increase their market share significantly.

9.17 Sustainable capability and capacity can ultimately only be built based on practical work experience. We believe that the challenger firms are making positive progress in securing audit appointments with smaller FTSE 350 companies. They are doing this by focusing on sectors they know and understand and, to meet quality standards and mitigate liability risk, wish to grow in a controlled and measured way. Imposing regulatory requirements to force companies to make audit appointments based other than on the basis of the relevant expertise and experience of the audit team, simply in the hope that it will ultimately result in increasing the resilience of the market, seems rather strange, particularly as all three of the Government-commissioned reviews were triggered principally by concerns expressed about the quality of financial reporting and audit following certain high-profile corporate collapses.

9.18 It is clear from conversations with the larger challenger firms that they are thinking carefully about risk and their capabilities and have no interest in being appointed as the auditors of the largest/ complex groups or, for the most part, in managed shared audit, and are focusing their efforts on sectors of the market where they have the required capability and where risk and reward are in balance for them. It is also clear that their share of the statutory audit market is growing, though it remains small. However, we accept that a way needs to be found of increasing the opportunities for challenger firms to grow their share of the UK audit market while minimising the risk. The 'meaningful proportion' of audits to be carried out by challenger firms referred to in the consultation document should not be a

proportion of a group's statutory audits, as would be the case with managed shared audit, but what is meaningful to the challenger firms to help them grow.

9.19 Ways of assisting the challenger firms that would not distort the market might include action by the regulator to require companies to invite at least one challenger firm to tender for the audit the next time the audit is re-tendered, to encourage companies to appoint a challenger firm to provide assurance services other than the statutory audit, and to encourage audit committee chairs to have more direct contact with challenger firms in order to increase their understanding of their capacity and capabilities. We acknowledge, however, that such steps would not be sufficient to bring about a significant increase in the challenger firms' share of the statutory audit market.

9.20 To bring about such an increase in the challenger firms' market share would require some form of market share cap to be imposed that would force the Big Four firms reduce their market shares (by not retendering for selected audits). The challenge would be how to define the population to which the cap would apply in such a way as to ensure that challenger firms appointed as a company's auditors had the capacity and capability to execute an audit of high quality that the audit would also help them develop their expertise further. In our view this would require the cap initially to exclude most FTSE 100 companies and companies in certain industry sectors with complex business models or specialised accounting and reporting requirements. This would be consistent with the actual strategies of most of the challenger firms, which are also directed towards securing sole (and not shared) audits. The scope of the cap and the need for a cap to continue in place would be reviewed after, say, five years.

9.21 Where, as a consequence of the cap, a company's choice of auditor was limited to the challenger firms and its audit committee was not satisfied that it would obtain a high quality audit, the company should have the right to appeal against the operation of the cap.

10 The monitoring of audit quality

In our view, a fundamental change of direction is needed in the audit quality review (AQR) regime. The quality classification system used by the FRC is not understood by stakeholders. The statistics it publishes are guaranteed to foment public criticism of auditors rather than to focus on those cases in which auditors had not obtained sufficient appropriate audit evidence to support their report on the financial statements. This is largely because the current AQR regime essentially equates audit quality with compliance with the enormous number of procedures required by auditing standards, i.e. with inputs, and not with outputs, i.e. the audit report.

The Brydon Report defines a high quality audit in terms of 13 attributes and also identifies 10 behaviours that are required to fulfil the purpose of auditing. No reference at all is made to these in the consultation document. We urge the Government to require ARGA to develop a definition of audit quality based on the Brydon definition and to identify related quality indicators.

10.1 The questions in the consultation document relating to the publication of Audit Quality Review (AQR) reports implicitly assume that the FRC's current approach to audit quality inspections is fit for purpose. In our view, however, it is not. The approach focuses on very detailed compliance with the specific requirements of auditing standards, of which there are literally hundreds. Its reviews therefore focus on process and procedures – essentially on inputs - and not outcomes – rather than cases in which at the time it issued its audit report, and on the basis of the audit of the financial statements as a whole, the audit firm had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements.

10.2 The FRC makes an overall qualitative assessment of each audit it reviews, classifying it as 'Good', 'Limited improvements required', 'Improvements required' or 'Significant improvements required'. Only the regulator understands the criteria that it applies to make these classifications and it has been suggested that it has, unannounced, changed the classification criteria it applies from time to time. The mystery is compounded by the 'quality target' set by the regulator that 90% of FTSE 350 audits by each firm should require no more than 'limited improvements'. This target implies that audits requiring only 'limited improvements' are not, overall, unsatisfactory. Indeed, in view of the very large number of procedural requirements spread across more than 30 auditing standards, it would be very surprising if absolutely every one of these requirements had been fully met on any audit of the financial statements of a large company other than one with a very simple business model and no significant areas with higher risk of material misstatement or accounting estimates that involve management judgement.

10.3 The really important aspect of the FRC's classification system is what distinguishes 'significant improvements required' from 'improvements required' as the classification system suggests that only the finding 'significant improvements required' calls into question the audit opinion on the financial statements – suggesting that, at the time the audit report was issued, the auditor had not obtained sufficient appropriate audit evidence to support the opinion on the financial statements concerned. It is, however, impossible to know whether that is what 'significant improvements required' means, even though, at the end of the day, that is the most important information the market needs about the audit. We

believe that the regulator needs to 'come clean' about this, as some other audit regulators do, such as the Public Company Accounting Oversight Board in the United States. In our view it is more important that the regulator publishes results of AQRs for the audit firms that are meaningful than that it publishes AQR reports on individual audits.

10.4 The current AQR regime essentially equates audit quality with compliance with procedures required by auditing standards. The Brydon Report proposed a rather different definition of a high audit quality based on 13 attributes relating to 'ethics', 'operations', 'judgements', 'outputs' and 'effectiveness'. The 'outputs' attributes, for example, are "informs stakeholders in a decision useful manner" and "reports faithfully to the audit committee all material disagreements with management, whether resolved or not", and the 'effectiveness' criteria include "diminishes the ability of management or the board to obscure the reality of the company"[53]. No reference at all is made to this definition in the consultation document. We regard this as a missed opportunity.

10.5 The Brydon Report also presented a set of 10 principles which the Report states "will provide an overarching framework for the behaviour of auditors beyond that which simply follows standards and the law"[54] and recommended that "each audit report contains a statement to the effect that in conducting the audit the auditor has acted faithfully in accordance with the principles". However, no reference is made in the consultation document to these principles or the related recommendation: a further missed opportunity, in our view.

10.6 The FRC published a report on its thematic review of Audit Quality Indicators (AQIs) in May 2020. The report was based on the AQIs used by the large audit firms at a firm-wide level, although their use appears to be somewhat embryonic. The report refers to the Brydon definition but merely says "It is not within the scope of this thematic review to seek to reproduce the work performed in the Brydon report", which is factually correct but disappointing if it is the FRC's last word on the Brydon definition. We would also observe that the AQIs used by the firms are very heavily biased towards inputs and processes and that the 'outcome'-related AQIs are only indirect measures of quality which in many cases would not apply to individual audit engagements. We urge the Government to require ARGA to develop a definition of audit quality based on the Brydon definition and to identify related quality indicators.

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

We have great concerns about allowing the regulator to publish audit quality review reports without the need for consent from the audit firm and the audited entity. References to aspects of an audit that are said to require improvement could cause questions to be asked about the appropriateness of accounting treatments, thereby damaging the reputation of the company concerned, about the effectiveness of the audit committee, about transactions that the company has no obligation to disclose and has not disclosed, and about the competence of the audit partner concerned, who is named in the auditor's report.

[53] Brydon Report para 7.4
[54] Brydon Report para 6.4.2

10.7 We are not aware that reports on the quality of individual audits are published in any jurisdictions, other than where investigations into allegations of negligence or complete audit failure have been carried out. However, we agree with the those who told the Kingman Review "that greater transparency with regards to audit quality findings is needed"[55] .

10.8 Historically, the FRC has not engaged with audit committees or companies on any individual AQR result, even in private. It is starting to do this now and would seem to be highly appropriate. Greater engagement by the regulator with audit committees and companies would be more productive in terms of improving the quality of audit, and indeed the quality of the audit committee's monitoring of audit effectiveness, than the publication of individual AQR reports.

10.9 As we have explained above, we believe that the current lack of transparency arises largely from the impenetrability of the FRC's classification system and that this should be addressed before any consideration is given to the publication of the results of reviews of individual audits.

10.10 The FRC carries out some 130 audit quality reviews per annum. Around 75% of these reviews are rated 'Good' or 'Limited improvements required'. It is quite unlikely that the AQR reports concerned will contain information that is sufficiently sensitive to justify redaction. We also question whether such reports contain any information that is useful to stakeholders, especially as such reports currently do not give a balanced overall picture of the audit because they focus heavily on aspects in which the audit falls short and not on aspects in which the audit work carried out is of high quality.

10.11 We reiterate the point we make above in relation to the Audit and Assurance Policy, that most stakeholders, including shareholders, have a limited understanding of the requirements of auditing standards and the significance of particular audit procedures in the context of the circumstances of the company concerned. Stakeholders may well believe the required improvements, even though classified as "limited", to be more significant than is in fact the case. If individual AQR reports were to be published, great care would need to be taken in the drafting of the reports to minimise this risk.

10.12 We are concerned that the publication of individual company AQR reports that are classified as 'Improvements required' or 'Significant improvements required' would cause stakeholders and the media to conclude that the audit committee had failed to monitor the effectiveness of the audit. Whilst this might well be so, particularly in more extreme cases, it would normally not be so. Audit committees can only assess the quality of an audit from what they observe in terms of audit activities and outcomes. They have no access to the auditors' files, which are (at least under the current AQR regime) the principal evidence on which AQR findings are based, and audit committees must assess audit quality on a real time basis and not after the event, with the benefit of hindsight and without any limitations on the amount of time available in which to make the assessment.

[55] Kingman Report para 2.2

10.13 In explaining failures by the auditors to meet the requirements of auditing standards in relation to specific significant transactions or events, the transaction or event concerned might be identified in the report and if this is not redacted in the published report, it could well prompt questions in the media about the company's accounting treatment of the transactions or events, particularly if the shortcoming in the audit related to accounting estimates or judgements such as the recoverability of debts, long-term contract valuation, asset impairment and so forth. It does not seem right that the publication of a report on the quality of the audit alone should result in questions being asked about the company's financial reporting.

10.14 It is also possible that an AQR report contains information about a specific transaction or group of transactions that the company itself is under no obligation to disclose and does not wish not to disclose. Again, it does not seem right that such information should become public through the medium of an AQR report. We also have some concerns that the AQR reporting only shortcomings in the audit (i.e. not a balanced presentation of the audit as a whole) may damage confidence in the company's financial statements. We doubt whether reports of AQRs that eliminated the risks and addressed the other issues we have referred to would be of interest to stakeholders.

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?

If the regulator were to publish AQR reports on individual audits, the most essential safeguard would be a swift independent appeal process which would be available to the audit firm and the audit partner concerned and also to the company concerned if it believed that publication could cause damage to its reputation.

10.15 Were the regulator to take advantage of the proposed power to publish AQR reports without the company's consent, there would need to be a swift independent appeal process if the company believes the publication of an AQR of the audit of its financial statements would risk damaging its reputation. This process would need to be and perceived to be independent of the regulator.

10.16 No question is asked in the consultation document about the consequences for the audit firm or the audit engagement partner of the publication of audit quality reviews of individual audits. However, the reputation risk arising from the publication of an audit quality review report that classifies the audit as "needs significant improvement" or even "needs improvement" is more significant for the audit firm involved, and especially for the audit engagement partner who is identified in the audit report concerned, than it is for the company concerned. In the case of the audit partner, publication such a report would very likely be a career-terminating event. The threat of such a report might well increase even more the already excessive time spent by auditors on sanitising their audit documentation for the benefit of the regulator, and therefore the cost of audit to companies. Again, natural justice would require the audit firm and more particularly the senior members of the audit team concerned to have the right to appeal to an independent expert tribunal against the regulator's decision to publish a report that it had classified as "improvements required" or "significant improvements required".

11. The role and powers of ARGA

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

We are disappointed that the consultation document does not seek views on the proposed statutory objectives for ARGA as the proposed combination of quality and competition objectives raises some fundamental issues.

11.1 We have no objection to the proposed general objective and it should help to establish the mindset of the new regulator. It is, however, so general as to be somewhat nebulous.

11.2 We are disappointed that the consultation document does not seek views on the proposed statutory objectives for ARGA as the proposed combination of quality and competition objectives raises some fundamental issues. The document expresses the view that "there could in the future be situations where the importance of promoting quality outweighs the need to promote effective competition. Similarly, the regulator may also need to promote effective competition where the importance of doing so may outweigh the need to promote quality"[56]. In exercising oversight of corporate reporting and auditing, the regulator would be expected by those it regulates to pursue only its quality objective: indeed, this is the objective that drives the regulator's corporate reporting review activity and its audit quality review activity.

11.3 So far as we are aware, the FRC has never previously included competition in its stated objectives. We assume that the proposal to include such an objective now is due to the managed shared audit proposal and an acceptance that its implementation cannot be justified on the basis of the regulator's quality objective. However, that is not stated in the consultation document (which actually implies that its managed shared audit proposal will create "greater choice and resilience in order to deliver the desired improvements in quality"[57]) and indeed the document goes as far as to say that the proposed competition duty would "in effect require ARGA to prioritise its competition objective wherever possible"[58] . The document then says "this broadly follows the Financial Conduct Authority's competition objective"[59]. However, this is a false analogy. The role of the Financial Conduct Authority is to make financial markets work well. The role of ARGA is to oversee compliance by companies and auditors with corporate reporting, governance and auditing requirements. Competition is at the heart of financial markets. Quality, not competition, is at the heart of compliance with corporate reporting, governance and auditing requirements. Giving the competition objective the same importance as the quality objective in ARGA's statutory objectives is in our view completely inappropriate. Any action by the regulator that is inconsistent with the quality objective should be justified publicly by the regulator as a departure from its primary objective, including an explanation of how the regulator plans to address the possible effect of the action on the quality of corporate reporting, corporate governance or audit, as the case may be.

[56] para 10.1.18
[57] para 8.1.10
[58] para 10.1.16
[59] Para 10.1.16

11.4 We would point out that since auditing is driven by corporate reporting, corporate governance and accounting, it should follow rather than precede the references to these activities in the wording of the quality objective.

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 agree with the four duties proposed for ARGA in the consultation document but in our view, the duty to act in a proportionate manner and to prioritise regulatory activity on the basis of risk are of such importance in relation to ARGA that they also should be included in the specific duties of ARGA.

11.5 We agree that ARGA should have regard to the four principles listed in paragraph 10.1.21 of the consultation document.

11.6 The consultation document proposes not to include in ARGA's duties two duties that the FRC Review recommended should be included and instead states that the Government proposes to legislate to ensure ARGA must "have regard to the general regulatory principles and Regulators' Code"[60], as the Regulators' Code addresses the duties concerned. In our view, however, the two duties – that essentially would require ARGA to act in a proportionate manner and to prioritise regulatory activity on the basis of risk – are extremely important in relation to ARGA, particularly in the light of the very significant expansion of the regulator's remit that is proposed in the consultation document but for which information about the specific regulatory requirements and standards has not yet been developed. In our view the two duties should therefore be included in ARGA's specific duties as they need to be 'top of mind' with ARGA. In this regard we note that several of the actions recommended by the FRC Review state that they should be risk-based or proportionate.

[60] Para 10.1.24