THE INVESTMENT ASSOCIATION

IA Response to Consultation

BEIS: Restoring Trust in Audit and Corporate Governance

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary

The IA warmly welcomes the Government's white paper, *Restoring Trust in Audit and Corporate Governance*, and the chance to provide views on the proposals. Investors rely on the quality and robustness of the audited information companies report to the market when making investment decisions and holding company management and boards to account. High quality and effective audits are vital to ensure the markets trust and have confidence in the information companies report. Ultimately, the investment managers are seeking to invest in companies which will deliver long-term value to their clients. The reforms set out in the White Paper should, as a whole, improve the quality of audit and corporate governance in public interest entities; establish a strong, robust regulator; facilitate investor stewardship; and provide benefits to the wider economy.

The investment management industry recognises and welcomes the role it will need to play in restoring trust to corporate governance and audit. Our members are proud of the role they play as stewards, allocating, managing and overseeing capital to create long-term value for clients and beneficiaries that leads to sustainable benefits for the economy, the environment and society. Our members' role as stewards situates them at the heart of the economy and it is a role investors take seriously. In November 2020, the Asset Management Taskforce Stewardship Working Group published its report, *Investing with Purpose: Placing Stewardship at the Heart of Sustainable Growth*¸ for which the IA provided the secretariat. This report provided a blueprint of twenty recommendations for integrating stewardship into the investment process to cement the UK as a global centre of excellence in stewardship practice. The findings and recommendations therein will provide mechanisms to help improve stewardship, allowing the industry to play their role, alongside the other actors such as directors, auditors and the regulator, to improve audit and corporate governance in the UK.

Timelines

This is a wide-ranging and comprehensive consultation, bringing together the suite of recommendations that emerged from Sir John Kingman's review of the FRC (the Kingman

Review), the CMA market study (the CMA study) and Sir Donald Brydon's review into the effectiveness and quality of audit (the Brydon Review). Each of these reviews were, in and of themselves, comprehensive and full of recommendations.

Whilst the IA is broadly supportive of the individual proposals and the need to address audit quality and corporate governance, the Government will need to consider the cumulative impact of the proposals on the UK economy as a whole. The impact of the pandemic and the UK leaving the EU has created new challenges for UK businesses and the economy and there are concerns about the capacity of companies, the regulator and the audit market to absorb the full range of proposals. There are further concerns about the potential costs for UK companies and the resulting impact on the competitiveness of UK businesses, including how UK companies compete with peers internationally and how the UK attracts companies to establish, operate, list and grow in the UK. To ensure the success of these reforms, we would stress the importance of clear, appropriate and realistic timelines for implementing the proposals. It is critical that the timelines reflect the need for companies, the audit market and ARGA to build sufficient capacity and capabilities to meet the extended requirements. There will also be a need to review the effectiveness of the proposals as they are adopted across the market to ensure individual elements are having the desired effect.

At the same time, the IA would like to stress the need to balance these timelines with the importance and urgency of the proposals put forward in the White Paper. The majority of the proposals are drawn from a suite of consultations taking place over the past three years. The corporate failures which the proposals seek to address may continue in the meantime. The pandemic, and the position it has put many companies in, only increases the urgency by which the Government's proposals need to be implemented.

The Government should therefore prioritise those proposals which will have the biggest benefit to the audit and corporate governance regime. A narrower initial focus will allow companies, shareholders, regulators, and the audit market to implement them more effectively. In particular the Government should focus on issues where the UK's governance regime is seen to be lagging behind global peers.

The IA would therefore encourage the Government to focus on the following key proposals:

- Increase director accountability through provisions on corporate reporting and internal controls.
- Establish ARGA on a statutory footing with powers over auditors and directors with the appropriate checks and balances.
- Enhance corporate processes and reporting through internal controls, Resilience Statements, the Audit and Assurance Policy and mandatory assurance on sustainability reporting.
- Focus on improving audit quality and increasing competition in the audit market to improve the resilience of the audit sector.

Key Themes

We have endeavoured to provide responses to the vast majority of the questions posed. Throughout, our response has been guided by a number of key considerations that will ultimately impact on the ability of investors to deliver long-term value on behalf of clients. Our focus has been on the impact of the proposals on audit quality, director and shareholder responsibilities and accountability, investor stewardship, and the role of the regulator.

Improving the quality of audit will be fundamental to restoring trust in audit and corporate reporting. As the primary users of the audit and the corporate reporting it oversees, investors know audit quality and corporate governance are key to a well-functioning market. In our responses to the previous reviews, we have focussed on improving audit quality as we consider this is the key market failure which needs to be addressed. Audit, and in particular improvements to audit quality, has been a key concern for members for a number of years: in 2020 the IA published its *Shareholder Priorities for 2020*, in which audit quality was one of four priorities for our members, replete with investor expectations for audit committees. Audit quality continued to be a priority in 2021. So far, we have not seen the desired progress.

Ultimately, investors and other stakeholders rely on the information presented in a company's annual report and accounts and other disclosures to make informed investment decisions and hold companies to account. The quality and robustness of the audits of these accounts and disclosures is, therefore, essential and should form the backbone of the proposals. Increasingly, investors are relying on corporate reporting beyond the financial statements to base their investment and stewardship decisions. This means that assurance of reporting beyond the statutory audit needs to be transparent, improved and more consistently required.

It is also important to recognise the differing roles of shareholders and directors. Investors rely on company directors to run the company, ensure it meets its statutory obligations, and ultimately promote its success for the benefit of its members. It is shareholders' responsibility to hold the directors accountable for the decisions they take. In making proposals that seek to give shareholders a larger role in upholding audit outcomes, it is critical that the reforms do not shift responsibility away from the directors – it is not the shareholders' role to micromanage the company or direct the company to take a specific approach to audit. Directors should make the appropriate decisions for the company and be held accountable for those decisions through the normal shareholder engagement and voting mechanisms, such as the annual vote on the approval of the report and accounts or re-election of individual directors.

Nonetheless, investors will play a critical role in delivering the objectives of the White Paper. To facilitate effective stewardship by shareholders, companies need to provide transparent disclosures to investors. Where these issues disclosed could have an impact on the long-term value of the company, investors will use them to engage with management, the audit committee or wider board to ensure that the company is responding to any risk to long term value. We therefore welcome the proposals that facilitate strengthened shareholder engagement in audit, including the Audit & Assurance Policy, the opportunity to comment on the audit plan, and auditor/audit committee attendance at the AGM. These will provide additional shareholder engagement avenues. However, we would stress that effective stewardship is about engaging on the right issues, with the right company, at the right time. Engagement on audit related issues should be focused on material risks to the business and its long-term value rather than creating engagement for engagement's sake.

Finally, we welcome the progress already made by the regulator under the leadership of Sir Jon Thompson and support the proposals for a stronger, robust regulator with appropriate statutory powers which is funded on a statutory basis. It will be critical in overseeing this broad sweep of reforms that ARGA continues to build its capacity and capabilities. In this rapid expansion of powers and scope, it will also be critical that ARGA is held accountable for the decisions it takes and the outcomes it seeks to achieve.

Specific Proposals

In addition to the key principles we have highlighted above, there are also a number of specific issues that we think should be addressed:

- **Mandating assurance of certain disclosures** – Investors are increasingly using a wider range of information beyond the financial statements for their investment and stewardship decisions. Investors consider that there are a number of areas of corporate reporting, including sustainability disclosures; APMs and KPIs, and internal control statements, where assurance should be mandated. The level and scope of this assurance should be decided by the audit committee and set out to shareholders in the Audit and Assurance Policy.

- **Internal Controls** – We welcome the proposals to enhance the internal control framework in the UK. We believe that it is proportionate and would encourage the Government to extend the responsibility statement and effectiveness review to consider all material controls, including financial, operational and compliance controls and not just financial reporting.

- **Vote on the Audit and Assurance Policy** – We welcome the increased transparency and focus provided by the Audit and Assurance Policy as the scope of audited and assured disclosures expands to meet the needs of investors. There are mixed views on the merits of having a vote on the Audit and Assurance Policy and we believe that there should not be a specific vote on the Policy at this stage. This will give companies and investors time to develop approaches to the Policy, engage on the most material audit matters, and use the existing mechanisms, such as votes on the re-election of the audit committee, to hold directors accountable for the Policy. We recommend the Government keeps the need for a vote on the Audit and Assurance Policy under review, subject to whether the desired behavioural changes materialise.

- **Improving competition and resilience in the audit market** – Investors are concerned with the lack of competition and resilience in the UK audit market. However, they are unconvinced of the merits of managed shared audits. They are concerned that the proposals will not lead to improved audit quality and will increase cost for little benefit. Instead, they recommend that the Government consider a market share cap. The Government needs to work with other governments globally to find an international solution to the lack of competition in the audit market: this is not an issue which can be solved domestically.

- **Resilience Statements** – These are important disclosures to ensure that directors are appropriately considering the going concern and viability of the company, but we do not believe that a list of issues should be specified by the government. Instead companies should focus on identifying and reporting on the material risks to their individual business. This will lead to more informative reporting and less box ticking or boiler plate disclosures.

Please see next page for responses to individual questions.

1.3 - Resetting the Scope of Regulation

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

The IA supports the inclusion of large private companies within the definition of PIE. We agree with the assessment that corporate failure can and will happen. But it should rarely be a surprise.

The ambition to restore trust in corporate governance and reporting cannot be achieved while there are a different reporting requirements for publicly listed companies and private companies. Private companies play a key role in society, delivering employment and significant services to the economy. The public rarely distinguishes between corporate failure at a publicly listed company and a private company; public trust and confidence in financial markets is informed as much by the behaviours and actions of these companies as those of listed companies. The impact of corporate failure, as in the case of both BHS and Carillion, does not alter depending on whether the company was publicly listed or not. Irrespective of its listing status, corporate insolvency impacts on workers, suppliers, customers, investors, creditors and pension funds and taxpayers. As the White Paper notes, the succession of sudden and major corporate collapses, both public and private, have caused serious economic and social damage.

The extension of the definition of PIEs to large private companies comes at an important moment. Recent years have seen asset owners wanting increased exposure to private markets. As asset allocation shifts, the importance of robust, assured corporate reporting beyond listed companies will also shift and grow.

As investors in UK plc, private companies and corporate debt, our members will play a critical role in restoring trust in companies through their stewardship functions and holding the companies they invest in, to account. As stewards, our members responsibly allocate capital and oversee their investments to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. Investors can best fulfil this function where the information they receive is accurate and robust, supported by a high-quality audit. The extension of the PIE definition will help investors fulfil their stewardship responsibilities in private markets and is in line with recommendation 4 of the Asset Management Stewardship Working Group, *Investing with Purpose: Placing Stewardship at the Heart of Sustainable Growth*, which called for greater emphasis on stewardship in private markets. We would, however, also encourage the Government to consider how the needs of creditors are being factored into the criteria for the extended definition of PIEs: would a company’s net liabilities, for instance, be relevant to its importance to the public.

The emphasis on corporate reporting from large private companies, and investors’ stewardship of these assets, will increase over the coming years as the UK strives to meet its Net Zero commitments in recognition of the significant contribution that large private companies will make to the net zero carbon transition. For the UK to honour its commitments to bring about net zero greenhouse gas emissions by 2050 (“Net Zero”) and to achieve the Paris Agreement goals, significant change will have to occur across the entire economy. Public and private companies alike will have to make changes to their business to reduce emissions and manage the impact of climate change. As we remark throughout our response, sustainability reporting, including the assurance of such reporting, will be a key component of corporate reporting moving forward.

Finally, asymmetric requirements on private and listed companies can disincentivise listing and hamper the competitiveness of the UK as a place to list. A challenge for policy makers is to balance the flexibility permitted by the unlisted sector, recognising that these companies are not seeking capital on public equity markets (though some may seek capital on debt markets), with the need for large private companies to step up to increased expectations on corporate reporting, in line with their significance to the economy and wider society. We therefore agree with the proportionate approach taken by the Government and emphasise that without extending the definition to large private companies there is a danger that the discrepancy between reporting and audit requirements for private and listed companies becomes too large to be bridged. In this vein, it is important that the Government consider how the proposals here interact with other reforms and consultations on the UK's business attractiveness.

We recognise that there are issues which will need to be addressed in extending the definition of PIEs to this extent. The proposals set forth here are comprehensive and will undeniably present new challenges to companies. For those companies that have not previously been subject to similar requirements, this will be a fresh challenge. The audit market may need to expand to meet the requirements in these proposals, let alone to cover the statutory audit requirements that will flow from the expanded definition of PIE. Similarly, ARGA, given extensive new powers, will also oversee a significantly enlarged base. Given our general support for the proposals set forth here, and the belief in their importance to public and private companies alike, we would stress the importance of clear, appropriate and proportional timelines for implementing the proposals and extending the definition of PIE – see response to Q10. It is critical that the timelines reflect the need for companies, the audit market and, crucially, ARGA, to build sufficient capacity and capabilities to meet the requirements of the extended definition.

In addition to the above considerations, we would encourage the Government to consider how certain exemptions could be included to ensure a proportional approach is maintained. For instance, safeguards should be introduced to ensure that large subsidiaries do not inadvertently become PIEs, putting an unnecessary burden on reporting requirements that have already been provided at the Group level. It would therefore be helpful to consider exempting wholly owned subsidiaries of a UK or international listed parent entity from certain requirements such as the internal controls statement if they are meeting the reporting and governance requirements at the parent company. We would also encourage the Government to provide exceptions for investment trusts – for which a number of the proposals would not be applicable.

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

The IA supports Option 1.

Option 1 best reflects the importance of large private companies to the economy and wider society. The succession of sudden and major corporate collapses has caused serious economic and social damage. At the most basic level, this is because of a) the number of employees impacted, and b) the role of large private companies in the economy. Option 1 captures both elements – those with a large number of employees but relatively few assets or turnover as well as those with a high turnover/strong balance sheet but relatively few employees.

Option 1 also has the benefit of aligning with existing requirements to include a corporate governance statement in the directors' report. This was introduced to focus on those companies that had a large impact on the economy through employment or assets. It is logical that the extended definition of PIEs is therefore consistent with the existing requirements.

Ultimately, and irrespective of the option adopted, the Government should seek to rationalise the differing thresholds applicable to reporting requirements for private companies to ensure consistency as far as possible. This review should include the Streamlined Energy and Carbon Reporting (SECR) regulations, the Corporate Governance Reporting Requirements for Large Private Companies, reporting on Directors Duties, and other reporting requirements. We note, for instance, that the BEIS consultation on mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs, adopted a definition more aligned to Option 2. Reconciling the various approaches will ensure a more coherent and understandable disclosure regime.

The IA appreciates that the estimated 1,960 additional entities brought into scope under Option 1 is significant. As discussed in our response to Q10 and Q11, the Government will need to take a proportionate approach, with appropriate timetables to allow the market to adjust. Most importantly, the Government will need to ensure that auditors and ARGA have sufficient capability and capacity to provide sufficient audit and oversight capabilities to the extended market. ARGA will need to be adequately resourced through a statutory levy to deal with the additional requirements.

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

The IA supports AIM companies with market caps exceeding €200m being included in the definition of PIE. As companies with publicly traded shares, shareholders rely on the quality of information to make investment and stewardship decisions.

In addition to the proposal, the IA would further support all companies listed on an unregulated market with a market capitalisation exceeding €200m being included in the definition of a PIE. Otherwise, the IA would be concerned that the proposals would unduly disadvantage AIM relative to other unregulated markets.

The IA would also suggest that the threshold be specified in Pound Sterling rather than Euros.

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

The IA does not support temporary exemptions for newly listed companies.

Crucially, the new reporting and attestation requirements may be most needed in newly listed companies where companies are trying to build investor confidence in their financial reporting, governance and oversight. IA members would expect newly listed companies to be required to comply with the new reporting requirements from the outset.

A key example is the internal controls statements – in those companies without a public and proven track record, the effectiveness of the internal controls will be a key consideration for investors. The concern is that, were a temporary exemption to be granted, it would be those companies which most needed to provide commentary on the effectiveness of their internal controls that took the option not to.

The IA recognises the delicate balancing act between the measures proposed in the White Paper, which increase the requirements on companies and their directors, and the ambitions of Lord Hill's review to improve the attractiveness of the UK listing regime. As noted in our response to the Review, the IA and its members have an ambition to re-energise public markets and create a savings and investment ecosystem which delivers for end savers and that is attractive to both companies and global investors. To this end, the IA is keen to ensure that disincentives to listing are not significant.

However, the IA would stress that Lord Hill's review should not be seen as necessarily in tension with the proposals set forth here: improving investor rights and corporate governance expectations increases investor confidence, attracting capital from UK and overseas investors to the market, in turn providing companies with access to patient capital. The pandemic has highlighted the important role investors play in financing companies. Investors supported UK plc through the pandemic, providing around £22bn in new capital to companies between March and November of 2020. Access to this capital should be accompanied by appropriate investor protections. The IA is keen to work with the Government to explore other measures, such as changes to prospectus requirements that would continue to encourage more companies to list in the UK.

5. **Should the Government seek to include Lloyd's Syndicates in the definition of a PIE? Please give your reasons.**

The IA does not have a view on this question.

6. **Should the Government seek to include large third sector entities as PIEs beyond those that would already be include in the definitions proposed for large companies? If so, what types of third sector entities do you believe should be included and why?**

The IA supports the inclusion of large third sector entities, specifically Housing Associations. In 2017, the IA published Governance and Disclosure Guidelines for Housing Associations Seeking Funding from Capital Markets. In the paper, the IA noted that investors are keen to see greater transparency from housing associations and improved reporting. The inclusion of Housing Associations in the definition of PIEs would help those investors of Housing Associations which have issued debt to the capital markets, to have sufficient information to make appropriate investment and stewardship decisions.

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

The IA does not have a view on this question.

8. **Should any other types of entity be classed as PIEs? Why would those entities be included?**

Other than as outlined in responses to Q3, Q6 and Q7, we do not believe that any other companies should be captured by the definition.

9. **How would an increase in the number of PIEs impact the number of auditors operating in the PIE audit market?**

As noted in our response to Q1, the IA appreciates that the estimated 1,960 additional entities brought into scope under Option 1 is significant.

There is a need for the audit market to have the capability and capacity to meet the extended requirements and the regulator to oversee these audits and the auditors. The increased demand should result in increased supply over the long-term, though we recognise that supply may struggle to meet demand immediately. This should be a key consideration when considering the appropriate timeline for extending the definition to ensure that the market operates effectively. If this is not the case, the IA would have concerns about the impact on the quality of audits.

Whilst we have no specific comments on competition, the IA agrees with analysis in the consultation document and consider it to be an important consideration, particularly as it relates to the capacity of the regulator. We also note that the supply gap may be bridged by increased activity from ‘challenger’ firms, or by further concentration of the Big Four, the latter of which should be monitored by the regulator if it occurs.

10. **Do you agree that the Government should provide time for companies to prepare for the introduction of a new definition of PIE?**

The IA agrees the Government should provide time for companies to prepare for the introduction of a new definition of PIE.

A significant lead-time of at least three years before introducing a new PIE definition is critical given a) the number of companies being brought into the definition, and b) the scope of the proposals that will apply. The IA agrees with the assessment in the White Paper that the timing would need to reduce the potential for bottlenecks and provide companies with the time they need to prepare. As noted in our response to Q9, the lead-time will also be critical to auditors as they build the requisite capacity to conduct a high-quality audit across the PIE universe.

At the same time, the IA would note the importance and urgency of the proposals put forward in the White Paper. The majority of the proposals are drawn from a suite of consultations taking place over the past three or more years. The corporate failures which the proposals seek to address will continue in the meantime – as demonstrated most recently by Patisserie Valerie. The pandemic, and the precarious position it has put many companies in, only increases the urgency by which companies, including large private companies, will need to improve their corporate reporting, and the importance of a high-quality audit that can identify key risks to the business.

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

The IA agrees with a phased introduction. This would provide sufficient flexibility to avoid unintended consequences and onerous costs.

2.1 – Stronger Internal Company Controls

12. 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?

The IA strongly supports the need for strengthening the internal control framework for UK companies. We believe this was one of the key recommendations to come out of Sir Donald Brydon's review and are pleased to see it being taken forward by the Government.

IA members want to invest in well governed and controlled companies. Whilst on the whole companies' risk reporting appears to be adequate, reporting on the review of the effectiveness of internal controls is largely boilerplate and we do not consider that the existing requirements, which only cover premium listed companies via the Corporate Governance Code on a comply or explain basis, go far enough.

The experience in the US, where the Sarbanes-Oxley Act was implemented in the wake of corporate failure to restore investor confidence in markets, is a useful guiding light for the proposals. As the evidence from the US shows, reporting requirements on internal controls sharpens director focus and increases their priority on the directors' agenda. Requiring directors to be accountable for the operation of the controls will positively impact investors' views on the controls' effectiveness. As the Brydon Review noted when recommending a director statement on internal controls, "there is sufficient evidence to suggest that such attestations have improved relevant internal controls and may have helped to lower the cost of capital".

Improving the internal control regime would also have wider implications, including working alongside the proposals on tackling fraud – see response to Q42. Studies have found that the Sarbanes-Oxley "has the desired effect of inducing stronger internal control systems and less fraud".

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

The IA is supportive of the Government's initial preferred option but have identified a number of issues the Government should consider, headlined by the need for mandatory external assurance.

The Government's preferred option has a number of benefits. Overall, we believe the Government's preferred option draws from the Sarbanes-Oxley regime in a manner that is proportionate and in line with the UK's existing provisions.

Directors Responsibility Statement and Annual Review of Internal Control Effectiveness and New Disclosures

The Government's preferred option is headlined by a director's responsibility statement and a review of the internal control effectiveness. The IA considers director sign-off to be crucial to ensuring internal controls are effective and appropriately prioritised. Requiring directors to be accountable for the operation of the controls will positively impact investors' views on the controls' effectiveness.

In contrast to the US approach, and Sir Donald Brydon's recommendation, we welcome the extension of the requirements to all directors, in line with the principle of a unitary board that is key to the UK system.

However, we have concerns about the scope of the Government's initial preferred option. The directors' responsibility statement refers to responsibilities for an "adequate internal control structure and procedures for *financial reporting*". Similarly, the proposed effectiveness review is limited to the "internal controls over *financial reporting"*. We would question the dichotomy between internal controls over financial reporting and other internal controls, such as operational and compliance. Ultimately the operational and compliance control environment could have a material impact on the financial position of the company; the internal control statement should not draw a false distinction between the two. To draw a distinction between the two is to permit unnecessary risk and reduce the effectiveness of the proposals.

We note that under the UK's Corporate Governance Code, directors of a premium listed company are required to "monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should *cover all material controls, including financial, operational and compliance controls*". The proposals set forth here should seek to build on the UK's existing provisions, rather than dilute. We would therefore recommend that the responsibility statement and effectiveness review consider all material controls, including financial, operational and compliance controls.

Principles and Guidance

The IA supports the regulator developing, or endorsing, principles and guidance on internal control effectiveness. Any guidance would need to avoid providing a template for boilerplate responses.

External Audit and Assurance

The IA's major concern with the Government's preferred option is its approach to external audit and assurance. The proposals consider the audit and assurance of the internal control effectiveness statement to be a matter for audit committee and shareholders as part of the Audit and Assurance Policy. We do not concur.

The IA strongly believes that the internal controls, and the proposed statements, should be subject to mandatory external assurance. Internal controls are a critical element in ensuring the integrity of the financial and accounting information, promoting accountability and preventing fraud. Reporting on these controls should be subject to external assurance to provide investors with confidence in their functioning. We consider that if directors are to be required to make a statement on the effectiveness of the internal controls, auditors' responsibilities should be expanded so that they form a view on that statement.

The Government should therefore mandate external assurance on the internal controls over financial reporting. Given the auditors' responsibilities for auditing the financial statements, we consider auditors should only be required to opine on the controls over financial reporting, as opposed to the wider internal controls. The assurance of the operational and compliance controls would be a matter for the Audit and Assurance Policy. Please see our response to Q22 for a further elaboration of our views on the Audit and Assurance Policy.

Enforcement
The IA welcomes the further strengthening of this accountability through the enforcement proposals; ARGA should have powers to investigate the internal control disclosures and sanction directors where they have failed to establish and maintain an adequate internal control structure and procedures for financial reporting.

Scope
See our response to Q14.

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

The IA supports the proposed timeline, with the requirements applying initially to premium listed companies and extended to other PIEs after two years, subject to an impact assessment at the time. This will allow best-practice to develop and ensure that the requirements remain proportionate.

Prior to the requirements applying to premium listed companies, we would welcome sufficient time to allow companies to ensure they have the appropriate systems and controls in place to make adequate disclosures. We understand that it can take between 12-36 months to design, test and embed an automated control environment under Sarbanes Oxley. However, we would note that companies should already be considering their internal controls as per the Corporate Governance Code and would therefore expect this delay to be minimal.

If the reforms are to achieve their aims of restoring trust, it is vital that the internal control requirements are extended to all PIEs – as noted in our response to Q1, the distinction between a publicly listed company and a private company collapsing is lost on the general population and the affected employees/supply chain. However, it may be helpful to provide an exemption for private PIEs which are wholly owned subsidiaries of a listed parent which provides its own internal controls statement to avoid duplication of what will be a complex and costly exercise. We would also recommend that investment trusts be scoped out of the internal control framework to reflect the fact that they do not have employees and provide no goods and services, as well as outsourcing their key functions and processes to external service providers.

The IA would not support a temporary exemption for newly listed companies. As noted in our response to Q4, given the importance of internal controls, especially for companies which have not previously been subject to more rigorous shareholder and auditor oversight, this would be detrimental as investors seek to build confidence in newly listed companies' financial reporting, governance and oversight.

2.2 – Dividends and Capital Maintenance

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

The IA supports the regulator having stronger responsibilities for defining what should be treated as realised profits and losses. The IA agrees that the establishment of an independent and stronger regulator represents an opportunity to better define realised profits and losses.

The IA supports option 1 (to give ARGA a duty to prepare guidance on what should be treated as realised profits and losses in accordance with generally accepted principles prevailing at the time). This is a proportionate response which provides flexibility going forward and across sectors as best practice principles evolve. Option 2 would not provide adequate flexibility.

We would expect ARGA's guidance to be reviewed by an independent lawyer to ensure consistency, in particular as it relates to the capital maintenance regime set out in part 23 of the Companies Act.

The current guidance, provided by the ICAEW and ICAS, is widely accepted and adopted by premium listed investment companies when disclosing distributable profits. Presently, the guidance's strength is limited by having no formal legal status and we would encourage ARGA to prepare guidance on the basis of the existing technical guidance.

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

The IA supports the new distributable profit reporting requirements. The IA has previously called for greater transparency from companies in our response to the BEIS consultation on Insolvency and Corporate Governance, our research on votes on dividend payments; Shareholder Votes on Dividend Distributions in UK Listed Companies the Case for a Distribution Policy, and our explicit call for this requirement in our response to the Brydon review.

Although we cannot comment on the cost of these disclosures, the benefits to investors are numerous. Dividends are an important income stream for many savers, pensioners and institutional investors, including pension funds and charities. They are a core component of a company's overall approach to capital management. Capital management decisions form an important basis for investor engagement; how well a company utilises its capital has a significant impact on its long-term profitability and success. Investors want to support capital allocation decisions that will drive productivity improvements and will only support distributions which will not impact on the long-term sustainability of the company.

While regular dividend returns are welcomed by investors, and form an important income component for many funds, prioritising these distributions should not come at the cost of a well-informed assessment of whether these returns are sustainable over the long term. There is a misconception amongst some companies that investors expect cash to be returned at all costs, resulting in aggressive dividend policies. On the contrary, investors are known to support reductions or the freezing of dividend payments where they think this is more appropriate for the long-term sustainability of the company.

The IA has previously articulated the concern that company reporting on their capital management is excessively focused on the short term, making it challenging for investors to engage and make informed investment decisions. The reporting requirements proposed here would provide useful information about the legality and potential future sustainability of dividends. We thus agree that distributable and non-distributable reserves should be required to be disclosed in the audited financial statements.

In order to gain further clarity on the sustainability of the dividends across complex group structures, the IA welcomes the proposed narrative disclosures on any restrictions on dividends paid by subsidiaries to the parent and why. This would enhance investors' confidence in management's oversight by demonstrating that dividends are not being proposed out of capital and clarify the headroom between the level of distributable reserves and the proposed dividend. The fact this information is included in the audited financial statements will mean that it is subject to the audit.

The IA would support the use of organograms of group structures to assist with the explanation of how reserves are held within the group.

The IA agrees with the proposals applying to listed and AIM companies only but would reiterate previous concerns about the proposals unduly disadvantaging the AIM market relative to other unregulated markets and would encourage the Government to consider whether extending the requirements would be appropriate.

In addition to the above, the IA notes that some investors do not consider that accrued income should be treated as realised profits, arguing that realised profits should only be those that are realised in cash or near cash. In light of this, the Government may want to give further consideration to the distinction between realised and unrealised profits.

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

The IA supports an explicit statement about the legality of dividends and their effect on the future solvency of a company. Investors have concerns when companies fail to maintain distributable reserves and pay unlawful dividends: trust in companies depends intrinsically on strong capital protection. As with our support for the directors' statement on internal controls, a statement on the legality of dividends and their effect on the future solvency of a company would be instrumental in building external confidence.

As noted in our response to Q16, investors want to support capital allocation decisions that will drive productivity improvements and will only support distributions which will not impact on the long-term sustainability of the company. To this end, a directors' statement on the effect of the dividend on the future solvency of a company is imperative. These considerations should already be taken into account when considering the company's viability statements, but any such statement will need to link to the proposed Resilience Statement.

The existing framework is clearly not sufficient: investors regularly have to retrospectively approve dividends which have been paid by companies illegally as the company has had insufficient distributable reserves. These are often presented as administrative errors by companies. But shareholders are liable for recovery of the dividend payment of an illegally paid dividend. Giving investors certainty of the legality of the dividend is therefore important to the efficient functioning of the market.

More generally, in seeking to return trust to the markets, the reputational damage caused by dividends paying out prior to insolvency, as was the case with Carillion, is extreme.

The IA would support the requirements being limited to listed and AIM companies but is minded to support the Government extending the requirements to other PIEs should this be considered necessary – especially given the experiences of BHS and other companies with major solvency issues.

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

In addition to the reporting requirements introduced under the Companies Act, and the proposals outlined above, the IA supports companies disclosing a distribution policy, setting out the board's long-term approach to making decisions on the amount and timing of returns to shareholders, including dividends, share buybacks and other capital distributions within the context of any relevant legal or financial constraints.

A distribution policy would provide further insight into the company's approach to capital management, beyond issues of legality and future solvency. Companies should more clearly articulate a distribution policy which clearly sets out their approach to making decisions on the amount, structure and timing of returns to shareholders. This will allow companies to set out their anticipated approach, which would be based on conversations with shareholders, and provide shareholders an opportunity to engage with and hold them to account for the implementation of this policy.

For further consideration of a distribution policy, please see the IA's case for Shareholder Votes on Dividend Distributions in UK Listed Companies.

Chapter 3 – New Corporate Reporting

3.1 – Resilience Statement

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

The IA supports the introduction of a Resilience Statement to replace the Going Concern and Viability Statements. However, we do not support the Government mandating a list of matters to be considered in the Resilience Statement – see below.

The current Going Concern and Viability disclosures contain information that is critical to investors. However, the IA agrees with Sir Donald Brydon's assessment that there is "ample room to improve the current requirements" on going concern and longer-term viability reporting. We agree that the current going concern assessment sets the bar too high in allowing proposed mitigating actions to be taken into account when disclosing material uncertainties. Likewise, we generally agree with both Sir John Kingman and Sir Donald Brydon that the current viability statements all too often lapse into boilerplate disclosures – although improvements have been made in recent years.

The primary concern from investors is how the Government will ensure that the components of the Resilience Statement are not subject to the same pitfalls as its predecessors. Investors have already set out clear expectations on what would improve viability statements in the IA's guidelines: "longer time horizons; state clearly why the period was chosen; differentiate time horizons for prospects and viability; assess the sustainability of dividends; and address stress testing". In the main, these requests have been met by the Government's proposals.

While we support the extension of the mandatory minimum time horizon for medium term statement from three to five years, we would caution that this should only be instituted if the Government is confident that the resulting viability statements will be meaningful and based on solid projections. Companies should continue to be encouraged to select a timeframe that is suitable for the company, in particular the specifics of the company's business and sector need to be considered, and not only its business cycle but its investment cycle as well.

We strongly support the newly introduced long-term statement. The IA's Guidelines on viability statements note that investors want companies to provide an insight into their plans for the future which may be separate from the plans that support the viability statement. To facilitate this, directors may wish to consider separating their assessment of prospects from their assessment of viability. The former then gives them the opportunity to demonstrate that they have considered the future of the business over the long-term. The long-term statement provides a useful opportunity for boards to provide a more nuanced, informative picture of the company's future to investors.

List of Matters

The IA does not support the list of matters set out by the Government. A list of matters runs counter to the directors' duties to identify the principle and emerging risks of the company. This is a matter for the board to consider and determine. Part of the value of the Resilience Statement derives from the insight it gives into the board's decision-making process. Moreover, as highlighted by the pandemic, risks can evolve quickly and the constant reassessment of what those risks are and how they impact on the company is critical to making decisions that are appropriate to the company and disclosures that are useful to investors.

While the matters themselves are well chosen and, by and large, we would expect most companies to address these areas when considering the resilience of the company, the IA has significant concerns that a mandatory list of issues would result in a checklist approach by companies, returning the Resilience Statement to the boilerplate responses that has characterised viability statements. Climate change risk is a useful example. Investors expect companies to proactively identify and manage climate related risks. Increasingly these risks are shared by all companies: as the IA's Shareholder Priorities for 2020 noted, "business as usual will lead to business failure". However, if the board sees fit to not consider climate change risk as part of its Resilience Statement, this will be more revealing to investors, and initiate more engagement, than had the directors considered it pro-forma to meet the minimum content.

If companies are consistently failing to address certain risks, investors should identify this as part of their stewardship responsibilities. Where these omissions happen at a market-level, it may be useful for either investors or the regulator to provide guidance on what is expected from viability statements. We consider this approach to be preferable to a minimum content list.

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

The Resilience Statement should not be used as a vehicle for TCFD reporting in whole. This would run the risk of either unduly lengthening the Resilience Statement, making it unwieldly for investors, or dramatically shortening TCFD reporting.

The IA strongly supports TCFD reporting. The information provided is critical to supporting long-term sustainable value, enabling investors to make more efficient capital allocation decisions and to conduct quality oversight and engagement through their stewardship activities. These steps are critical for companies to minimise the negative impacts of climate change on their long-term value and to help realise the financial opportunity of a sustainable transition. In our response to the FCA's consultation on proposals to enhance climate-related disclosures by listed issuers (FCA CP20/3), the IA called for the FCA to introduce TCFD requirements for all commercial premium listed companies on a mandatory basis. We believe these are a critical component of corporate disclosures moving forward.

The IA maintains that companies and their directors should determine where it is appropriate to disclose their TCFD reporting requirements within their Annual Reports and Accounts, as per our response to FCA's CP20/3. In response to BEIS' consultation on mandatory climate-related financial disclosures, we called for companies to be required to make disclosures in line with the 11 recommendations of TCFD as opposed to only the four pillars. Given that disclosures at the 11-recommendation level are likely to be extensive, the company may wish to provide a summarised version of its TCFD disclosures at the four-pillar level in the strategic report with clear references to more comprehensive disclosures at the 11-recommendation level in a separate document. This level of detailed and comprehensive reporting would not fit comfortably within the Resilience Statement.

While we would expect companies to reference their TCFD reporting in their Resilience Statement, this should not be seen as a sufficient substitute for more comprehensive TCFD disclosures.

21. 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?

The IA agrees with the proposed company coverage to initially apply to premium listed companies, who already have extensive experience in disclosing viability statements, before being extended to PIEs within two years.

As per our response to Q4, we would not expect a temporary exemption for recently listed companies. This kind of disclosure may be more important for newly listed companies.

3.2 – Audit and Assurance Policy

22. 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?

The IA supports the proposal for an Audit and Assurance Policy. However, members would like to see certain key issues subject to mandatory assurance. There are concerns about the efficacy of the associated vote – please see our response to Q23 for further details.

Of foremost importance to investors is a high-quality audit. Delivering this will be critical to the Government achieving its aim of restoring trust in audit and corporate governance more generally. With that said, investors are increasingly using a growing range of measures to assess a company; financial statements do not necessarily provide the only measures of a company's performance. Despite this, there continues to be a wide range of corporate reporting which falls outside the scope of the audit. If audit and assurance is to remain relevant to user needs, and trust in decision useful information is to be rebuilt, the scope will need to expand to provide confidence across the reporting spectrum.

The introduction of an Audit and Assurance Policy is an important step in creating the 'user-driven' audit process that Sir Donald Brydon recommended. It is also a recognition that building trust in corporate reporting and auditing is not just about how the audit is conducted, or by whom. Increasingly, robust corporate reporting is also defined by what is subject to audit. Audit and assurance of financial reporting alone no longer reflects the information requirements of investors, nor the demands of society, the economy or the planet. In recent years, the disclosure of adjusted financial information and significant environmental and social issues has become increasingly important to investors as they integrate these factors into the investment process. If the UK is to maintain and develop its reputation as a world-leading place to invest and list, it will need to adopt an audit and assurance framework that captures these wider concerns and are in step with international developments.

Accordingly, while we generally agree with the minimum content proposed by the Government, the IA also recommends that a number of key disclosures are subject to mandatory assurance, with the level and scope of the assurance determined by the audit committee and communicated to shareholders through the Audit and Assurance Policy. The IA consider the following disclosures require mandatory assurance:

- ESG disclosures, in particular TCFD and sustainability reporting.
- APMs and KPIs, including those linked to executive remuneration
- Internal controls statement relating to financial reporting.
- Short-term Resilience Statement and other risk disclosures

The Audit and Assurance Policy will serve as a valuable transparency tool, helping investors to understand which disclosures are subject to assurance and which are not. The IA has previously heard concerns from members that they are currently unclear on which disclosures are subject to assurance and the level of that assurance, whether in the Annual Reports and Accounts (i.e. APMs and KPIs, sustainability reporting) or outside the Annual Report (analysts presentations and other company reporting). The Audit and Assurance Policy would go some way to providing that transparency and alleviating these concerns.

The Audit and Assurance Policy also provides a valuable mechanism by which investors can engage with the audit committee to communicate the wider information and metrics they consider important and requiring external assurance. The types of information that investors want external assurance on beyond the four areas outlined above will differ depending on the company, sector and through time. The flexibility of the Audit and Assurance Policy, which essentially extends the scope of the audit on a company-by-company basis is well designed to respond to these changing expectations. However, as noted in our response to Q23, it is vital that engagement with shareholders does not reduce the ultimate responsibility on the auditor and directors to fulfil their statutory requirements. The final decision and accountability for the assurance decisions rests with directors.

Regarding flexibility, the IA agrees with the Brydon Review that increased user expectations for assurance of corporate information is likely to require assurance services from other providers, as well as from the accountancy profession. Where assurance is provided on disclosures not typically covered by the statutory auditor, the IA welcomes the ability to commission the services of specialist providers to conduct this.

We also welcome the requirements for describing the company's internal auditing and assurance processes, and a description of what policies the company may have in relation to the tendering of external audit services. The IA's Guidelines on Audit Tenders outline the importance of transparency around the audit tendering process to ensure that the integrity, independence and objectivity of the auditor is not impacted, which would ultimately impact on audit quality.

Together, these disclosures will increase investor confidence in the entirety of the reporting package and ensure decisions are made against the most robust disclosures.

Mandatory Assurance

As noted above, the IA also recommends that a number of key disclosures are subject to mandatory assurance, with the level and scope of the assurance determined by the audit committee and communicated to shareholders through the Audit and Assurance Policy. Our reasons for calling for mandatory assurance on each these areas is as follows:

ESG disclosures, in particular TCFD and sustainability reporting.

In recent years, the disclosure of significant environmental and social issues has become increasingly important to investors as they integrate these factors into the investment process. Members consider that material ESG risks can have a material impact on the long-term value of the company, and it is therefore important that these risks are identified, managed and mitigated to maintain and enhance long-term shareholder value. To understand whether and how companies are mitigating and managing these risks, companies need to provide comprehensive disclosures on these issues. However, investors are dissatisfied with the quality and consistency of the information at the current time.

The variety of reporting standards and frameworks around environmental and social issues can cause practical problems in assessing a company's approach to them and comparing reports between different companies and industries. The information is often inconsistent, not available or not verified. Furthermore, it can be difficult for investors to determine what has been audited and what has not, and the level of assurance provided. The IA has called for the global harmonisation of reporting standards, and welcomes the recent progress in this area, but the level of assurance needs to be clearly explained and disclosed.

The IA appreciates that the variety of reporting standards and frameworks also poses a significant challenge to auditors. However, the IA is greatly encouraged by the movement towards global harmonisation of sustainability reporting standards, headlined by the IFRS Foundation's commitment to establish a Sustainability Standards Board to develop reporting standards. Full audit of this information may not be possible or proportionate until single standards are developed.

We would encourage the Government to position the UK in line with other world leading jurisdictions on this front. The EU's proposed Corporate Sustainability Reporting Directive (CSRD) will require "all companies within the scope to seek limited assurance for reported sustainability information, while including an option to move towards a reasonable assurance requirement at a later stage". This would require the external assurance provider to perform a limited assurance engagement on a company's sustainability reporting, including on the compliance of the sustainability reporting with the reporting standard and on the process carried out by the company to identify the information. Future proofing the proposed regulations in this way will be critical to the UK remaining a global leader on sustainability-related matters.

<u>APMs and KPIs</u>
Auditors should be required to provide assurance on both Alternative Performance Measures (APMs) and KPIs as presented to investors within the annual reporting package, including those used to calculate executive remuneration (e.g. the annual report and results announcements/investor presentations relating to the same period as the annual report).

The IA considered this a central recommendation in the Brydon Review. In reality, a large portion of the numbers in the annual report used by investors are those that have been adjusted. As noted in the Brydon Review, 93% of respondents to a survey of investors "would welcome some change to the scope of assurance, with the additional scrutiny of APMs and KPIs used in remuneration topping the list". We would echo Sir Donald Brydon's assessment that the use of APMs has "contributed to suspicion about executive remuneration and, in order to achieve complete clarity, users deserve more certainty over the use of these APMs". APMs frequently provide the principal avenue of communication of company performance, which investors may rely on to make investment decisions.

However, with KPIs:

- It is not always possible to see how they have been calculated.
- It is not clear whether they have been consistently calculated over time. Companies, even in the same industry, can use varying methods such that there is a lack of comparability.
  The subjectivity in how they are calculated make them prone to management bias. The adjustments can be opportunistic with business as usual items being treated as exceptional. Invariably non-GAAP financial measures paint a more favourable picture than GAAP.

At a minimum, the auditor should assure that APMs and KPIs are in line with ESMA's Guidelines and are defined with the basis of the calculation clearly disclosed; an explanation is given as to why they are presented and are useful; and they are presented consistently over time.

Under IFRS, management have to report additional information, non-GAAP financial measures or APMs, if the minimum line items required by IFRS are insufficient to enable investors to understand the financial position, financial performance and cash flows. Thus, EBIT and EBITDA are often reported on the face of the Statement of Income and Expense, and revenue or operating income excludes certain expenses on the basis they are non-recurring. These measures can be helpful to investors and can convey changes to the business that are separate from those that may be considered unusual, infrequent or not representative of underlying trends. This can help in the analysis of future trends and if included in the financial statements then these measures are subject to an audit.

There are also APMs in the narrative part of the annual report and other corporate reports such as preliminary announcements of results and analyst/investor briefings, for example, return on capital employed or invested capital, as well as non-financial measures and industry specific indicators or KPIs, such as like for like sales in the retail sector. The combination of APMs and KPIs within the audited accounts conveys more than either dataset on its own.

In recognition that KPIs can be inherently harder to assure than APMs, we would support the level of assurance for APMs and KPIs being determined by the audit committee and confirmed to shareholders through the Audit and Assurance Policy.

<u>Internal controls statement relating to financial reporting.</u>
Please see our response to Q13.

<u>Resilience Statement and other risk disclosures</u>
The IA would expect the short-term Resilience Statement to be subject to audit in the same way the current going concern statement is. This is a key disclosure which forms the basis on which the accounts are prepared.

We would also expect the medium-term Resilience Statement to be subject to some form of assurance, with the extent of this work determined by the audit committee and set out in the Audit and Assurance Policy.

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

IA members have expressed mixed views on the necessity of a vote on the Audit and Assurance Policy. On balance, the IA would urge the Government to reconsider whether a vote on the Audit and Assurance Policy is necessary and proportionate to fulfilling its aims. We would recommend that the Audit and Assurance Policy not be subject to a vote on its introduction, with shareholders expected to engage and use existing mechanisms, such as the vote on audit committee re-election, to hold directors accountable. The need for a vote could be kept under review, subject to evidence that behaviours and audit quality are unchanged.

The IA appreciates the desire to increase shareholder engagement in the audit process and supports the Government's aim to increase engagement. However, it does not necessarily follow that the Audit and Assurance Policy should be subject to a shareholder vote. Voting at AGMs is just the tip of the iceberg: investors' stewardship activities cover a much broader range of activities all year round. Climate-related matters has been stark proof of this: despite no specific vote on climate-related matters, investor engagement has been consistent and continues to increase. On the other hand, the vote on remuneration has led to significant time demands on companies and investors with unintended consequences. As with all stewardship activity, it is critical that engagements are focused on the issues which are material to the company and will have an impact on the long-term value of the company.

Accordingly, what disclosures are subject to assurance or audit may not be the most material audit or stewardship issue for the company. Investors might have a preference to focus on issues of audit quality or concerns that the audit plan is not covering material aspects or high-risk areas of the company's operations sufficiently. In these cases, shareholders would focus their engagement and other stewardship activities here rather than the Audit and Assurance Policy.

To this point, there are already a number of votes available to investors on audit matters, from the re-appointment and remuneration of the auditor to the re-election of directors on the audit committee, if they feel that companies are not responding to their concern or engagement on audit related issues. Director accountability, in particular, is a powerful tool for investors where engagements have not made sufficient headway.

There are concerns that asymmetry of information between investors and the directors and auditors will mean that investors are not best placed to determine the extent of the audit or assurance through a vote.

If the Government does introduce the Audit and Assurance Policy being subject to a vote, we believe it should be once every three years, except where there are significant changes to the Policy. This timeframe is in line with the existing company policies for shareholder approval (i.e. Directors' Remuneration Policy) and would allow for a more considered engagement between the audit committee and investors. We have seen that the vote on remuneration has increased company engagement with investors on their remuneration policies and outcomes and would expect an uptick in audit engagement as a result of the vote; engagement requires both parties to be engaged in the process. It will be important to ensure that this engagement is on material issues which can impact on the long-term value of the company and not engagement for engagement's sake.

We would not expect the Audit and Assurance Policy to alter significantly on a year-to-year basis. Yearly votes runs the risk of reducing the quality of the engagement between committees and investors.

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

The IA agrees with the requirement initially applying to premium listed companies. This would allow the new requirements to be tested and appropriately honed prior to more general uptake.

Moreover, by narrowing the scope initially, best practice will emerge from those companies with the resources and experience needed.

3.3 – Reporting on Payment Practices

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

Investors are increasingly considering the issue of supplier payments and prompt payments as part of their analysis of companies. Setting a consistent approach to reporting on supplier payments will ensure that shareholders have consistent information on the company's performance on this issue. As we have seen with other reporting requirements, it will also lead to the company focusing on the issue and improving their practices. A reporting requirement will improve the consistency and comparability of information on supplier payments to shareholders but will also lead to quicker payments to suppliers, so as not to embarrass companies on their performance. We therefore support the Government's proposals.

In addition, a simple performance measure such as average payment days will be a helpful barometer for investors to use. The combination will provide helpful information for investors to consider as part of their analysis of companies and their wider impact on society.

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

As noted in our response to Q2, the IA encourages the Government to rationalise the reporting thresholds to ensure a consistent approach. The IA supports the new requirement applying to all PIES that are large companies, with appropriate exceptions for, for instance, investment trusts.

3.4 – Public Interest Statement

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

The IA supported the underlying objective of the Public Interest Statement proposed by Brydon and recognise that corporate reporting needs to serve the interests of an increasingly wide range of stakeholders.

The current reporting requirements on the directors' Section 172 duties provide an opportunity for shareholders and others to form a view on the company's approach to wider stakeholders and the public interest. We would encourage the Government to allow this requirement, and the others identified in the White Paper, to bed in. We therefore agree with the Government's decisions to keep Sir Donald Brydon's proposal under review, to be brought forward if and where significant gaps in reporting are identified.

4.4 – Influencing the Corporate Reporting Framework

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

The IA supports the proposals for strengthening the regulator's corporate reporting review function:

- Power to direct changes to company accounts - The IA supports this proposal.
- Power to publish CRR correspondence and summary findings – The IA believes that the publication of summary findings will lead to better outcomes than the publication of all correspondence. We therefore support the Government's expectation that the regulator move to full publication only if the initial approach fails to deliver adequate transparency, with commercial sensitivities and identities protected as appropriate. These disclosures will help investors to identify material issues which need to be raised with company management or the audit committee.
- Extension of corporate reporting review powers to the entire annual report – The IA believes it is sensible for ARGA to have review powers over the whole annual report.
- Power to offer a pre-clearance service – The IA agrees with the principles set out in the consultation on how the pre-clearance service should work. If there is limited demand, ARGA should focus on other areas of its work as a priority.
- Expanding the volume of CRR activity – The IA supports this proposal.
- Focussing CRR activity on PIEs – The IA supports this proposal, in particular that the focus of CRR activity should be on the newly expanded definition of PIEs.
- Extending CRR work to a wider range of investor information – The IA supports this proposal.
- Promoting brevity and comprehensibility in accounts and annual reports – In principle, the IA supports this aim and recognise its importance. However, we note that the proposals set forth in the White Paper will require a number of new reporting requirements – in addition to the already extensive list of reporting requirements – that will inevitably extend the length of accounts and annual. While this increases the importance of brevity in particular, it will be important to consider whether there are existing reporting requirements which are superfluous or no longer serving their purpose.
- A more disciplined approach to guidance and discussion documents – The IA supports this proposal. We also believe that the regulator should do more to ensure that the guidance, once produced, is used. Currently, guidance is not appropriately publicised and subsequently not utilised by companies. It would be beneficial if the regulator had better mechanisms by which to encourage the adoption of guidance by companies.

5.1 – Enforcement Against Company Directors

29. Are there any other arrangements the Government should consider to ensure that overlapping powers are managed effectively?

The IA strongly supports the proposals to give the regulator investigation and enforcement powers to hold company directors of PIEs to account for failing to meet their corporate reporting duties. We think it is important that directors of companies are held accountable and appropriately sanctioned for failing to fulfil their reporting duties. As noted throughout our response, investors rely on directors and company reporting, with the transparency of the latter being critical to making investment decisions and holding directors accountable for the management of the company. The IA believes a functioning enforcement regime is one of the central pillars of the proposals and will be crucial to restoring trust in corporate governance.

The current situation, where the FRC does not have direct powers to enforce the directors' reporting duties if they are not a chartered accountant, is not sufficient to provide universally robust corporate reporting and hold directors to account where this is not achieved. For these duties to be of value, accountability needs to be improved and extended to all directors - not just chartered accountants.

The new reporting and attestation requirements covering internal controls, dividend and capital maintenance decisions and resilience planning will provide much needed confidence in director oversight. However, the power of these requirements will be immediately diminished if directors are not accountable to shareholders and the regulator.

While consideration is rightly given to the impact of the measures on progress towards more diverse boards, the IA does not think that the proposed enforcement regime will represent a significant obstacle to prospective directors. While we have heard concerns that the talent pool for directors may be diminished as a result of the proposals, we feel that if the approach ARGA is going to take is appropriately communicated to the market and focuses on enforcement of directors who are negligent in their reporting duties, it will not have a material impact on the supply of directors. ARGA will need to play a critical role in providing additional confidence to the market on this issue.

The IA supports the Government's proposals for managing overlapping powers and encourages ARGA to work closely with the FCA and PRA in particular. In addition, we would recommend that that the Government establishes a centralised contact point to allow investors or other stakeholders to raise concerns confidentially regarding director behaviour, which could then direct the issue to the relevant body. This highlights one issue, which is important across a number of the proposals; the various regulators will have to work closely together and collaborate on their regulatory approach to ensure the right outcomes for companies, investors and wider society.

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

As per our response to Q29, the IA strongly supports additional accountability mechanisms for directors.

We believe the existing statutory duties relating to corporate reporting and company audits are clear, fair and set the right framework for directors. Accordingly, the proposed scope is correct and should apply to all PIE directors.

In line with our response to the Corporate Governance and Insolvency consultation (2018), we would also welcome further consideration of the appropriate sanctions regime for the directors' duties not relating to corporate reporting. In our response to the consultation, we identified the need for new measures "to ensure that directors take proper account of their duties, in all circumstances", supported by a single body responsible for director sanctions when individuals have been negligent in fulfilling their duties. However, we recognise that the recent improvements to reporting on Section 172 duties has reduced the urgency of this recommendation and any proposals will have to consider the recent impact of those reporting requirements.

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

The IA supports giving ARGA power to impose more detailed requirements as to how certain statutory duties are met by directors.

The IA would welcome further elaboration of the duty to keep adequate accounting records (in line with the recommendation by Sir Donald Brydon) and further clarification on the true and fair requirements in practice. Regarding the latter, we note that the current FRC guidance has been challenged in the past. Please see our response to Q44 for further thoughts on the true and fair requirement.

32. 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?

The IA does not support extending the scope of the enforcement regime to behavioural standards. The current duties, alongside the general duties under S172 of the Companies Act 2006, are sufficient means by which to hold directors to account. As we note above, there may be a need to look at the enforcement of Directors Duties under S172.

The IA also has concerns that behavioural standards for directors would provide substantial enforcement challenges. The burden of proof would fall on the regulator but it is not clear how standards regarding, in the example given, honesty would be judged, monitored and upheld.

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

The IA supports the enforcement powers being made available to the regulator in respect of breaches of directors' duties.

In our response to the BEIS Consultation on Insolvency and Corporate Governance, the IA called for the Government to appoint a single body responsible for director sanctions when individuals have been negligent in fulfilling their duties. The development of such a body, ARGA under these proposals, would represent the best starting point for improving director accountability and will send a strong signal to boards that directors who negligently ignore their duties will be under scrutiny. We therefore strongly support legislation to provide ARGA with the necessary powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors

As highlighted in the consultation, there is a mismatch of sanctioning regimes that are held between the regulators, government departments, courts and other bodies; this has meant that where there have been clear breaches in the past, there has not seemed to be processes used for investigation or sanction. Negligence that takes place outside of an insolvency context, for example, is rarely addressed.

As the body ultimately responsible for the preparation of company reports, it is appropriate that ARGA has powers to set and enforce standards for company directors on corporate reporting.

5.2 – Strengthening Clawback and Malus Provisions in Directors' Remuneration Arrangements

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

The IA supports the need for strengthened malus and clawback provisions but is concerned that the proposals are not the right approach to take. While improvements have been made to the conditions subject to malus and clawback in recent years, there continues to be major concerns about the enforceability of malus and clawback provisions. These concerns have not been addressed.

Malus and clawback provisions are an important consideration in the IA's Principles of Remuneration. The provisions are a critical safeguard against payments which ultimately rewarded inappropriate behaviour or risk.

There remains uncertainty surrounding whether malus and clawback provisions are enforceable. Clawback is subject to being contested in a court of law – its enforceability in court has not yet been tested and the ability of companies to demonstrate direct culpability on the part of the executive is a major issue of enforceability. Our Principles of Remuneration ask remuneration committees to consider the enforcement power they have available to them to implement each process and note the importance of ensuring that the documentation for the LTIP and bonus rules, the remuneration policy and employee contracts are all consistent. Beyond this, the legal power to clawback rewards remains uncertain.

With regards to the proposals made, the IA has concerns regarding the use of the Corporate Governance Code, the minimum period identified and the minimum conditions themselves.

The IA's corporate governance research service, IVIS, has seen significant development on malus and clawback provisions since the 2018 research conducted by Deloitte referenced in the White Paper. Investor pressure and engagement in the past two years has contributed to a significant expansion of the malus and clawback provisions in company's remuneration policies, with marked improvements to the extent of the triggers companies are using. In certain aspects, the conditions put forward in the White Paper will not expand current market practice. We therefore question the need for a list of minimum conditions.

We would also question whether the Corporate Governance Code is the correct vehicle for the minimum conditions to be included. The Code may struggle to keep pace with emerging best practice, and could embed practice which is less stringent that current market practice.

Finally, we note that the conditions would have a minimum period of application of "at least two years after an award is made". This is out of line with market practice. Long Term Incentive Plan (LTIP) awards, in the form of shares subject to performance conditions, form a significant part of an executive's variable remuneration. Such awards typically cover a three-year performance period from the award being made, with an additional two-year holding period. Clawback should apply for "at least two years after an award vests", in line with current market practice. In defining the minimum period, there is a danger that companies adopt two years as standard rather than a longer time period which is already evolving through market practice.

Given the above, we would call on the Government to give greater consideration to how malus and clawback provisions can be made legally enforceable.

6.1 – The Purpose of Audit

35. **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 IA supports the requirement to consider wider information. We agree with Sir Donald Brydon that, presently, "audit confines itself, inappropriately, to rules-following without taking wider views sufficiently into account" missing out on "rich alternative sources of information and signals which are available about the company being audited". We welcome auditors being free to include original information and not be confined to commenting on what has already been disclosed, allowing the auditor to focus on the real risks companies face as opposed to simply commenting on the information management provides.

As Brydon notes, in the course of their examination and assessment, auditors may become aware of other information which "in their professional judgment would be significantly useful to those using their audit report and which the directors are not communicating, in the auditor's opinion, with sufficient clarity." As the White Paper notes, in light of this information, "auditors may reach different judgements in certain cases". We recognise, for instance, that certain corporate collapses may expose deficiencies in the audit when the auditor did not identify issues in the reports and accounts. Consideration of wider financial and other information may assist in overcoming this risk.

This requirement will need to be accompanied by appropriate guidance on what is meant by wider information and clear boundaries regarding the extent to which auditors are required to seek it out. There are concerns about the additional costs that would be incurred should auditors be required to source wider information and incorporate this into their audit. The requirement's aims should be to provide auditors freedom to consider wider information as it becomes available, rather than pursuing it at cost.

Nonetheless, a broader understanding of the company's position and strategy will help produce a more well-rounded auditor opinion – one which is more trusted, more informative and more valuable to the UK. This will help shareholders to identify potential issues or risks which may impact on the long-term value of the company and could lead to further engagement with the management, board or auditors.

36. 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?

We do not think that a new purpose of audit is necessary and echo both the Government's and Sir Donald Brydon's assessment that the debate is "notable only for its familiarity and circularity". The IA supports the Government's proposal to adopt the Brydon Review's purpose of audit as a broad ambition for its own programme of reforms, and to ask the new regulator to incorporate that ambition across the relevant parts of its work, consistent with its statutory objectives.

Were a definition to be adopted, it should reflect the primacy of shareholders (both current and prospective), similar to the approach taken in Section 172 of the Companies Act 2006. It is they that rely on the auditors' work, to whom the auditor reports and who ultimately bear the cost. This will lead to benefits for wider users, as recognised in the FRC's definition of stewardship.

6.2 – Scope of Audit

37. 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?

The IA generally supports the approach of defining wider auditing services through the Audit and Assurance Policy. ARGA should oversee the provision of the wider audit services, including through the creation of a framework for all corporate auditing, covering both the auditing of financial statements and the auditing of wider information. This will ensure that wider auditing services, and the regulators oversight, evolves with the audit activities that companies choose to seek, and ultimately with investor demand. As we have noted above, other corporate reporting, particularly sustainability reporting, is impacting on investment and stewardship decisions. Ensuring that the provision of audit and assurance on these disclosures is appropriate and appropriately regulated is becoming increasingly important.

The implementation of the Audit and Assurance Policy will be key to the success of this. Please see Q22 for further views on the Policy.

38. 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?

The IA supports the regulator's quality inspection regime being extended to corporate auditing to ensure those providing wider audit services via the Audit and Assurance Policy are covered by the regulator. It will be important that a high-quality audit and assurance market develops for the assurance of wider disclosures such as sustainability disclosures, so that investors and other stakeholders can rely on this assurance. The oversight by the regulator will be a key part of this development.

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

The IA supports the proposal to give the regulator functions in relation to all corporate auditors. In addition to setting, supervising and enforcing standards, ARGA will also play an important educational role. The publication and dissemination of guidance should be a further role for ARGA.

6.3 – Principles of Corporate Auditing

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

The IA supports the principles suggested by the Brydon Review and would consider these to be a good basis from which to start from. As noted throughout the IA's response, improvements to audit quality are paramount. For these improvements to happen, it is important that the audit profession focuses on delivering a high-quality audit, rather than compliance with standards. We agree with Sir Donald Brydon that the present approach, overly determined by compliance with standards, "hinders an auditor's ability… in terms of discouraging sense-checking and makes it difficult for auditors to differentiate themselves". Establishing new, enforceable principles of corporate auditing would provide an overarching framework for the behaviour of auditors beyond that which simply follows standards and the law.

We would welcome further clarity on the principle that "auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders". This principle is open to interpretation as to whom auditors are ultimately accountable to.

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

The IA agrees that the new principles should be set by the regulator and that applicable standards and requirements be subject to those principles.

We would not expect departure from the standards to meet the principles to occur on a regular basis: in the majority of cases, auditors should seek to meet the principles within the existing standards and requirements. However, where this is not the case, and where not doing so would result in a higher quality audit, this would be beneficial to the market. Where auditors depart from the standards to meet the principles, we would expect this decision to be explained by the auditor to the regulator, as well as to the board of the relevant company and its shareholders.

An independent regulator will be vital to setting, monitoring and enforcing these principles. The regulator must be transparent about how it is interpreting the principles and the outcomes that may occur should the principles not be adhered to. The IA note that there have been concerns in the past that although auditors need to be involved in the audit standard setting process, if they are too heavily involved it may ultimately undermine the standards' effectiveness in meeting users' needs.

6.4 – Tackling Fraud

42. 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.

The IA supports the proposals to:

- Legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud;
- Clarify that it is "the obligation of an auditor to endeavour to detect material fraud in all reasonable ways"; and
- Legislate to require auditors of PIEs, as part of their statutory audit, to report on the work they performed to conclude whether the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually accurate.

Currently, the ambiguity in the standards regarding the auditor's duty to detect fraud contributes to weaknesses in the system. Currently an audit provides auditors with 'reasonable' assurance to support their audit opinion. As such, this is a high but not an absolute level of assurance in that UK auditing standards state that absolute assurance is not possible because of the inherent limitations of an audit. These include the practical and legal limitations to obtaining audit evidence, including the effect of fraudulent collusion, and the need for the audit to be conducted within a reasonable period, at a reasonable cost.

Users expect auditors to identify material misstatements in the financial statements whether due to fraud or error. However, they are particularly concerned that the need for the audit to be conducted in a reasonable time frame and at reasonable cost is an inherent limitation in being able to do so. We thus support the proposal to make clear that it is the obligation of an auditor to detect material fraud in all reasonable ways. Similarly, the IA supports auditors stating in their report how they have assured the directors' statements on material fraud and the steps taken to assess the effectiveness of the relevant controls.

The IA also welcomes the FRC's plans to consider how the current regulatory framework for auditor education and continuing professional development can be strengthened to embed fraud awareness training throughout auditors' careers, in particular as it relates to forensic accounting.

In addition to the proposals put forward, the IA would welcome further consideration of Brydon's proposals regarding:

- An open access case study register detailing corporate frauds hosted by ARGA; and
- Establishment of an independent Auditor Fraud Panel similar to the Panel on Takeovers and Mergers to judge auditors' culpability, recognising that not all fraud will be detected.

We would also note the importance of the interaction here between the proposals for tackling fraud and the introduction of a more comprehensive internal controls framework in the UK. The two proposals working in tandem will lead to better outcomes, this further demonstrates the importance to shareholders of requiring the internal controls to be subject to mandatory assurance by the company's auditors.

6.5 – Auditor Reporting

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

The IA is concerned that the duty to consider wider information will not be sufficient to capture Sir Donald Brydon's recommendations and would therefore encourage the regulator to consult swiftly on proposed changes to its standards.

The IA supports Sir Donald Brydon's recommendation that the auditors should be free to report new information materially useful to a wide range of users, in their audit report and at the AGM, rather than be confined to commenting solely on the information reported on by the directors. Shareholders need additional information on the issues which the auditor has considered and addressed to understand if these issues will be material to the long-term value of the company, which could lead to engagement with the audit committee or auditor. The more company specific the information the better.

The IA supports the recommendations by Sir Donald Brydon included on page 106 of the White Paper. In particular, the IA supports requiring auditors to report on external signals that influenced their work and provide updates on the key audit matters.

Reporting on external signals would focus auditors on the real risks companies face as opposed to simply commenting on the information management provides. We would also welcome directors reporting on their reaction to those signals and the auditors on the extent to which they have accepted or tested the directors' conclusions. This was one of the key recommendations that would make a difference to users.

In addition to the above, investors supported Sir Donald Brydon's suggestion that the audit report should include some substantive discussion of the key areas of measurement uncertainty and provide information on the ranges and sensitivities associated with the point estimates for those measurements. However, we continue to believe that further consideration should be given to the disclosure of graduated findings or information on the ranges and sensitivities should be required, as opposed to it being left to the market as recommended. At present, despite investor support and demand, graduated findings have not been forthcoming. As long as the market is not responsive to investor demands, other solutions should be explored to ensure a high-quality audit of value to investors. Such a requirement would give investors more tools to hold both audit committees and auditors to account.

6.6 – True and Fair View Requirement

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

The IA supports the true and fair view requirements. For investors, this view is paramount. We concur with Sir Douglas Flint that the true and fair view is a "philosophical concept and not susceptible to definition by a detailed set of rules is, in fact, its most fundamental and characteristic feature". The preservation of true and fair allows boards, auditors and ultimately the courts to go beyond box-ticking compliance with a set of accounting rules. Accordingly, we welcome the decision not to adopt a requirement to "present fairly, in all material respects".

As the Government's proposals acknowledge, what is required is not new terminology but clarification as to what true and fair requirement means in practice and we would therefore be supportive of a new user guide to audit by the FRC. We note that current FRC guidance, however, has been challenged previously and would welcome further review by an independent lawyer.

Any departure from the financial framework proposed by the directors should be informed by the proposed Principles of Corporate Auditing and should be set at a high level – see our response to Q41 for further details on the IA's approach to the Principles of Corporate Auditing.

6.7 – Audit of Alternative Performance Measures and Key Performance Indicators Linked to Executive Remuneration

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

The IA does not support the assurance of APMs and KPIs being entirely subject to the Audit and Assurance Policy – please see our response to Q22 for further details.

The IA would expect APMs and KPIs, including those linked to executive remuneration, to be subject to, at a minimum, some form of external assurance or audit. The level of assurance provided would be determined by the audit committee and disclosed to shareholders through the Audit and Assurance Policy.

As noted across this response, financial statements do not necessarily provide the only measures of a company's performance. In reality, a large portion of the figures or KPIs in the annual report used by investors are those that have been adjusted. Moreover, those KPIs used for executive remuneration are directly incentivising the strategy of the company. At a minimum, the auditor should assure that: for APMs ESMA's Guidelines have been followed; and that for any KPIs used to calculate executive remuneration that: they are defined with the basis of the calculation clearly disclosed; an explanation is given as to why they are presented and are useful; they are presented consistently over time; and do not conflict with the other information presented.

6.8 – Auditor Liability

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

The IA understand that companies have not generally agreed LLAs with their statutory auditors as their shareholders will not support them. A number of our members, have stated that they would not support companies limiting the liability of the company's auditors, therefore they would not support an LLA, and, in their capacity as shareholders, would vote against the approval of any LLA where these are put to shareholders for approval.

Ultimately, auditors are engaged to scrutinise the company's directors' disclosures. For IA members, a high-quality audit is one where the auditor challenged management's judgements and assertions, displayed independence from management and exercised professional scepticism. A limited liability agreement would in effect be made with the very directors they are engaged to scrutinise.

Moreover, on the other side of the coin, we do not consider that a quantifiable limit on auditor liability would lead to improvements in audit quality and/or effectiveness; exposure to liability induces service providers to be more diligent, reducing liability could therefore lower the quality of service.

We also note that significant claims against auditors tend to be settled out of court, thus avoiding the reputational damage of a court case, and that for companies listed in the US, LLAs are not permitted.

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

The IA would question any analysis that identifies exposure to litigation as the primary drag on more informative auditor reporting. A number of other issues require more pressing reform, including the structure of audit firms, the incentives and accountability of audit partners, and the lack of competition in the market. These represent significant drags on innovation that will need to be remedied before the Government focuses on the exposure to litigation.

Nonetheless, the IA is sympathetic to the argument that the audit profession's willingness to embrace change may be constrained by its exposure to litigation. For instance, the proposals in this consultation that would lead to auditors potentially covering forward-looking statements, such as in the Resilience Statement, would require auditors to benefit from an equivalent safe harbour to the directors that make those statements. In addition, the IA consider the disclosure of graduated findings or information on the ranges and sensitivities should be required but understand auditors have concerns about their liability should this happen.

However, as noted above, the IA does not consider a quantifiable limit on auditor liability would necessarily lead to improvements in audit quality and/or effectiveness. Exposure to liability induces service providers to be more diligent and reducing it could induce a lower quality of service.

While the IA does not support limiting liability for the audit, it would welcome greater consideration of appropriate safe harbour to allow for new reporting requirements, of the assurance of forward looking statements, especially for the provision of graduated findings, which the IA would strongly support, and on forward looking statements like the Resilience Statement.

6.9 – A New Professional Body for Corporate Auditors

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

The IA supports the need for a new distinct professional body for corporate auditors. As Sir Donald Brydon notes, "auditing is not the same as accounting, and in the years ahead it will encompass even more".

A new distinct professional body for corporate auditors would further the focus on audit quality beyond the fulfilment of accountancy standards. A quality audit is one where the auditor challenged management's judgements and assertions, displayed independence from management and exercised professional scepticism. A distinct professional body would need to play an important role in encouraging this behaviour. Moreover, as the content of this White Paper suggests, the delivery of a quality audit extends beyond the actual audit process to include engagement practices with the audit committee and investors. A professional body dedicated to the development of market practice, training of auditors and focusing auditors on the delivery of a high-quality service would be beneficial to audit quality.

Additionally, to Sir Donald Brydon's point that audit will "encompass even more" in the years ahead, assurance and audit increasingly goes beyond accountancy: in this response, for instance, investors are calling for mandatory assurance of sustainability reporting and APMs and KPIs. A distinct professional body will need to give consideration to the increasingly extended scope of the modern company reporting and audit.

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

In establishing a new professional body, the IA supports ARGA acting as a midwife to establish the appropriate professional body with appropriate training and authorisation requirements, including satisfactory curricula, and a specific auditor qualification.

The IA would note, as above, that in order to be able to audit effectively, an auditor also needs to have certain accountancy and other skills, for example, to understand the rationale for and requirements around the judgements and valuations that underlie the financial statements and to be able to challenge them. Therefore, a minimum requirement will be to be a chartered accountant, before joining the audit profession. Before this recommendation can be taken forward, we consider there needs to be a root and branch review of the range of skills required and then a structure established so these can be secured, the qualifications required assessed, and the necessary mechanisms devised for ongoing supervision and review.

We would encourage the professional body to be guided by the Principles of Corporate Auditing identified by Sir Donald Brydon, encompassing public interest, objectivity, transparency, challenge to management and clarity of reporting.

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

The IA does not have a view on this question.

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

The IA does not have a view on this question.

7.1 – Audit Committees – Role and Oversight

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

The IA strongly supports ARGA being given powers to impose additional requirements on FTSE 350 audit committees in relation to the appointment and oversight of auditors. It is imperative that the regulator play a role in emphasising the need for audit committees to continuously monitor audit quality, and consistently demand challenge and scepticism from auditors.

Investors expect companies to be active participants in improving audit quality. Audit committees play a vital role in overseeing the auditor, from overseeing the audit tender process and recommending the ongoing appointment of the auditor, through to ensuring the auditor has been challenging in completing the audit. However, investors are concerned that while the best audit committees genuinely act independently of company management, not all committees use the relationship with the auditor to improve reporting. Nor do all committees sufficiently challenge management on their judgements or auditors on the depth of their work and analysis.

The IA's 2020 and 2021 Shareholder Priorities papers noted that audit committee disclosures too often fail to provide informative statements on the quality of audit and how it was assessed. To improve this position, audit committee reports need to properly disclose where challenges have been raised, professional scepticism has been applied and how a quality audit has been delivered. We outlined the following expectations of audit committees:

- Annually assert how it determined that the auditor has provided a quality audit, including the granularity of key accounting issues and how the auditor challenged management's judgement and assertions and exercised professional scepticism.
- Audit committee reports should not merely replicate what has been provided by the auditor but should, where appropriate, show a tension with the auditor's report. The committee should also report on what it itself challenged and the specific areas it asked the auditor to look at and why.
- It is vital that audit committees consider the unique circumstances applicable to the company and the auditor during the year and provide details on how these were factored into the committee's decision. At present these matters are rarely transparent.
- If there has been a tender, the committee should be transparent as to why it recommended a particular auditor and considered that firm would provide a quality audit.

Additional disclosures from audit committees would help provide the information that shareholders need to inform and guide their engagement on audit. This is especially pressing on audit quality, where current disclosures do not provide a full picture of the audit committees approach to, or evaluation of, the quality of the audit. The ability of investors to be effective stewards is shaped by the disclosures they receive.

We would encourage the regulator to consider these investor expectations in formulating the additional requirements of audit committees. It would also be helpful for ARGA to request reports from audit committees on how they have met the requirements.

However, as noted in our response to the CMA study, the IA would not support ARGA being given a power to place an observer on the audit committee. The discussions at an audit committee can be confidential and the committee needs to challenge management's judgements as part of a high-quality audit environment. The presence of a regulator could impact on the discussion at, and dynamics of, the meeting.

53. 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?

The IA supports the focus of ARGA's powers on the company directors and/or the audit committee where breaches occur. As noted elsewhere in our response, director accountability is a key component in improving trust in corporate disclosures. Investors would welcome the further transparency from the regulator in making statements to shareholders in circumstances where it is unsatisfied with the audit committee's response. This will again provide further information to engage with audit committees if these issues are likely to impact on the long-term performance or value of the company.

Please see our response to Q52 for further details.

7.2 Independent Auditor Appointment

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

The IA does not agree with Sir John Kingman's proposal to give the regulator the power to appoint auditors. We would not support legislation to provide ARGA flexibility to be given such powers in the future.

The IA believes the appointment of the auditor is a matter for the directors of the company, with approval from shareholders. We have significant concerns that the proposals would disenfranchise shareholders and remove directors' responsibilities to shareholders in this respect. Furthermore, questions of conflict of interest need to be considered: how would the regulator assess an auditor it has appointed?

We believe that oversight of the auditor should and can be achieved through existing arrangements. We would ask the Government to provide clarity on where the existing arrangement under the Companies Act, whereby the Secretary of State has power to appoint an auditor where the company has failed to appoint an auditor within 28 days of circulation of its accounts, have been deemed insufficient.

Furthermore, we take this opportunity to stress the importance of improved audit quality disclosures, as mentioned in our response to Q52. If audit committees provide more insights into the quality of the audit, and how they are determining this, it will facilitate greater shareholder engagement. From this starting point, rather than requiring regulator intervention, investors could then hold auditors and directors to account where the limited circumstances identified have occurred. For example, where quality issues have been identified, shareholders, more fully informed of this, could vote against the reappointment of the auditor.

55. To work in practice, ARGA's power to appoint an auditor may need to be accompanied by a further power to require an auditor to take on an audit. What do you think the impact of this would be?

The IA does not support ARGA being given power to appoint an auditor. For further details, please see our response to Q54.

56. What processes should be put in place to ensure that ARGA can continue to undertake its normal regulatory oversight of an audit firm, when ARGA has appointed the auditor?

Should the Government determine to provide ARGA the power to appoint an auditor, we would expect there to be significant safeguards in place to ensure the management of conflicts of interest and a transparency around the process.

57. What other regulatory tools might be useful when a company has failed to find an auditor or in the circumstances described by Sir John Kingman (i.e. when quality issues have been identified around the company's audit; when a company has parted with its auditor outside the normal rotation cycle; and when there has been a meaningful shareholder vote against an auditor appointment)?

As noted in our response to Q54, the current powers of the Secretary of State are sufficient to ensure the appointment of an auditor.

In the specific, limited circumstances outlined by Sir John Kingman, the IA would support the Government granting the regulator the power to require a retendering or change in the audit partner. This may provide incentives for better results without weakening the responsibility of directors to shareholders.

7.3 Shareholder Engagement with Audit

58. 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?

The IA welcomes the proposals to provide shareholders an opportunity to engage with risk and audit planning. However, while we support the proposals, it is important that this proposal is brought forward with realistic expectations. The vast majority of investors are unlikely to engage on the audit plan, unless there are specific issues or concerns with the company or the audit plan. Asymmetry of information and the technical detail of the audit plan will mean many investors are not best placed to comment on the audit plan. The final decision on the audit plan is and should remain a matter for the auditors and the audit committee, with investors able to highlight risks or specific areas of the business which they consider to be important but not appropriately covered.

The proposal's value is in providing another opportunity for investors to further understand the approach to the audit and, where material issues are identified, trigger more informed conversations between audit committees, auditors and investors. To this end, the investors would benefit from a summary version of the audit plan provided to the audit committee (subject to the necessary safeguards on the publication of commercially sensitive information), setting out key audit matters, information on materiality and the proposed areas of focus for the audit. It would be helpful if, as Sir Donald Brydon suggests, auditors referred back to the prior year's audit report and in doing so, clearly highlight and explain changes in the Key Audit Matters and materiality from one year to the next. Similarly, the auditor should explain in each of the two succeeding audit reports what procedures have been undertaken and conclusions reached in relation to those matters (Key Audit Matters or identified deficiencies); and highlight the actions taken by the company in response to these deficiencies. We agree that the audit committee should only be expected to make an additional disclosure if there has been a material change to the principal risks facing the company since those already disclosed in the last annual or interim report.

Ultimately, engagement will be determined by whether material risks to the long-term value of the company have been identified or overlooked in the audit plan. The opportunity to comment on the audit plan is best understood as an additional arrow in the shareholders' quiver, which may be appropriate in limited circumstances, rather than a silver bullet.

We support the proposals applying only to premium listed companies and look forward to working with ARGA to consider how this engagement will work in practice.

In addition to the above, the IA also supports establishment of the Audit Users Review Board (AURB) and has already agreed to provide the secretariat. This is an important step towards a "user-driven" audit process and will provide a forum to consider the audit standard-setting process, audit quality and other issues affecting users of audit reports. We look forward to working with Government and other stakeholders to make the AURB an effective tool for increasing investor engagement in audit and, ultimately, positively impacting on audit quality.

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

The IA strongly supports a standing item at the AGM to permit questioning of the audit committee chair and auditor. We have heard that member experience of this approach has been positive in the jurisdictions where it occurs. These requirements would offer shareholders a real opportunity to influence the key focus of an audit and what they want to see reported and potentially identify other areas of importance that auditors had not previously considered. Key judgements identified by shareholders may be better incorporated into future audit plans. Likewise, investors would be exposed to further information on the key issues, judgements and approaches the audit committee and auditor have considered.

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

The IA does not believe the Companies Act provisions are sufficient and would support the Brydon Review's recommendations regarding the requirement to state the reasons for the auditor's departure.

However, the IA is uncertain whether the Brydon Review's recommendation for a general meeting to be held following the dismissal of the auditor. While in some circumstances the reasons for dismissal might be of sufficient interest to shareholders, in other circumstances the events would likely not warrant a full general meeting – especially given the associated costs.

Instead, the IA would support a requirement for the issue to be addressed at the next shareholder meeting, which would allow the discussion to address the specific circumstances – where the dialogue is insufficient, the IA would expect shareholders to hold the directors to account through existing mechanisms, including votes against the audit committee.

8.1 – Market Opening Measures:

61. **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?**

The IA recognises the need to address competition and resilience in the market. Investors are concerned that the lack of competition in particular is detrimental to audit quality: the Big Four appear to be largely "cosily competitive" with each other, resulting in little evidence of the developments in product and quality that a fully competitive market might incentivise.

However, we do not support proposals for a managed shared audit and would encourage the Government to pursue a market share cap from the outset.

Delivering a high-quality audit should be at the forefront of any proposals to increase competition and resilience in the audit market. IA members have expressed concern that the proposals for a managed shared audit do not address audit quality; in fact, in the short term, it is possible to foresee a situation in which the proposals reduce audit quality.

Given concerns that shared audits will not necessarily lead to an increase in audit quality, independence and choice, we would ask the Government to explain more clearly the expected interaction between audit quality and a managed shared audit regime. The regulator would need to have a clear mechanism in place to ensure that audit quality improves if a managed shared audit approach is introduced. We believe that the

Government should give greater consideration to implementing a market share cap immediately – please see our response to Q63.

We are concerned that there may be practical issues with a managed shared audit leading to a lack of consistency in approach and increased costs. We have heard from investors, companies and auditors that there may be a danger that information "slips through the cracks". A more common issue will be the different methodologies and approaches that different audit firms take to aspects of the audit, which could lead to discrepancies or, at the very least, additional workloads to reconcile analysis provided by the lead firm and the challenger firm. This could take focus away from delivering a high-quality audit, especially where the audit is particularly complex, as will often be the case for a FTSE 350 company. We have heard from Big Four firms that this may lead to additional costs.

We would question how challenger firms would be assessed by the regulator and companies alike. Would audit committees have sufficient information on the challenger firms' performance in order to a) provide transparent disclosures on audit quality to shareholders and b) potentially appoint the challenger firm in the future? Ultimately, it is not clear how trust in the challenger firms would be built up without greater transparency as to their performance and track-record.

We also have concerns about the lack of discernible evidence that this will necessarily encourage challenger firms to build up capacity and increase market share. We would question whether challenger firms would not be better supported by measures to increase their market share of the FTSE Small Cap, on the grounds that the audit of the whole organisation would provide more valuable experience and challenger firms would be confident that an increased capacity would be rewarded with more customers. We believe this may provide a means by which competition and expertise could be increased, potentially in the interim period before a market share cap is adopted.

While we support a market share cap (please see our response to Q63 for more details), we also believe there are a number of practical interim proposals that should be considered that may have a more positive impact on audit quality. For instance, sharing solutions, for both staff and technology may be an interesting avenue for exploration. Secondment programs for audit partners may assist in valuable knowledge transfer. As the audit and the companies it is responsible for becomes ever more complex, the need for technological solutions increases. We understand the costs of these solutions are often prohibitive for smaller firms. It would be helpful to give further consideration to how this obstacle could be overcome.

Regarding the scope of the proposals, should they be taken forward, the IA would encourage the Government to consider carve outs for high risk or complex companies in the FTSE 350, especially in the regimes initial phase, to avoid significant detriment to the audit quality of the most complex audits. The existing challenger firms need to scale up their operations in order to compete for the audit of large complex entities. The proposals are further complicated by our understanding that some of the major challenger firms are considering not pitching for work on the shared audit of FTSE 100 companies, which would jeopardise the legitimacy of the regime if it is not addressed.

The IA does not have a position on what proportion of the audit should be covered by challenger firms to encourage participation and increase choice.

62. 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 per our response to Q61, the IA question whether the managed shared audit is the best means by which to incentivise challenger firms to invest in building their capability and capacity. It may be more beneficial for challenger firms to build up capabilities by taking on a greater share of the FTSE Small Cap initially. This would allow firms to build experience and capabilities.

63. 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?

The IA supports the introduction of a market share cap. A market share cap would more effectively address competition concerns in the market while having a less detrimental impact on the quality of audit.

A market share cap would better enable 'challenger' firms to secure a reasonable portion of the FTSE 350 market as the primary auditor of the company. We understand that some challenger firms have exited the FTSE 350 market because of concerns about pitching for audits, at a high expense, with little chance of winning the tender. A market share cap would provide appropriate certainty to overcome this concern. This certainty should also provide challenger firms with the confidence to invest in making the necessary investments to improve their capabilities. The IA is confident that implementing a market share cap will force the market to react. Ensuring that the cap is introduced in a timely fashion, with a significant lead-in time will therefore be essential to ensuring the market has time to react and consolidate in anticipation of the changes.

As with every solution that has been floated to address competition in the audit market, a market share cap would create new risks and would need to be designed with appropriate safeguards in place to mitigate these risks. Cherry-picking, for instance, whereby Big Four firms relinquish the audit of only the most risky audits, is a legitimate concern. We therefore strongly support the Government's proposal that the regulator review the pipeline of FTSE 350 tenders and reserve a proportion for challenger firms. We appreciate that this may reduce choice in the short term but believe that it is an appropriate price to pay for expanded choice in the long term.

It is critical that the Government provide an appropriate transition period before the market share cap is implemented. As noted above, a firm commitment to implement a market share cap in five to ten years, for example, would force the market to adapt and respond prior to implementation. Challenger firms, confident of their opportunity to win FTSE 350 tenders, would need to build capacity. Big Four firms may need to restructure. Partners may move to smaller firms in search of new opportunities. The market will adapt.

Irrespective of when it is adopted, should a market share cap be implemented, it will need to consider a number of issues, as identified by the IA in our response to the CMA market study:

- Ensuring there is sufficient sector expertise and global reach in the market. There could be a decline in audit quality if firms are appointed that do not possess the necessary capabilities.

- We therefore support the regulator's duty to consider whether the cohort of challenger firms have included sufficient capability to undertake the audit.
- Whilst a market share cap may open the market to new entrants, it could blunt incentives for audit firms to compete, reducing competition and resulting in audit fees increasing or quality falling.
    - While further consideration will have to be given to how competition is incentivised, we do not believe this is a serious obstacle at this stage.
- Companies would have less choice if an audit firm is at its capped limit. This could also impact the attractiveness of the UK for international companies to list.
    - We therefore support the proposal for there to not be a single numerical/percentage market share cap applied to any single audit firm.
- It is important that safeguards are introduced so that the Big Four do not cherry-pick the less risky audits. For example, say a cap was imposed of 20% of the audit market for any one auditor. Prohibiting the Big Four resigning without the audited company's approval and limiting the Big Four's choice as to which company they can bid for would each have unintended consequences.
    - We therefore support the proposal for the regulator to review the pipeline of FTSE 350 audit tenders and reserve a proportion of them for challengers. The IA would welcome further clarity on what considerations the regulator will giving to identifying restricted tenders.

8.2 – Operational Separation Between Audit and Non-Audit Practices

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

The IA strongly supports the Government's aim to reform the balance of incentives and working culture within audit firms while maintaining their multidisciplinary structure.

The IA strongly supports the central proposal to give ARGA powers to strengthen the governance of audit practices, building on the FRC's principles published in July 2020. The success of these and any changes to auditor behaviour as a result will depend on how the regulator acts in enforcing the proposals. An independent regulator will be vital to setting, monitoring and enforcing these principles.

<u>The strengthening of governance within audit practices through the creation of independent Audit Boards within firms</u>

The IA supports this proposal and considers it an important accountability mechanism for firms that will provide an additional focus on audit for the executives.

<u>Audit Boards to have oversight of audit partner remuneration and ensure it is linked to audit quality and regulatory oversight of the remuneration of audit partners, with a view to supporting policies and practices that reward high-quality audits</u>

The IA considers these to be two critical proposals for correctly incentivising audit partners to deliver a high-quality audit. It would be helpful if this was accompanied by better disclosures in firms' transparency reports on of the basis of how individual auditors are incentivised and remunerated so that shareholders can assess the extent to which audit quality is taken into account.

We recommend that the regulator engage with the IA and other stakeholders to consider the lessons learned from executive remuneration in UK plc when considering guidance on audit partner remuneration.

In addition to the focus on audit quality, the IA would call for further consideration of incentivising long-term thinking. Currently, audit firms are constituted under partnership law where profits are paid out annually. Given the systemic importance of the firms and the need to develop and innovate over the long term, and in the interests of ensuring audit quality, consideration should be given to requiring them to operate under long term incentive plans. This may mean that any constraints in partnership law that prevent the operation of such plans need to be addressed.

<u>The publication of a separate profit and loss account for the audit practice, accounting for cross subsidies between the audit practice and the rest of the firm through arm's-length transfer pricing</u>

The IA supports this proposal. The fair valuation of the audit is an important aspect for investors, who are concerned that the audit is not appropriately priced to be a self-supporting and sufficient product. This diminishes the audit firm's engagement in the product and instead turns their focus to the non-audit services that ultimately subsidise the audit. Investors want the audit to be a viable product and would support it being priced accordingly. We therefore support the proposals for greater transparency over the levels of cross-subsidy.

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

As noted in our response to Q64, the IA supports greater transparency on partner remuneration. In addition to the disclosures provided to the regulator, we would encourage further transparency for investors and other stakeholders so that these stakeholders can assess the extent to which audit quality is taken into account.

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

The IA does not have a view on this question.

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

The IA has significant concerns about the efficacy of full separation of professional services.

If this remedy is adopted, the Government will need to consider the international reach of the changes given the global nature of the firms in question. The Big Four audit firms are international and often responsible for the audit of global groups, many of which will have a holding company listed on the UK market. The UK audit-only firm would need to remain connected to the international network to service global clients leaving questions over the non-audit services provided by that network. There is also a risk that the international networks break away from the UK audit-only firms impacting the firms' global reach, ability to audit global companies and the attractiveness of the UK market.

In addition, a quality audit requires quality staff who can challenge and apply economic rationale (not simply box tick). If firms were restricted to providing only audit services, particularly due to the seasonality of audits (the majority of companies have 31 December year ends), it could impact their ability to retain such staff. Moreover, due to the level of complexity and judgement required in undertaking a major audit, specialist non-audit staff are often needed to help and advise. Investors want auditors to exercise professional scepticism which necessitates access to the widest possible experience so that their staff can see economic substance over form and are up to date with accounting requirements. If this resource is not available to audit-only firms this is likely to reduce rather than enhance audit quality. Lastly, smaller firms may not have the necessary economies of scale to recruit and fund such resources in an audit-only environment.

A structural spilt also may only serve to exacerbate the dominance of the Big Four in that they would no longer be precluded from participating in audit tenders on the basis of the non-audit services they provide.

That said, if the above issues are addressed certain investors would go further and consider the actual and/or perceived conflicts and threats to independence that exist by allowing audit firms to provide non-audit services merit the creation of audit-only firms. The complex structures and range of non-audit services provided by the Big Four can be a substantial barrier for entry for the non-Big Four or challenger firms. An audit-only firm environment could encourage new entrants and it may be that an audit-only firm would be able to procure the specialist knowledge required in the market or if there is sufficient demand, retain it in-house.

To achieve a positive structural split, given the complexities described above, would require detailed regulatory oversight to ensure it is effective in delivering the anticipated benefits for audit, such as reviewing transfer pricing and information-sharing arrangements.

The IA believe that there is a need for international co-operation on the reform of the audit market; some of the issues identified can be minimised or addressed if the UK is able to negotiate an international solution through the G7 or G20 to the dominance of the Big Four.

8.3 – Resilience of Audit Firms and the Audit Market

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

The IA supports the proposals to address the resilience of audit firms and the audit market overall. However, the IA would also emphasise the importance of competition and audit quality to resilience. First and foremost, resilience of the audit market will be determined by the number of firms in the market. The current market structure, addressed elsewhere in the consultation, means that the market is dependent on the resilience of four firms. This needs to be addressed.

Secondly, the role of ARGA in maintaining audit quality will be key to protecting the audit market. Where audit firms are most susceptible to failure is where a lack of audit quality leads to regulatory sanctions, diminishing confidence from the market and, subsequently, a decreased customer base. The regulator will have an important role in seeking to maintain audit quality to avoid such a spiral.

In addition to the proposals put forward by the Government, as per our response to Q65, we would like to see the incentive structure at audit firms amended to better reflect audit quality and long-term horizons. We therefore welcome the proposal to provide the regulator oversight over audit partner remuneration. Audit firms are constituted under partnership law where profits are paid out annually. Given the systemic importance of the firms and the need to develop and innovate over the long term, in the interests of ensuring audit quality, consideration should be given to requiring them to operate under long term incentive plans. This may mean that any constraints in partnership law that prevent the operation of such plans need to be addressed.

9.1 – Approval and Registration of Statutory Auditors of PIEs:

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

The IA agrees with the Government's approach. The IA has been consistent in its calls for a stronger regulator. As part of this, the regulator should reclaim the function of determining whether individuals and firms are eligible for appointment as statutory auditors of PIEs.

As the White Paper notes, "an important cause of poor-quality audits is weak performance by the lead auditor". As such, we agree that the regulator should directly approve the individuals, as well as the firms, carrying out PIE audits.

In carrying out this function, the FRC can look to the approach of other regulators, including the FCA, who approve firms and individuals to conduct regulated activity.

9.2 – Monitoring of Audit Quality

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

Investors are supportive of the work of the Audit Quality Review. As noted in our response to the Kingman review, investors would like to see greater transparency relating to AQRs. For example, the regulator should make public the outcomes of AQR into individual companies, so that investors can understand the regulator's findings and concerns. Investors will be able to use this information in their engagement with companies and when making investment decisions. To ensure that these disclosures are useful to users, investors should be provided an opportunity to feed into the template developed by the regulator.

We therefore welcome the proposals.

While we are sensitive to the commercial sensitivities that will need to be considered, we would call for as much transparency as possible. It is not for us to comment on what information should be exempt and we would encourage the regulator to receive consent from the audit committee where possible prior to publication.

The regulator should have ultimate discretion over what information is exempt from disclosure, with an appropriate mechanism in place to understand corporate views. It would be helpful for the regulator to consult with investors and corporates on its general approach to sensitive information once determined, with an appropriate mechanism once established by which companies could address specific concerns. However, the IA would support the regulator taking a leading role in determining what it considers sensitive, coupled with a mechanism by which the company could challenge the decision.

71. **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?**

In addition to redacting sensitive information, the IA would support companies being provided with sufficient time to address any issues raised, so that they can issue a statement to the market, responding to the issues so that it should not have a negative impact on the company reputation or market value.

9.3 – Regulating Component Audit Work Done Outside the UK

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

The IA is supportive of the Government's approach to component audit work done outside the UK. We agree that providing the regulator powers to require a UK group auditor to provide it with access to overseas component working papers will enable the regulator to assess more thoroughly how well the UK group auditor has discharged its responsibilities.

The IA would stress the need for collaboration between ARGA and its counterparts outside the UK across different jurisdictions to build working relations and facilitate a continuous dialogue to ensure a joined-up approach is taken.

9.4 – The Application of Legal Professional Privilege in the Regulation of Statutory Audit

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

The IA agrees that the situation outlined would be problematic as it would lead to the regulator being unable to evidence the quality of the audit in these areas. However, the IA is not best placed to comment on the means by which this issue could be solved or mitigated.

We encourage the Government and ARGA to explore mitigating solutions with appropriate parties to ensure there is sufficient comfort on the situations and circumstances in which this would be required. In addition, we suggest that there should be clear guidelines on how the regulator will use and protect this sensitive information.

10.1 – Establishing the Regulator

74. Do you agree with the proposed general objective for ARGA?

The IA strongly supports the need for a strong regulator and has been consistent in its calls for ARGA to be placed on a statutory footing at the earliest possible opportunity and funded by a statutory levy. The IA has previously stated that this regulator should continue to set and maintain best practice in audit, financial reporting and corporate governance in order to facilitate and promote investment in the UK. This body should be well-governed, transparent in its ideology and processes, and respected. It should have a diversity of perspective throughout its employee base and governance structures, be receptive to outside views, and have a strong and coherent culture.

The IA is pleased with the progress made towards this more robust regulator by the FRC in anticipation of statutory powers.

It is important that these additional powers are subject to appropriate checks and balances, including parliamentary oversight. Prior to recent changes, the majority of members believe there were significant areas for the FRC to improve upon. It is important that the additional powers are accompanied by safeguards, especially in the early stages where market trust in the regulator may not be commensurate with its new powers. In addition, given the breath of proposals in this White Paper, the regulator will have to manage any capability and capacity issues in terms of the extension of the PIE definition and oversight of all corporate reporting. Once introduced, the regulator will need to meet the expectations of market participants on these issues immediately, so that they build confidence and trust from the market as a robust regulator.

The IA is generally supportive of ARGA's proposed general objective to "promote the interests of investors, other users of corporate reporting and the wider public interest". We strongly support the accompanying quality and competition objectives. The FRC's current objective and mission statement are too wide-ranging to provide any real strategic guidance for the body and have contributed to a lack of focus in the organisation, and the general objective runs a similar risk, which the Kingman Review's recommended proposal avoided. We therefore support ARGA being given the additional objectives clearly setting out the body's central goals: maintaining a strong audit and corporate governance regime, characterised by high quality audit and reporting frameworks, and a competitive audit market to boost investor confidence in market mechanisms and encourage investment in UK companies.

75. 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?

The IA agrees with the regulatory principles outlined in the consultation.

11.1 – Supervision: Accountants and their Professional Bodies:

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

The IA does not have a view on this question.

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

The IA does not have a view on this question.

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

The IA does not have a view on this question.

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

The IA does not have a view on this question.

11.2 – Oversight and Regulation of the Actuarial Profession

80. Is ARGA the most appropriate body to undertake oversight and regulation of the actuarial profession?

The IA does not have a view on this question.

81. Should the regime for overseeing and regulating the actuarial profession be placed on a strengthened and statutory basis?

The IA does not have a view on this question.

82. Do respondents support the proposed principles for the regulation of the actuarial profession? Respondents are invited to suggest additional principles.

The IA does not have a view on this question.

83. Are the proposed statutory roles and responsibilities for the regulator appropriate? Are any additional roles or responsibilities appropriate for the regulator?

The IA does not have a view on this question.

84. Should the regulator continue to be responsible for setting technical standards? Should these standards be legally binding? Should the regulator be responsible for setting technical standards only?

The IA does not have a view on this question.

85. Should the regulator be responsible for monitoring compliance with technical standards? Should it also consider compliance with ethical standards if necessary?

The IA does not have a view on this question.

86. Should the regulator have the power to request that individuals provide their work in response to a formal request - and to compel them to do so if necessary?

The IA does not have a view on this question.

87. Should the regulator have the power to take appropriate action if work falls below the requirements of the technical standards? What powers should be available to the regulator in these instances?

The IA does not have a view on this question.

88. Do respondents agree with the proposed scope for independent oversight of the IFoA? In which ways, if any, should the scope be amended?

The IA does not have a view on this question.

89. Should the regulator's oversight of the IFoA be placed on a statutory basis? What, if any, powers does the regulator require to effectively fulfil this role?

The IA does not have a view on this question.

90. Does the current investigation and discipline regime remain appropriate? Should it be placed on a statutory basis? What, if any, additional powers does the regulator require to fulfil this role?

The IA does not have a view on this question.

91. Do respondents think that the regulator's remit should be extended to actuarial work undertaken by entities? What would be the appropriate features of such a regime, including the appropriate enforcement powers for the regulator?

The IA does not have a view on this question.

92. Should the regulator's independent investigation and discipline regime for matters that affect the public interest also apply to entities that undertake actuarial work? Should the features of the regime differ for Public Interest Entities?

The IA does not have a view on this question.

93. Does the regulator require any further powers in relation to its regulation and oversight of the actuarial profession?

The IA does not have a view on this question.

11.4 – Powers of the Regulator in Cases of Serious Concern

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

The IA is broadly satisfied with the approach outlined in the proposals. PIE auditors should be required to include viability and material governance concerns unearthed during the audit.

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

The IA is broadly supportive of the statutory protection proposed for auditors in their disclosures to the regulator.

96. How much time should be given to respond to a request for a rapid explanation?

The IA does not have a view on this question.

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

As outlined elsewhere, for ARGA to be a successful regulator and encourage confidence in the market, it is important that it is transparent. To this end, the IA is supportive of the regulator publishing expert reviewer's report where it considers it to be in the public interest.

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

The IA does not have a view on this question.