Sarasin & Partners submission to the BEIS Consultation: Restoring trust in audit and corporate governance

July 2021

1. About Sarasin & Partners LLP

Sarasin and Partners LLP is a London-based investment manager serving charities, private clients and other institutions. Our goal is to deliver sustained investment returns through an active long-term and thematic investment approach, which emphasises stewardship. We have been a longstanding advocate for reform of the UK's accounting and audit system to underpin effective and responsible stewardship[1]. We are strongly supportive of the Government's efforts to persevere with this critical agenda, often in the face of intense lobbying by the audit profession to desist.

2. Introduction and headline points

Company accounts must not hide the truth if they are to be trusted

As underlined by the Secretary of State in his introduction to this Consultation, we need a reporting system that can be trusted and, critically, that empowers shareholders to hold companies to account so that we are better equipped to face tomorrow's challenges. Above all, the accounting and audit system should prevent companies from hiding bad news that could put solvency at risk.

As has been demonstrated time and again, however, this is not the case today. While we must accept a certain level of bankruptcies as an inevitable feature of any dynamic economy, we have found too often companies collapsing as a result of what would appear to be preventable actions. Directors behaving imprudently by bringing forward expected future profits, and/or choosing to ignore foreseeable losses and liabilities should be stopped. Our accounting and audit should prohibit such excessively risky behaviour that enriches corporate leadership today, at the expense of staff, suppliers, customers and long-term investors tomorrow.

Climate crisis brings flaws in accounting and audit into sharp focus

The challenge of climate change brings the need for prudent accounting to underpin resilience into sharp focus. Companies across the economy are having to adapt, and many businesses will need to transform entirely. The sooner this happens the better, not just for shareholders and creditors, but for all of society. If we permit directors to ignore foreseeable liabilities associated with decarbonisation, for instance, they will continue to (mis)allocate capital to carbon-intensive activities. This puts these businesses – and all those stakeholders that depend on them – at risk of material stranded assets. It also threatens our planet. Auditors should be required to call out any understatement of climate risks[2].

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[1] Please see, for instance, Sarasin & Partners' submissions to the Brydon Review (https://sarasinandpartners.com/wp-content/uploads/2020/06/byron-review.pdf); BEIS Select Committee inquiry into "The Future of Audit" (http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/written/94924.html); CMA consultation on audit (https://assets.publishing.service.gov.uk/media/5bf2cbc9ed915d181653c1a5/sarasin-and-partners-statutory-audit-invitation-to-comment-response.pdf and https://assets.publishing.service.gov.uk/media/5c5b0852e5274a31874509c6/sarasin_response_to_update_paper.pdf); Kingman review (2019).

[2] Please see the paper we lead "Investor Expectations for Paris-aligned accounts", IIGCC, November 2020: https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/

White Paper offers welcome diagnosis and recommendations

The White Paper provides a welcome diagnosis of the problems that exist with the audit system today. It also offers important recommendations for improvements, not least the establishment of a new independent regulator with enhanced powers, steps to deliver a more independent and accountable audit profession, and a focus on protecting capital, going concern and resilience. Strong internal controls that are designed to pick up fraud are key to this. Other key recommendations we support relate to assurance of corporate reporting outside the financial statements ESG data.

Government needs to prioritise and avoid over-reach

While the White Paper is impressive in its breadth, it needs to prioritise. We would advocate for an immediate focus on ensuring existing Company Law protections are properly enforced because these are essential to the core Government objective: restoring trust.

While we support an expansion of the scope for audit and assurance beyond financial statements, it is imperative that the financial statement controls are properly implemented first and foremost (notably on fraud, going concern and capital maintenance). Put simply, getting auditor verification of carbon emission data won't help if the underlying entity is impaired. This would amount to rearranging the deckchairs on the Titanic.

We would also underline the obvious fact that ARGA cannot do everything. There is a need for ARGA's remit to expand, but just as markets fail, governments also fail. It is therefore imperative that wherever possible ARGA empowers shareholders and creditors to hold auditors and Audit Committees to account. ARGA will never be able to scrutinise every company's assurance process to the depth that is required – whereas investors have the resources and interest to do so. ARGA should thus prioritise providing investors with the information they need to do this job well, and then ensuring they are transparent in their efforts.

The Government should go further to underpin long-term resilience

While the direction of travel is right, the White Paper is too timid when it comes to the biggest problem of all: the failure to enforce the UK's existing statutory capital maintenance regime – those rules that reinforce an entity's going concern status and its long-term viability [Chapter 2].

Certainly, proposed actions to encourage directors to act more prudently, such as only paying dividends from capital they know to be available for this purpose [Para 2.2.15], and requirements for this to be audited, are sensible and extremely welcome. But they amount to a short-term fix, not a solution. Likewise, limiting the time horizon to two years runs contrary to directors' responsibility to consider headwinds they can see coming, even if it might be in, say, two and a half or three years. In the end, knowing what capital companies have accumulated that they can safely distribute should not be a matter of guesswork. If this is the case today as implied by BEIS, then this is a matter of enforcement, not consultation.

Worryingly, the Government states that in making these proposals it took advice from the audit profession (ICAEW), which is conflicted on this matter [Para 2.2.13]. No mention was made of an independent legal review that would assess what is required in the law today. This is particularly perplexing when two important legal opinions from Bompas QC obtained by concerned investors in 2013 and 2015 outlined harmful flaws in the current interpretation of the law relating to capital maintenance and the requirement for 'true and fair' accounts[3]. The FRC's past failures to look into

[3] https://lapfforum.org/engagements/lapff-legal-opinions/

these serious allegations remain a mystery. The fact that they have once again been overlooked in this important document raises serious concerns.

The Government should therefore make clear that its recommendations for partial disclosure are just a first step towards directors being required to calculate and publish precisely what a company has available as capital to distribute, taking account of foreseeable losses and liabilities even if these cannot be measured or timed precisely (e.g. climate-related liabilities). The published distributable capital should also take out accrued but unrealised profits, to avoid cash being paid out before it is received and thereby putting a company's future in jeopardy. This is the requirement today.

Fixing a car's mechanical faults won't help if the car is driving the wrong way

In this submission, we provide our views on specific recommendations where we believe we can offer an informed view. The vast majority of these move us in a positive direction towards a more robust ad reliable accounting and audit system. However, in line with our introductory remarks above, it is vital the Government does not miss the wood for the trees. Fixing all the mechanical faults will not do any good if the car is driving in the wrong direction. We, therefore, ask that the Government focus on the question that matters most: how to ensure our accounting and audit system underpins long-term and sustainable businesses to deliver for the public interest.

3. Responses to specific recommendations

Our submission does not respond to every question, but we offer thoughts on those where we have a clear view.

Chapter 2 – Directors' Accountability for Internal Controls, Dividends and Capital Maintenance

Proposals in this section are perhaps the most important of the package of proposed reforms, and are welcome for two reasons. First, they highlight the existing flaws in our rules designed to underpin corporate resilience and, thus, the need for reform. Second, they move us in the right direction to address them.

The only problem is they do not go far enough. The Government should make clear that it will take steps to enforce fully existing capital maintenance requirements under Company Law, which in turn require enforcing internal controls and dividend rules.

The Government should start with an independent legal review of what is already required under the UK's capital maintenance review, including how this underpins judgements on going concern and longer-term viability and resilience. This must be undertaken by lawyers that are fully independent of the audit profession. This review should consider objectively the two legal opinions on existing flaws in our enforcement system provided by Bompas QC in 2013 and 2015. Specific proposals are set out below.

Section 2.1: Internal controls

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

Under the current system, directors are already responsible for ensuring effective internal controls. The accuracy of the company's financial statements (and meeting the true and fair view requirement) depends on this, as does the legality of their proposed dividends (these can only be paid out of reserves available for this purpose – which have been calculated in accordance with company law requirements).

Where auditors have any concerns over internal controls such that they believe there could be material misstatement, e.g. a potential sanction/litigation liability linked to misconduct, potentially resulting in an illegal dividend, they are obliged to highlight this in their Opinion to members. Furthermore, auditors are obliged under the Companies Act to check that the company has kept “adequate accounting records”.

In practice, it is not clear that this system is working, or whether auditors are undertaking sufficient checks. For instance, we have highlighted over the past 15 years concerns that the controls preventing illegal dividends are not being adhered to.

Several companies have since come forward to report that they had paid illegal dividends, often describing this as a minor ‘technical’ matter. This understates the problem. It is an indicator of an internal control failure, which could result in material consequences for the business. Moreover, these cases have all been self-reported by directors or in a few cases by the FRC, rather than picked up by the auditor. In some cases, they were going on for years (e.g. Domino’s Pizza)[4].

We are not aware of any instance where the auditor identified the problem through their checks and alerted the Audit Committee and/or shareholders. There is, therefore, a sense that auditors presume the system is working until there is evidence it is not, which is too late. This undermines trust in companies’ reporting.

Given the above points, there is a strong case for requiring formal attestation by directors that they have personally assured themselves that the internal control system is working effectively. Auditors should explicitly test that this is the case, including stating that the directors have kept adequate accounting records, and that the declared dividend is in line with Company Law requirements. These statements would be logical underpins for the Auditor’s opinion that the accounts provide a True and Fair View.

ARGA should set out explicit guidance for what is an acceptable standard to meet these requirements. Critical to this, will be reviewed guidance on the principles that govern the dividend legality test. This is dealt with under Q15 below.

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

We are supportive of directors being required to vet internal controls and make an explicit statement of their conclusion, supported by evidence as suggested under the Government’s preferred option.

However, we also believe the auditor should be required to state whether the internal controls are robust, and thus underpin their opinion on whether the financial statements can be considered to provide a true and fair view (TFV).

Currently, the auditors’ TFV Opinion is widely treated as the same as their Opinion on whether the accounts comply with accounting standards, IFRS. There is no narrative justifying how they have arrived at this conclusion. This is inadequate, since meeting the TFV statutory requirement requires

[4] See, for instance, https://www.ipe.com/accounting-roundup-more-illegal-dividends-unearthed/10017559.article

meeting duties under Part 23 of the Companies Act (capital maintenance rules – dealt with in section 2.2 below), which the IASB has explicitly stated IFRS is not designed to do[5].

The TFV Opinion would be significantly strengthened if it were supported by a statement by the auditor as to the veracity of the internal control system. It should likewise include a statement as to their confidence that any declared dividend is legal in line with the Companies Act, supported by a strong system of internal controls around the calculation of distributable reserves.

We do not believe that the COSO framework, identified as a possible benchmark for assessing internal controls (Para 2.1.23), is a desirable methodology. This is primarily because it presumes management's initial risk management framework is appropriate, and then checks implementation of that. What auditors should do is vet whether the framework itself is properly calibrated.

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

We believe these proposals for stronger internal controls should be applied to all PIEs, phased in such that companies and auditors can build capacity to meet the requirements.

Section 2.2 Dividends and capital maintenance

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

The regulator must own the guidance and ensure it is consistent with the Law

Yes, the regulator should be responsible for setting the guidance for what is treated as realised profits under Section 830, and also how the net asset test is met as required under Section 831. The current position of the audit industry setting this guidance is not acceptable due to the obvious point that they should not be put in charge of setting the rules that govern their own work. This self-regulatory model has resulted in a grave weakening of our company law protections, and needs to be urgently rectified.

Whether or not the Government pursues Option 1 (guidance) or Option 2 (rules), it should be reviewed for consistency with Company Law requirements that the accounts provide a true and fair view (TFV) and provide a basis for determining legal dividends. This review should be conducted by an independent lawyer, which has no historical or current links to the audit profession.

We have long pointed to flaws with the ICAEW and ICAS Guidance on calculating distributable profits (TECH02/17), for instance in our submission to the Brydon Review as well as to the BEIS Select Committee investigation into Audit[6]. A larger group of institutional investors have likewise called for this Guidance to be 'owned' by the government, and properly reviewed for its consistency with Company Law. This is because we are of the view that the current guidance runs contrary to the

[5] https://www.ifrs.org/news-and-events/news/2019/02/returns-reinvestment-opportunities-and-dividend-distribution/
[6] Please see https://sarasinandpartners.com/wp-content/uploads/2020/06/byron-review.pdf; http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/future-of-audit/written/94924.html

Law's intent, namely to ensure a prudent approach to dividend distributions that does not put the entity's viability at risk[7].

We are supported in this view by two detailed legal Opinions provided by George Bompas QC in 2013 and 2015, which have never been properly and transparently considered by the Government[8]. The FRC and BEIS appear to have turned a blind eye to these Opinions, relying instead on an Opinion provided by Moore QC, despite questions raised over his conflicts of interest given past commercial links to the the audit profession.

As highlighted in the Consultation, Section 853 prescribes that in defining 'realised profits' and 'realised losses', reference should be made to 'principles generally accepted at the time'. What is not made clear, however, is the critical importance is that these principles are themselves consistent with the requirements of the Companies Act. If they are not, then they can clearly not be relied upon to meet Company Law requirements. Above all, they should be consistent with the overarching requirement that accounts provide a TFV, such that directors have clarity on the capital available for distribution.

Yet, as emphasised in the Consultation document (Para 2.2.2), current IFRS accounting rules are not drawn up to meet dividend distribution or capital maintenance requirements, so cannot therefore be a basis for determining whether profits and losses are realised[9].

Audit industry has long sought to scrap the capital maintenance regime

Our concern is that the TECH Guidance draw up by the audit industry, nonetheless, relies excessively on IFRS, and thus provides too broad a definition of realisation to include accrued profits, e.g. from long-term contracts. While this approach has long been pursued by the audit industry to eliminate what they argued was excessive complexity, costs and obstacles to dividends (see for instance the attached ICAEW paper from 2005 outlining problems with the statutory capital maintenance regime as being 'overly rigid' and 'flawed' preventing companies from paying out dividends, and arguing for these rules to be scrapped[10]), these arguments were never accepted by Parliament and the Law remained in place.

Above all, the ICAEW's proposals to scrap our capital maintenance regime was, and remains, dangerous because it would undermine vital investor and public protections: if we treat expected income as realised, and treat this as distributable, then if this income fails to actually materialise the business could be put at risk. This is arguably a feature of what unfolded at Carillion, resulting in its bankruptcy.

Against this backdrop, and the conflicts of interest that exist, it is concerning that BEIS has taken advice from the ICAEW in drawing up the proposals relating to Capital Maintenance (see Para 2.2.13).

Expected liabilities and losses must also be provisioned for

In addition, it is worth noting that the requirement to provision for realised losses under the Act also takes a more prudent and forward-looking view than IFRS. The Consultation suggests the accounting

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[7] See Investor position paper "Investors and the public need to know whether profits and capital are real" (June 2019)

[8] https://lapfforum.org/engagements/lapff-legal-opinions/

[9] This is also underlined by the IASB in a paper published in 2019: https://www.ifrs.org/news-and-events/news/2019/02/returns-reinvestment-opportunities-and-dividend-distribution/

[10] ICAEW, "Implications of IFRS for Distributable Profits", ICAEW Briefing Paper, 2005.

requirements are ‘backward-looking’. This is not entirely true. To provide a reliable and prudent view, the accounts are required to look forward to determine any likely liabilities or expected losses associated with a past activity. These likely losses/liabilities must be provisioned for when determining what is available to distribute. In other words, if directors expect a large environmental liability, for instance, they should not pay out a dividend that ignores this. Funds should be set aside, and dividends only paid is there is enough distributable reserves left over.

This is not to say that directors must also pay due regard to obligations under section 172, but it is important to recognise the forward-looking elements baked into the capital maintenance rules.

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

Distributable profits should be disclosed

Yes, the proposal for the disclosure of distributable profits is a welcome step forward. It would bolster investor confidence into the capital strength of companies in the UK. This requirement should apply to all PIEs, as it underpins stakeholder trust in company accounts more broadly and their resilience. It should also apply to both parent and group accounts. The reported numbers should be audited in line with the Companies Act.

The Consultation sets out clearly the purpose of calculating distributable reserves, and limiting dividends to this amount, as a key mechanism for ensuring company viability. In short, it underpins companies’ going concern status. The fact that companies are not routinely publishing their distributable/non-distributable reserves undermines investors’, creditors’ and other stakeholders’ confidence in the capital strength of businesses. It also undermines shareholders’ ability to hold boards to account. It makes little sense to keep these numbers secret.

Companies must be required to calculate their distributable reserves

We would add that it is concerning if companies do not know what their distributable reserves are today, as suggested in the Consultation (“*Para 2.2.15 Where it is impossible to calculate the figure exactly, … it is envisaged that companies will be permitted to report a ‘not less than’ figure for its distributable reserves. Any proposed dividend would not be allowed to exceed the known figure*”). This underlines the problem we have been calling out for several years. That companies are not routinely tracking their distributable profits, nor undertaking the required net asset test as prescribed under the Companies Act.

Clearly, it is a step forward to prevent dividends if the board does not know they have sufficient reserves, but the Government should go further and require that they work out what these reserves are. This could be phased in over time, but it is not acceptable to allow companies to flout the legal requirement indefinitely.

There is a legal requirement for disclosure

We would disagree with the Consultation’s contention that there is no legal requirement for disclosure today. This has certainly been the audit profession’s and FRC’s long-standing position, but

it has never been compellingly defended[11]. As already highlighted, in his legal Opinions provided in 2013 and 2015, Bompas QC makes plain that disclosure is required under Company Law.

It is also clear from reading Section 836 of the 2006 Companies Act: 'Justification of distribution by reference to relevant accounts' explicitly requires that:

"…a distribution may be made by a company without contravening this Part is determined by reference to the following items as stated in the relevant accounts - ….(c) share capital and reserves (including undistributable reserves)…".

In other words, the accounts should explicitly state what is undistributable, permitting us to calculate what is distributable. And yet, hardly any companies make this disclosure.

It is also worth looking at Section 92 of the Companies Act, which reinforces this requirement for disclosure. Section 92 sets out rules for companies that are seeking to register as a public company. It is clear from the text that the undistributable reserve is disclosed as an item – and importantly the calculation using that item is an auditor (not a director) duty:

1) *A company applying to re-register as a public company must obtain—*
   a) *a balance sheet prepared as at a date not more than seven months before the date on which the application is delivered to the registrar,*
   b) *an unqualified report by the company's auditor on that balance sheet, and*
   c) *a written statement by the company's auditor that in his opinion at the balance sheet date the amount of the company's net assets was not less than the aggregate of its called-up share capital and undistributable reserves.*

   5) *For the purposes of subsection (3) a qualification is material unless the auditor states in his report that the matter giving rise to the qualification is not material for the purpose of determining (by reference to the company's balance sheet) whether at the balance sheet date the amount of the company's net assets was not less than the aggregate of its called-up share capital and undistributable reserves.*

   6) *In this Part "net assets" and "undistributable reserves" have the same meaning as in section 831 (net asset restriction on distributions by public companies).*

Interestingly, the FRC's guidance on Section 92 also makes it clear that the auditor must consider the undistributable reserves as stated in the audited balance sheet[12], even though elsewhere it claims there is no requirement for disclosure:

"With respect to the auditor's responsibility the auditor's statement states that it is limited to an examination of the relationship between the company's net assets and its called up share capital and undistributable reserves as stated in the audited balance sheet, so that it is clear that no further audit procedures have been carried out."

Parent vs Group disclosure

On the matter of parent level versus group disclosure, we have also been clear for many years that we require both in order for the disclosure to be meaningful, and achieve the goal of underpinning confidence in long-term viability.

[11] ICAEW TECH 02/17 reiterates the audit industry's belief that there is no legal requirement for disclosure of which reserves are distributable or non-distributable. In various documents, the FRC echoes this belief.
[12] "Miscellaneous Reports by Auditors Required by the UK Companies Act 2006", FRC, 2008.

While it is true that the dividend is paid by the parent company, what matters to shareholders and creditors is knowing the dividend paying capacity of the group in which their capital is distributed. Put another way, the ability of the parent to distribute depends implicitly on the distribution capacity of those subsidiaries that underpin it.

For UK only companies, each of the subsidiaries will be subject to the capital maintenance regime, so should be gathering this information, and it should be a straightforward job to compile it for the group. It is akin to compiling a group level cash flow statement.

Where there are more complex group structures that span multiple jurisdictions and different solvency regimes, if anything this makes the importance of having robust capital protection controls in place all the greater. Just because, for instance, the US applies a different regime, does not mean shareholders in the UK entity should no longer have visibility of their capital according to UK requirements.

This matters, for instance, where there are problems within a subsidiary that could materially affect the parent's ability to make dividend payments in the future. For instance, if the parent company lends to its subsidiaries, or has investments in subsidiaries, then the group position transmits straight to the parent position. Negative distributable reserves in subsidiaries (i.e. losses have been made and liabilities may exceed assets) may have a bearing on the distributable reserves of the holding company. The negative reserves of subsidiaries may themselves create adjustments to the distributable reserves in the holding company accounts, as the holding company may have a commitment to support the subsidiary (a liability) or may need to write down investments in subsidiaries or intercompany loans made. If the parent guarantees any subsidiary debt, then the subsidiary debt is the parent company debt. They are intertwined.

Disclosure of any intra-group restrictions on paying up dividends (e.g. the company's own policy, tax, banking covenants, exchange controls, etc) would be helpful to investors/creditors.

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

We are supportive of a requirement for an explicit directors' statement about the legality of dividends, and their effect on the future solvency of a company. While ensuring dividend legality is already a responsibility of directors, an explicit assurance of this could help to concentrate minds on the importance of this requirement. We are supportive of this requirement applying to PIEs more broadly.

We would only reiterate points made under Q15 above that the calculation of distributable reserves is not entirely backward-looking as suggested in the Consultation, as it requires that foreseeable losses/liabilities are also accounted for (and capital set aside to cover these).

Linking this statement to the going concern assessment and longer-term resilience statement makes sense, as they are closely intertwined.

It is not clear, however, why the outlook would be limited to two years as suggested in the consultation. We believe that any foreseeable loss/liability, as long as it has a material probability of occurring, should be considered, even if it happens to fall in, say, 3 years. Put another way, if directors decided to disregard a large liability just because it was due in 3 years, this would be irresponsible and arguably fall short of the legal requirement today.

Chapter 3 – New Corporate Reporting

3.1 Resilience Statement

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

We are supportive that the matters identified in the Consultation (threats linked to a major disruptive event; supply chain resilience; digital security risks; dividend sustainability and climate change risks) should normally be considered in companies Resilience Statement, but we would tend to offer companies flexibility to identify those matters most relevant to them. This is part of their responsibility so providing a standardised list could undermine accountability.

We would note that the proposed Resilience Statement appears to largely duplicate what was intended with the Viability Statement. The fact that the Viability Statement has not delivered as expected raises questions of enforcement. To ensure that this proposed statement on long-term resilience does not suffer a similar fate, the Government needs to ensure that ARGA acts to police implementation.

One issue that is worth emphasising is the foundation provided by proper enforcement of the capital maintenance regime discussed in Chapter 2 to the credibility and usefulness of this Resilience Statement. In the short-term, and entity's Going Concern status depends critically on it having protected shareholder capital, taking foreseeable losses/liabilities into account. The same can be said of the medium-term viability statement.

One area of particular concern relates to climate risks, and associated future write-downs and liabilities that could increase risks to dividends and, in more extreme cases, insolvency.

We have worked alongside other investors to set out explicit expectations for companies to stress test their financial statements for a 1.5C scenario (referred to as Paris-aligned accounts)[13]. Where they do not use critical assumptions and estimates consistent with this scenario, they should publish sensitivities in the Notes to their accounts to this scenario. They should also set out precisely how climate risks could impact their dividend paying capacity. This would provide valuable reassurance to stakeholders of the company's resilience to the accelerating energy transition and the ULK's 2050 Net Zero target. Naturally, these disclosures would be audited, and where the company fails to produce these numbers, the auditors have been asked to provide shareholder with a view of the financial risks.

In December 2020, we set out an explicit call for the UK government to make audited accounts aligned with a 1.5C scenario mandatory. This could be presented in companies' core Financial Statements, or the notes to their Financial Statements. The key point is that investors and other stakeholders have visibility of the risks to an entity's financial position from the net zero transition,

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[13]See IIGCC briefing paper https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/; also PRI statement: https://www.unpri.org/sustainability-issues/accounting-for-climate-change; The Investment Association has also recently highlighted the importance of companies providing greater visibility around how a 1.5C transition will impact the financial statements in its Shareholder Priorities for 2021.

which has now been mandated by the UK[14]. It would be logical for any sensitivity analysis linked to climate risks presented in the Notes to the accounts to be discussed in the Resilience Statement.

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

As already highlighted above, we view climate risks as a vital consideration in many, if not most, companies' resilience assessments. It would thus be logical for the statement to cross-reference the entity's TCFD (though not subsume or replace it).

However, currently envisaged TCFD disclosures are not sufficient to provide reassurance over long-term viability. For this, as underlined above, we need to understand how a Paris-aligned scenario will impact an entity's financial position. This scenario analysis should be disclosed within companies Financial Statements and audited. It can then be cross-referenced in the Resilience Statement, supported by additional narrative.

3.2 Audit and Assurance Policy

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

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

The concept of a rolling three-year Audit and Assurance Policy (AAP) for PIEs that would be voted on by shareholders could provide a mechanism for ensuring greater shareholder scrutiny of the audit process.

The lack of shareholder engagement and scrutiny of audit matters is a major barrier to improving audit quality[15]. This is because it means that the primary customer of the audit is absent, which results in a classic market failure – the provider is not incentivised to improve his / her service if it makes little difference to their reappointment. There is plenty of evidence of this problem, not least the fact that shareholders hardly ever vote against an auditor reappointment, even where there has been considerable evidence of past failure. The reappointment of EY at Wirecard in years following public revelations over material internal control failures and accounting misstatement is just the latest example.

The lack of shareholder oversight leaves the door open to auditors seeking favour with management, who they perceive (often rightly) to be the main decision-makers behind their reappointment and level of fees they can charge.

Of course, the Audit Committee should act on behalf of shareholders in holding the auditor to account, but – again – because shareholders have minimal visibility into the actions of auditors, they have little information for vetting the Audit Committee performance. Too often Audit Committees turn to management – e.g. the CFO – in drawing up details of how an external audit will need to be undertaken. In many cases the CFO is running the auditor appointment process behind the scenes.

The introduction of an AAP, which shareholders have to vote on could act as a bridge for providing shareholders with more granularity on their audits, and thus giving them reason to expend energy and resource in vetting these. We could envisage this vote resulting in greater attention by proxy research

[14] https://sarasinandpartners.com/stewardship-post/paris-aligned-accounting-and-audit-to-deliver-net-zero-emissions/

[15] Please see our article in the FT in 2018 emphasising this problem: https://www.ft.com/content/663c433a-2c38-11e8-97ec-4bd3494d5f14

agencies, for instance, which then helps to build market awareness. This could then be a stepping stone for ensuring more accountability of the auditor and audit committee directors at the AGM.

However, there are important points to take care over if AAPs are introduced, as follows:

- They must not be permitted to undermine existing statutory responsibilities of auditors under the Companies Act. This is not a matter of changing auditors' core duties, but adding to them.
- Boiler plate lists of technical activities that fail to meaningfully inform investors should be avoided. In this case, providing another shareholder vote, will not solve the underlying problem – delivering greater accountability.

We, therefore, cautiously support the introduction of an AAP as long as they bolster existing requirements, and provide meaningful insights into the audit process, which engages shareholders and strengthens accountability.

3.4 Public Interest Statement

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

We agree that proposed improvements to enforcement of the capital maintenance regime and associated resilience statement, alongside enhancements to reporting against requirements under s172 are sufficient at this stage to ensure companies are properly considering their impacts for the public interest. We would, however, suggest that this is kept under close review.

4 Supervision of corporate reporting

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?

We are supportive of a stronger regulator that can enforce changes to company reporting in line with the Companies Act. We also support extending their remit to the entire Annual Report. The current limited scope and powers of the regulator has undermined its ability to correct failures, and thus to enforce the Law and protect the public interest.

With increased powers, however, it is vital that the regulator's governance is strengthened to eliminate conflicts of interest as recommended by Kingman. This means ensuring far less reliance on the audit profession and preparers in key positions. The regulator must furthermore take steps to better understand the legal requirements it is tasked with implementing, and should be properly resourced to enforce them.

As discussed under Q15, a key element of this is enforcement of the TFV requirement and also rules around dividend legality and the disclosure of distributable reserves. The existing position of the FRC on these matters is based on a legal Opinion from Moore QC which was subsequently described as flawed in two subsequent legal opinions by Bompas QC. We would also note that conflicts of interest existed with Moore QC due to his commercial links with the audit industry. These were never properly disclosed.

In light of both questions raised by a senior and experienced QC as well as these conflicts of interest, the original Opinion on which the FRC relied should be urgently reviewed. Above all, the regulator should not merely focus on whether IFRS have been followed. It must investigate whether following IFRS will deliver TFV accounts, and provide a prudent basis on which to declare dividends in line with Company Law.

This examination would also provide a basis for reviewing the ICAEW/ICAS Guidance for the calculation of distributable reserves as proposed in Q15, which requires a clear statutory understanding on what is deemed realised, not just an accountants' view of what this should mean.

Where the regulator finds inconsistencies between the accounting standards and the company law requirements, it should flag these to the new Endorsement Board. We would highlight concerns we have already that the current Endorsement Board includes an excessive representation of the audit industry and related parties (e.g. those who have long-standing commercial relationships with the audit industry). The regulator should be in a position to alert the Government where it sees new standards resulting in problematic reporting by companies, that puts the public at risk.

Any new powers must be awarded only alongside proposed revamped governance that protects the regulators independence. Clearly, there will be a requirement for substantially larger staff and support services. The Government should ensure this function is properly funded.

Decisions the regulator takes should be visible to stakeholders. In particular, where a company is investigated and required to implement changes to its reporting, these remedies should be made visible to shareholders. This provides important information for shareholders to be able to effectively hold Boards and auditors to account.

5 Company directors

We are broadly comfortable with the proposed reforms, including extending ARGA's remit to cover enforcement of director duties as they pertain to reporting, but ensuring that existing enforcement by the Insolvency Service (for unfit conduct or the failure to maintain proper accounting records) and FCA are not compromised.

6 Audit purpose and scope

6.1 The purpose of audit

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

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

The most fundamental purpose of audit is to ensure that a company's financial position is prudently reflected in its financial statements, and that directors are therefore prevented from putting the company at risk of insolvency by paying dividends out of capital (as presented in those accounts). It is vital that auditors, first and foremost, fulfil this responsibility in line with Company Law. We discussed this at length under Q15 and Q16.

The annual reviews of audit quality undertaken by the FRC already point to worrying weaknesses in audit quality, with particular concerns arising around impairment testing of goodwill, long-term contracts and loan loss provisioning. Addressing these weaknesses is what is needed to restore trust, above all.

We, therefore, have considerable misgivings about enshrining in Law, or even as a broad ambition for ARGA, what we would view to be a rather woolly definition of the purpose of audit, as proposed by Brydon, to be: "*to help establish and maintain deserved confidence in a company, in its directors*

and in the information for which they have responsibility to report, including the financial statements."

At a high level this is not problematic, but it says nothing about what would be considered 'deserved', nor – critically – concrete matters such as the auditors' role in uncovering fraud or misrepresentation. One may presume that this is implied, but we are unsure how 'enshrining' this definition in Company Law, as proposed, will result in improved audit quality. Rather, by introducing a looser and less concrete purpose for audit, it could undermine its value further.

Brydon's proposal seems to assume that Company Law fails to set out clear expectations for audit, which we would challenge. The legal duties that exist for audit are already strong, the problem is one of ineffectual enforcement and inadequate disclosure by auditors to shareholders and the public. This is where the Government should focus its attention.

We are supportive of the auditor being required to consider wider information in fulfilling this core responsibility. By getting the basics right, the Government will do far more to underpin trust in accounts than adding a long list of new responsibilities on the auditor.

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?

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?

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

We believe that assurance of non-financial disclosures (those sitting outside the Financial Statements) is increasingly important as investor rely more on this information in their capital allocation decisions. It is, therefore, also important that it should be regulated.

Also, there are important benefits from this widened scope for reinforcing the existing requirement that the Financial Statements are consistent with other narrative disclosures.

The challenge we see, however, is how ARGA will cope with the vastly expanded remit to cover not just auditors, directors and all forms of reporting. The danger is that in trying to cover everything, it covers nothing well. As per our response to Q35 and Q36, ARGA needs to ensure it gets the basics right first and foremost, and any extension of remit is properly resourced.

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?

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 problem besetting auditing is pervasive conflicts of interest that interfere with auditors' accountability to shareholders and the public. Adopting new 'principles' may not do any harm, but will not address the root cause of audit failure.

Far more important actions are:

- measures to clarify the legal duties associated with delivering a TFV standard as well as the capital maintenance regime that underpins companies' going concern determination;
- measures to enforce these duties – both regulatory and through shareholders having more information with which to hold auditors to account at company AGMs; and
- measures to restructure auditors to minimise conflicts – most importantly a full structural separation of audit from non-audit work.

It may also be worthwhile considering existing obstacles to shareholders taking legal action against auditors, as this reduces their sense of accountability to those they are required to serve. At present members cannot take direct action against auditors, having to rely instead on the Company to pursue this. To act where boards do not requires, as we understand it, a derivative action that can be difficult and costly.

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 duty of directors and auditors with respect to fraud is well established in law. In essence, for directors to sign off accounts as providing a TFV and auditors to concur with this assessment, they would need to have established that there was no evidence of material fraud.

We are therefore supportive of any action by the Government to reinforce these existing requirements, and to ensure they are enforced as part of the broader expectation that directors and auditors establish that an entity is a Going Concern, and has not paid out illegal dividends. The fact that there is confusion on the above points is a reflection, above all, of weak enforcement in the past.

We would also note that while the Governments proposals are consistent with our points above, it is vital that the Government makes clear these linkages to the overarching framework rather than treating each and every material threat to mis-statement in a piecemeal fashion. Otherwise, directors and auditors will presume that if the matter – in this case fraud – is not specifically listed, it is not covered. This would result in a weaker, not stronger, system.

6.5 Auditor reporting

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

As already noted under Q35 and Q36, we are supportive of the auditor being required to consider wider information in fulfilling its core responsibility. We view this as already part of the requirements for auditors in the fulfilment of their existing duties under the Companies Act. The issue has been a problem of enforcement, above all.

So, stating more explicitly that auditors must consider wider information – such as external market signals or any problems with stakeholder relations – is helpful, but the focus must be enforcement of this.

We also strongly support more detailed disclosures by auditors, including graduated findings, that build on the Key Audit Matter reports that are already required. Also, if directors fail to publish material information that auditors believe would help in the interpretation of the accounts, then the

auditors should publish it themselves [para 6.5.8]. This provides important insights for investors to be able to better understand audit risks and to provide a basis for engagement with directors.

6.6 True and fair view requirement

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

No, we do not agree that departures from using IFRS should be done by reference to new Principles of Corporate Auditing. Any departure from IFRS should be done by reference to the legal TFV 'override' requirement. Likewise, auditors should justify their Opinion on compliance with the TFV standard by reference to the Companies Act, as they do today.

As outlined in the Consultations, departures from IFRS are required to ensure the published accounts meet the statutory TFV standard. The Consultation suggests that there is confusion over what this standard is, so there is a need to provide clearer guidance. They suggest this could come in the form of Principles of Corporate Auditing.

We would concur that there is a need for guidance, but this guidance must be firmly rooted in our common law standard not defined by what the audit industry or preparers would like it to be. We would propose that the Government seeks demonstrably independent legal input to review the existing TFV guidance and, based on this, publish the criteria for use of a TFV override.

The confusion today stems in large part from intensive lobbying by the audit industry over the years, and reflected in their 'capture' of the FRC on this matter. The audit profession has long tried to create a view that TFV is a subjective concept that is essentially the same as the requirement for 'fair presentation' under IFRS. This view was supported by the legal opinion provided by Moore to the FRC (and there was never any disclosure of the commercial links between Moore and the audit industry). It is also repeated again in Brydon's Review and the Consultation (para 6.6.1-6.6.5).

As detailed in our responses to Q15 and Q16, we believe this view is flawed. We would also point out that the BEIS Select Committee identified this as a core concern to be investigated. We would also note that the Consultation does not even mention the existence of these two legal opinions by Bompas, with are highly pertinent to this question. It is a mystery why these very serious matters are not being properly explored in this Consultation.

Our own view – supported by the two legal opinions by Bompas QC – is that the TFV standard has a clear statutory meaning. The TFV standard is met where the accounts provide a reliable basis for determining legal dividends, as set out in Part 23 of the Companies Act. The accounts must therefore be prudently drawn up, and differentiate between realised and unrealised revenue and also include foreseeable losses and liabilities, to prevent overstatement and thus the risk that directors will propose dividends out of capital.

To sum up, the Government should urgently:

- undertake an independent legal review of what TFV means, including linkages to the capital maintenance regime
- based on the outcome of this, publish guidance for directors and auditors so they can know where they should depart from IFRS, or supplement it with additional disclosures.

6.8 Auditor liability

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

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

The problems with accounting and audit in the UK stem to a large extent from a lack of accountability of auditors to members, not the reverse. If anything, auditors should face clearer sanctions from failing to undertake robust due diligence on behalf of shareholders who appoint them. We are therefore strongly against LLAs as this would further insulate auditors from accountability, and make them even less likely to defend shareholders' interests.

On the matter of innovation, again auditors are mostly disinterested in shareholder views and requests for additional disclosure. We have seen them push back on extended qualified audits, and a tendency for Key Audit Matter disclosures to become boiler plate. This is in our view more likely the result of their lack of accountability to investors, and a focus instead on not rocking the boat with management.

We have seen this play out specifically in two areas we have engaged with the Big Four firms:

- requests for disclosure of distributable reserves for listed entities[16]; and
- requests to auditors to publish their view on management's consideration of 2050 Net-zero carbon emissions scenarios, and requests that they publish their views on the financial exposure to such scenarios if the company fails to[17].

Again, we believe the government should be seeking to find ways to enhance the materiality of poor performance with respect to shareholder and the public interest, not to dilute it further.

6.9 A new professional body for corporate auditors

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

Again, this is perhaps desirable, but will not improve matters if the Government fails to strengthen enforcement of existing legal standards linked to TFV and capital maintenance.

7 Audit Committee Oversight and Engagement with Shareholders

7.1 Audit Committees – role and oversight

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

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[16] Engagement with Big Four over many years since 2012.

[17] See letters to Big Four from investors representing over $2 trillion in January 2019 (https://sarasinandpartners.com/stewardship-post/incorporate-climate-risks-into-company-accounts/), and then Investor Expectations for Paris-aligned accounts published by investors in November 2020 (https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/).

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

We are supportive of more scrutiny by the regulator of Audit Committees. We would also emphasise that in the end shareholders appoint Audit Committee directors at companies' AGMs, and thus that all reviews or sanctions imposed on Audit Committees should be clearly communicated to the market to empower shareholders to fulfil our stewardship responsibilities.

In the end the market failures identified by CMA are rooted in the failure of shareholders to ensure effective oversight and accountability, and rather than supplanting shareholders in tis, the Government should help to mitigate the market failure.

7.2 Independent auditor appointment

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

Q55. 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?

We are supportive of these new powers for ARGA in these situations, but would reiterate that shareholders should be empowered and not supplanted in the mater of strengthening auditor and Audit Committee accountability.

Q56. 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?

Q57. 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)?

These questions point to the limitations of relying excessively on ARGA to solve all the market failures. In the end, governments fail too, and the increased remit of ARGA already raises concerns over how implementable it is.

A more effective and sustainable solution would be for ARGA to align incentives with the public interest by ensuring shareholders and other stakeholders have the information they require to hold auditors and audit committees to account.

Linked to this, ARGA should explore mechanisms to hold asset managers and asset owners to account for their roles as stewards in overseeing audit. There's an argument for including this particular responsibility under the Stewardship Code as suggested under para 7.2.10. See also Section 7.3 below.

7.3 Shareholder engagement with audit

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

We are supportive of introducing a formal mechanism that requires Audit Committees and auditors to consult with shareholders over their concerns, or matters they consider to be material.

As already noted under Q47 we have sought precisely this kind of input in the past, only to find our views in most cases overlooked. We have also noted for most Audit Committees, the annual reviews of auditor performance hardly ever involves shareholder feedback. In fact, more emphasis has tended to be on getting management feedback, which is, in our mind, reinforcing the conflicts of interest that exist.

Any consultation with shareholders, however, must not supplant or dilute in anyway existing auditor and Audit Committee statutory responsibilities. For instance, just because shareholders want to have greater assurance over, say, Decommissioning and Restoration liabilities, this should not divert the auditors' attention from other areas they consider to be KAMs.

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

We are in favour of there being a requirement for Audit Committee directors and separately auditors to answer shareholder questions at AGMs.

We recently posed questions to both at Royal Dutch Shell's 2021 AGM, and we were not alone[18]. These questions were prompted by the auditor, EY, responding proactively to shareholders requests for their views on whether Shell's accounts were 'Paris-aligned', and provides a good example of how investor engagement with the auditor and Audit Committee can result in greater transparency on a matter of shareholder concern, and then this generates more active engagement at the AGM.

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

Additional, and meaningful disclosures to shareholders would be beneficial.

8 Competition, choice and resilience in the audit market

8.1 Market opening measures

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

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?

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?

[18] https://www.shell.com/investors/annual-general-meeting.html

We believe there is a need for greater competition, but the key problem will not be resolved simply by increasing the number of audit firms[19]. What matters is that auditors are being held to account for delivery of high-quality audits by shareholders, rather than being held to account for delivery of 'easy' audits by management. Importantly, as already underlined, we need to be clear what those audits are there to do above all. Namely, to sound the alarm where companies are mis-representing their capital strength and /or paying illegal dividends.

If this point on the purpose of audit is addressed, and auditors required to provide more transparency on how they meet the standard, then we may find competition increases naturally as shareholders become more engaged and seek out better providers. If the Big Four step up in delivering against these expectations, it is possible that effective competition is increased.

We would add that the most important structural problem in the market is one of conflicts of interest embedded in the combination of audit with consulting services. We favour a full structural separation that result in pure audit firms. If we move to this corporate structure, there could well be lower barriers to entry to new competition. See below under Q64.

We are less convinced that the proposal for shared audits will achieve the desired objective – again it won't achieve anything unless the legal requirements are clarified, and more transparency assured. Market share caps could help, even if the Big Four 'cherry pick' – this still provides scope for new entrants to gain a foothold and build scale.

Also, with the proposed expansion of auditing requirements, e.g. to cover the entire Annual Report, the demand for audit services will rise, creating new opportunities for mid-tier and new players.

8.2 Operational separation between audit and non-audit practices

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

As made clear in our submission to the CMA in January 2019 on its proposed Remedy 5, we believe only structural separation of audit from non-audit consulting will achieve the desired objective of robust independent audit. Operational separation will be cumbersome to implement, subject to gaming and continue to suffer from conflicts, in our view[20].

Our comment on this proposal in our CMA submission is copied below as the key points remain pertinent:

While a step in the right direction, we are cautious about the proposal for the operational separation (ring-fencing) of audit and non-audit practices primarily because we doubt that the proposal will eliminate the fundamental tension between the two business models.

We also think <u>the practical challenges of implementing and policing an operational split will likely be significant.</u> We would tend to agree with the comment by Grant Thornton, as quoted in the CMA report, that perceptions around conflicts would remain. Indeed, we think that real conflicts would

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[19] We have made this point in other submissions, notably to the CMA. Please see, for instance, https://assets.publishing.service.gov.uk/media/5bf2cbc9ed915d181653c1a5/sarasin-and-partners-statutory-audit-invitation-to-comment-response.pdf and https://assets.publishing.service.gov.uk/media/5c5b0852e5274a31874509c6/sarasin_response_to_update_paper.pdf

[20] https://assets.publishing.service.gov.uk/media/5c5b0852e5274a31874509c6/sarasin_response_to_update_paper.pdf

likely persist where there was continued sharing of systems, know-how, back-office support, training etc. The firms audit and non-audit partners would continue to have shared interests.

Importantly, the ability for staff to move between the two parts would undermine the goal of creating separate cultures. According to the CMA only 1% of hours spent on an audit are currently from the non-audit partner (para 4.127(b)). This means that the problem today lies primarily with the contradictory incentives (challenge versus cooperation) of non-partners, and this would not be addressed under this proposed remedy.

Concerns identified with the structural split option also appear overstated. The CMA's analysis indicates that on average 80-90% of a FTSE 350 audit does not require input from non-audit specialists. It seems feasible that audit-only firms will be able to retain the required non-audit expertise, either procured in the market or in-house where there is sufficient demand. The key benefit of this model is the non-audit advisory work would be demonstrably intended to support a high-quality audit.

The fact that the combined audit and non-audit model exists overseas, only suggests that audits abroad will suffer similar risks from conflicts of interests. It is not a reason to maintain a faulty model in the UK. This logic would result in a damaging 'race to the bottom'.

It seems feasible to us that audit-only firms in the UK could contract with or form partnerships with audit-only firms internationally where needed (law firms such as Slaughter and May could provide a model of how this might work).

The concern that audit-only firms would be insufficiently attractive to potential recruits also seems exaggerated. Based on the CMA's findings, very few audit staff seconded or permanently moved into non-audit teams at the Big Four and challenger firms during 2011-2018.

Concerns have also been raised that the possibly seasonal nature of audit work would present a greater resource challenge for audit-only firms. The CMA should investigate to what extent this reflects the reality of audit staff activity, since our impression is that work is not limited to the month or so immediately following year-end, certainly in the case of larger audits. Again, the CMA's findings that very few audit staff are seconded to non-audit practice would seem to indicate that they are sufficiently occupied within the audit business.

If it transpired that this might indeed present an obstacle to the functioning of audit-only firms, thought could be given to whether staggered financial year-end reporting could be encouraged among UK firms. We would expect this to lead to improvements in the quantity and quality of stewardship activity among UK investors, allowing more time to be spent analysing reporting and engaging with boards around AGMs, for example. It could potentially be less helpful for the purposes of comparative investment analysis, although again the CMA should investigate how important annual reports and accounts are to this process, compared to more frequent quarterly numbers and others forms of market communication.

Finally, the various concerns around financial resilience of audit-only firms fail to consider how the market will likely evolve in this scenario. If the businesses split, then new pricing models would emerge to reflect changes to their economics. If they are unprofitable, then audit fees would need to rise. If this is the cost of having a more robust and unencumbered audit, we think investors will be willing to pay.

However, we do not think fee increases are inevitable. As the CMA indicates, and this chimes with anecdotal evidence we are aware of, audit divisions are already profitable. With increased competition from challenger firms, so we would not expect substantial increases in fees. We would, though, expect higher quality audits.

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?

Remuneration is just one element of auditor incentives, but important. Having disclosure of partner remuneration will be important but this information needs to be made public. As noted in other sections, the notion that ARGA will have the capacity to police directors and auditors in the detailed way being proposed in numerous areas is not realistic. Instead the Government should focus on providing information to empower other stakeholders, notably shareholders, to hold their auditors to accounts.

As noted in other sections, there is a danger in many proposals in this Consultation of government over-reach in the sense that the Government seeks to replace the market entirely, rather than focusing on correcting market failures. The danger here is that we end up replacing the market failure with a government failure.

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 key problem this Consultation is trying to solve is poor quality audits, and a loss of trust in corporate reporting. This has arisen because there is a lack of visibility of the product (audit quality) and also a lack of accountability for this product. The result has been a market in which audits feel primarily accountable to management, to a lesser extent to audit committees and hardly at all to shareholders or the public.

The high level of concentration in the audit market has exacerbated the market failures, partly due to the influence the firms have over the standard setting, regulatory and policy making infrastructure.

Against this backdrop, it is not clear to us that putting in place a complex system that monitors resilience with a view to preventing failing audit firms will be beneficial. If a particular audit firm is shown to have systemic internal control failures that raise questions across its entire client base, that firm should pay the price of its own failure. We support the Government view that it should not intervene if a firm does in fact fail.

Where an audit firm fails, this would naturally be disruptive, but we do not view this as akin to the systemic disruption that could come from, say, a large bank failure (as also seems to be recognised in the Consultation para 8.3.22). Of course, companies would need to find new auditors, and for a period audits may be delayed, but we would not see companies failing as a result. But this does not justify in our mind a Government back-stop.

Moreover, even where an audit firm were to fail, its human capital would likely be rapidly reallocated to other entities. It would also create space for new entrants who are more focused on audit quality, therefore supporting the additional goal for increasing competition (this would be additionally supported by market share caps). If the Government seeks to prevent failure, on the other hand, this would not only lead to complacency within audit firms, it would run contrary to the broader goal of increasing accountability.

In summary, while we are pleased the Government is not proposing to interfere with an audit firms' failure, we have concerns over the high level of interference proposed when it comes to propping up 'at risk' audit firms. In practice, there are risks that these early steps suck the government into additional measures from which it will find it hard to free itself. In essence, these interventions could

morph into a government backstop, which would tend to undermine the central purpose of the other proposed reforms. Those who will pay for a more ossified audit market are the public.

9 Supervision of audit quality

A number of sensible proposals are set out in this section, which we support. As highlighted at the start, we have focused out commentary on those questions we believe to be most important for the Government to address at this stage.

10 A strengthened regulator

10.1 Establishing the regulator

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

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?

We view the proposed objective *'To protect and promote the interests of investors, other users of corporate reporting, and the wider public interest'* as too vague, and not sufficiently clearly linked to the expanded remit of ARGA to uphold director and auditor duties under the Companies Act as they pertain to accounting and audit.

While the Government clearly intends for ARGA to be the vehicle for implementing Company Law requirements related to corporate reporting and audit, it is important to make this clear in the stated objective. In our view, the failure of the FRC to have an explicit statutory basis was a key flaw in its constitution that then led it to essentially govern itself, and become a vehicle through which the audit industry controlled their own oversight.

ARGA's goals need to be firmly grounded in what Parliament has determined to be in the public interest, not what it believes to be in the public interest. In implementing this remit, it must be transparent and accountable, and demonstrably independent of the audit profession and preparers. Only then, should it be awarded the substantial increase in powers and resources that are proposed in this Consultation.

11 Additional changes in the regulator's responsibilities

11.1 Supervision: Accountants and their professional bodies

There are a number of welcome proposals in the section that extend the regulator's oversight of the professional accounting bodies, and more broadly to all accountants. Increased powers to collect information in order to undertake investigations and enforce requirements are detailed. We view these as necessary steps for the new regulator to fulfil its remit.