The Department for Business, Energy and Industrial Strategy
Audit Consultation Team
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Submitted via email to: audit.consultation@beis.gov.uk

22 June 2021

Dear Sir or Madam

Restoring trust in audit and corporate governance

Thank you for providing the opportunity to comment on the above discussion document[1].

1. Background to our concerns

We write as directors of the Corporate Accountability Network[2] and as Professor of Accounting and Society (Adam Leaver) and Professor of Accounting (Richard Murphy) at

[1] Published 18 March 2021 with the above title

[2] Corporate Accountability Network Limited

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Sheffield University Management School, where Adam Leaver directs CRAFiC, the Centre for Research into Accounting and Finance in Context[3].

The Corporate Accountability Network[4] campaigns for improved accounting for the benefit of all the stakeholders of a corporation. Richard Murphy[5], who directs its work, created country-by-country reporting, which is now used for corporate reporting[6] for tax purposes in more than seventy countries in 2003, and sustainable cost accounting[7], which is intended to bring the cost of climate transition onto corporate balance sheets, in 2019.

CRAFiC studies accounting and finance issues within the contexts in which they arise. CRAFiC examines the wider impact of accounting and finance practices on organisations, markets, society and the environment. The aim is to influence the ideas and behaviours of organisational stakeholders in order to change policy and practice, and to provide a voice to all segments of society affected by accounting and financial decisions at local, national and global levels.

We bring these mutual concerns to the comments that we make in this submission.

We comment on the questions that you raised in the discussion document in Appendix 1 to this letter. However, as will be noted from the comments that follow, most of our concerns are more broadly based. As such we make them in the body of this submission.

Appendix 2 to this submission sets out our understanding of some of the more basic needs that many stakeholders have for data that should as a consequence be included in financial statements. That understanding informs much of what else we have to say in this submission.

2. The nature of audit and accounting and the conflicts between the two

In making this submission we note audit is defined as follows in the UK at present[8]:

> *The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. <u>This is achieved by the expression of an opinion by the</u>*

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www.corporateaccountabilitynet.work

Registered at the above address. Registered number 11791864

[3] https://www.sheffield.ac.uk/crafic

[4] http://www.corporateaccountabilitynet.work/

[5] https://www.taxresearch.org.uk/Blog/richard-murphy/

[6] https://www.internationaltaxreview.com/article/b1f7nbbytrk83b/no-9-richard-murphy

[7] http://www.corporateaccountabilitynet.work/wp-content/uploads/2019/12/SCANov2019.pdf

[8] Para 3 of ISA (UK) 200 https://www.frc.org.uk/document-library/audit-and-assurance/2020/isa-(uk)-200-updated-january-2020

auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.

We lay particular emphasis on the underlined sentence. As it makes clear, the quality of an audit, and the role of the auditor cannot, according to the Financial Reporting Council (FRC) and the International Auditing and Assurance Standards Board (IAASB), whose work informed this standard, be differentiated from the accounting framework under which the financial statements on which the auditor reports were prepared. It is therefore vital that the purpose of the commonplace 'general purpose [accounting] frameworks' to which this definition refers be understood. It is not possible to understand the current auditing framework without doing so.

The International Financial Reporting Standard Foundation (IFRS) says in their Conceptual Framework[9] that the purpose of accounting is:

Objective, usefulness and limitations of general purpose financial reporting

1.2 The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.[2] Those decisions involve decisions about:

(a) buying, selling or holding equity and debt instruments;

(b) providing or settling loans and other forms of credit; or

(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

1.3 The decisions described in paragraph 1.2 depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:

(a) the economic resources of the entity, claims against the entity and changes in those resources and claims (see paragraphs 1.12–1.21); and

(b) how efficiently and effectively the entity's management and governing board[3] have discharged their responsibilities to use the entity's economic resources (see paragraphs 1.22–1.23).

IFRS standards are those most commonly used by PIEs in the UK. It will be noted that:

[9] https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/

- These standards are designed solely for use by limited liability corporate entities;
- It is assumed that the equity and debt instruments of the entity can be traded;
- It is assumed that the entity has loans or other forms of debt instrument;
- It is assumed that the entity has a voting membership;
- It is assumed that accounts are produced to inform investment decision making decisions;
- It is assumed that no other interests in accounting data are of significance (para 1.10, not noted above, makes this clear).

In contrast, UK Financial Reporting Standard 102 issued by the Financial Reporting Council[10] (FRC) makes clear that in its opinion the objectives of accounting are:

Objective of financial statements

2.2 The objective of financial statements is to provide information about the **financial position**, **performance** and **cash flows** of an entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

2.3 Financial statements also show the results of the stewardship of management – the accountability of management for the resources entrusted to it.

As is apparent, these two statements conflict with each other. The FRC accepts a broad range of users of a set of financial statements whilst the IFRS defines a narrow user group. The FRC thinks that a there are a wide range of uses for the data in accounts, and the IFRS disagrees. As a consequence the purpose of an audit apparently varies completely depending on which generally accepted accounting framework is used by an entity.

Just to confuse matters, some entities use IFRS for their consolidated accounts and UK generally accepted accounting principles for their parent company reporting, both being published in the same financial statements[11]. In that case the auditors are required to report on accounts prepared under two conflicting accounting frameworks that are published as one set of financial statements. It is hardly surprising that there might be audit risks arising as a consequence, and considerable uncertainty as to the purpose of any audit report. We suggest that this is an issue that the reforms that you are looking at must address if the reforms you propose are to be meaningful. It is therefore a central tenet of our submission that the drive to resolve audit failure must also engage these ambiguities in the wider accounting framework.

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[10] https://www.frc.org.uk/document-library/accounting-and-reporting-policy/2018/frs-102-frs-applicable-in-the-uk-and-republic-of-i

[11] GlaxoSmithKline plc is an example of a company doing this. https://www.gsk.com/media/6662/annual-report-2020.pdf

3. Our suggestion as to the purpose of accounting

It is our suggestion that the purpose of accounting has to be restated as part of your consultation process if the purpose of audit (to which we will turn in a following section) is to in turn be properly stated and understood. We suggest that:

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allows them to make informed decisions.*

We suggest that relevance is defined by the stakeholder's need, reliability means free from material misstatement and that sufficiency is determined in relation to purpose. These together represent a new meaning for 'true and fair' fit for the twenty first century.

We would suggest that a great many of the audit failures of recent years have arisen through failures in the provision of relevant, reliable and sufficient information. Resolving this one issue, which will in due course require reappraisal of UK accounting standards and a reconsideration of the appropriateness of IFRS standards, would we suggest contribute considerably to the resolution of the audit crisis that the UK has suffered. It would also close much of the audit expectation gap. We also suggest that this change is firstly consonant with the aims of the White Paper which wishes to extend definitions of PIEs to large public enterprises and, secondly, consonant with the Brydon principles, broadly supported by the White Paper that 'Auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders' (White Paper para 6.3.3).

4. Our suggestion as to the purpose of an audit

Producing symmetries between the purpose of accounting and the purpose of audit is a prerequisite to good policy in our view. Audit has suffered what has been described as an expectation gap for as long as anyone now working in the profession has been engaged in it. The most likely explanation for this expectation gap is that auditors have believed it to be their duty to report solely to the shareholders of a company on whose financial statements they report, and then solely with regard to the appropriateness of the information included within those financial statements for the purpose of supporting decisions on whether a shareholder wishes to engage with the company, or not.

The problem with this approach is that at least seven stakeholders for the accounts of a public interest entity (PIE) can be identified[12] [13]. They are:

1. The shareholders, if there are any;
2. Other providers of capital to the entity;
3. Trading partners of the entity;
4. Employees of the entity, whether past, present or future;
5. Regulators of the entity;
6. Tax authorities who engage with the entity;
7. Civil society in all its forms, however they might have interest in the entity.

Because the needs of at least six of these seven groups of users the financial statements of PIEs have not had their needs met by audited accounts, and because not all PIEs do in any case have shareholders, there has been considerable, and quite reasonable, confusion as to the purpose of the audit of public interest entities.

The White Paper suggests that the purpose of audit is:

> *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.*

In terms of purpose, the focus on confidence may be too narrow and inward-looking; it is their wider economic consequence that often needs to be appraised when using company accounts. Audit must therefore also have an outward looking focus if it is to meet stakeholder needs

The White Paper continues that:

> *auditing should provide information that is useful to present and potential investors, lenders, creditors and other users in making rational investment, credit and other decisions and assessments about the company.*

We would support this wider stakeholder view; particularly if – as is later suggested in the White Paper – definitions of a PIE could be extended to include many non-shareholder-controlled institutions. But we would argue that the role of audit is not just to *check and*

[12] http://www.corporateaccountabilitynet.work/what-we-are-about/stakeholders/

[13] See also the answer to question 1 from your consultation, below.

verify information, but to *proactively* ensure that information appropriate to the needs of those stakeholders are provided by the directors.

We suggest as a consequence that the purpose of audit should be redefined. This redefinition should focus upon the supply of information that meets the needs of all users of financial statements whilst giving auditors a proactive responsibility to ensure that these needs are met.

This point about the proactive role of auditors builds on sentiment within the Brydon Review. It also reflects our review of the history of financial reporting and the role that auditors have historically played within its development, frequently demanding data from companies that might not have otherwise been made available. It is our suggestion that the auditor has a duty to decide not just on that data that a PIE might include in its accounts, but quite specifically upon what might be missing from them that a stakeholder might require, and then either demand its inclusion or alternatively supply it based upon the data that it can secure from the PIE, or to explain that it is not available. The auditor does, in that case, have a proactive role in the provision of accounting data. Our resulting suggested definition of an audit is:

> *The purpose of the audit of a public interest entity (PIE) is to firstly report on whether the financial statements on which the auditor offers an opinion deliver relevant, reliable and sufficient information to users of those statements and to secondly, where there is a shortcoming, remedy that shortcoming or, if it is not possible to do so, to report why that is and what its consequences are.*

We thus align the purposes of accounting and audit in this statement. We think that essential if there is to be consistency in the approaches used by those engaged in the process of delivering true and fair financial statements.

We think that the positive role that this definition gives the auditor as not just a person checking that accounting standards have been complied with but in actively seeking to determine that the needs of users of financial statements have been met is a critical role for the auditor in the future.

5. Defining a PIE

We welcome the extension of the concept of the audit to what you define to be public interest entities (PIEs). We think that this idea that there are Public Interest Entities is important. We are, however, concerned that the definition is insufficiently rigorous.

We would suggest that a PIE is any entity that has macroeconomic significance. What we are familiar with is the idea that firms are microeconomic entities. The whole economic theory of the firm is built on the premise that they are. So too has auditing been based on that logic. It has been assumed (as is clear from the IFRS definition of the purpose of accounting) that it is assumed that audited entities only have consequence for a limited range of 'insiders' within the entity itself, and that broader responsibilities or consequences of their existence can be ignored. We do, however, know that this is not true. Since the 2008 Global Financial Crisis the idea that some firms are 'too big to fail' has been commonplace. This was originally used to describe banks but has also been used to describe the Big 4 audit firms themselves. We are now aware that the failure of even relatively minor entities can have significant macroeconomic consequence[14].

It would therefore seem to be appropriate to consider that any entity capable of having macroeconomic impact meets is a public interest entity. This would be true even if that impact is concentrated in one relatively small location. As such income of £100 million may well be sufficient to identify a PIE, whilst employment of 500 people always be sufficient for this purpose. Legal form and purpose will be inconsequential if potential macroeconomic impact is the criteria for determining which entities are PIEs, as will the nature of activities undertaken also be inconsequential: the scale of the impact of failure is what matters.

As a consequence, whilst we suggest that guidelines on certain attributes (e.g. listed, AIM listed, turnover, number of employees, etc) will be of use in determining which organisations are PIEs, they will be sufficient to indicate all entities likely to be considered to be PIEs. This is because all definitions can have unintended consequences, and one of those that might result from such a rigid approach is the abuse of such rules. For example, entities may cease to operate under apparent common legal control e.g. through a single parent company, and might instead become loose federations of entities operating in a manner that apparently avoids the requirement that they either present group consolidated accounts showing a true and fair view, or to be recognised as a PIE[15]. This potential abuse has to be avoided.

It is as our recommendation that the regulator (ARGA) should have the power to deem any entity a PIE if it thinks it would have macroeconomic consequence in the event of its failure.

We also recommend that any auditor should be obliged seek determination on the PIE status of any client from ARGA if they are in doubt as to its status. Failing to do so should be a regulatory offence.

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[14] The failure of Greensill Capital is a recent obvious example.

[15] An obvious example of a group of entities working in this loosely federated way are the firms that make up the Gupta Family Group Alliance (GFG) https://www.bbc.co.uk/news/business-57149731

6. Resolving audit issues arising from the use of currently available accounting frameworks

As noted, audit as it has been defined for about twenty years requires that the person appointed to undertake that task confirm that the financial statements that an entity presents to its membership have been prepared in accordance with an agreed accounting framework. Presuming that this is the case then the internationally established professional standards for auditing have suggested it to be reasonable for the auditor to presume that the financial statements in question present what has been described, in the UK at least, as a 'true and fair view'.

This formulaic approach to audit replaced the previous judgement-based approach to audit. That approach was based on the concept of prudence. That required that if there was doubt profits were not recorded and that if there was a risk of loss that it was recognised.

The change in audit approach, which few understood had taken place, largely coincided with the introduction of International Financial Reporting Standards (IFRS) as the general accepted accounting framework in accordance with which most financial statements outside the USA and Japan were prepared from around 2005 onwards. UK generally accepted accounting principles are, of course, very closely related to IFRS.

IFRS does not always encourage prudent accounting. Income, and so profits, can often be recognised earlier under IFRS than under previous standards. Losses have generally been recognised much later under IFRS than when a prudent approach to audit was in operation. In addition, company directors have been provided with considerable scope for judgement when valuing many assets and liabilities on their balance sheets under IFRS. The result has been a significant increase in the value of some types of assets, including the intangible assets such as goodwill that now dominate the valuation of many companies.

As some recent accounting scandals have shown, the flexibility available within IFRS can be abused by some companies and the resulting financial statements can still be said to be prepared under the provisions of IFRS, leaving little room for the auditors to express adverse opinion upon the accounts of companies that sometimes fail only months after being given a clean bill of health by those auditors.

There is a very obvious need to address this issue if confidence in auditing is to be restored. In particular, it is important to recognise that no audit is independent of the accounting framework under which it is prepared. Some of the more subjective elements within IFRS do need reappraisal if confidence in financial reporting is to be restored. A new approach to audit should recognise and encourage this.

That approach should also encourage the extension of accounting standards to those areas where reporting is required to meet the needs of the users of the financial statements of public interest entities (PIEs) where at present there are none e.g. country-by-country reporting, the reporting of the costs of climate change on the balance sheet, and the reporting of data to meet the specific needs of employees and trading partners of PIEs. Without this happening, auditors will not be able to confirm that such reporting has taken place within an agreed accounting framework. We elaborate the accounting needs that must, in our opinion, be addressed in an appendix to this submission.

As importantly, auditors also need to be encouraged to use their professional judgement when undertaking audits, whatever accounting framework is in use. In particular they should be required to be much more circumspect on three issues.

The first is whether the accounting framework used by the reporting entity is really applicable in its case. They should be willing to require that alternatives be adopted when this, in their judgement, appears necessary to ensure that a prudent true and fair view is given.

Second, they should be required to consider whether or not the entity is a going concern despite the correct application of the chosen accounting framework for use in its reporting. In other words, they should actively appraise whether there are conflicts between the apparently reported situation of the reporting entity and the underlying financial performance that its cash flow, in particular, suggests to be the case. This conflict has been apparent in many of the companies that have been the subject of recent audit failure. One mechanism that might achieve this goal is to require auditors to state whether the balance sheet position shown in the financial statements is itself abnormal e.g. the cash balances at the year-end date are significantly different from those customarily disclosed in management reporting throughout the preceding period because of deliberate manipulation at the year-end date to present what is a correct but nonetheless not true and fair view.

Third, the auditors should more actively appraise the ability of a company to make payment of dividends to its shareholders, and report whether they think these appropriate even if the apparent rules permitting a distribution to take place have been complained with. The first duty of the directors of a company is not to its shareholders, but to its creditors, whoever they might be[16]. Active review of the cash flow management of dividend payments, and whether they create underlying stress within the entity, whether or not legally compliant, is

[16] Without wishing to introduce a hierarchy of creditors we nonetheless recognise that from a governance perspective the adoption of a capital maintenance concept that highlights the ability of an entity to meet its liabilities to creditors on an ongoing basis necessarily places a focus on creditors on occasion.

the expression of that duty on which auditors must be required to comment. We address this point in more detail in the next section of this letter.

7. Capital maintenance

When PIEs fail, either individually or collectively, society suffers. All stakeholders therefore have an interest in ensuring that companies are resilient. This idea is enshrined in the principle of capital maintenance, set out in the 2006 Companies Act[17], that the protection of capital should be the superordinate legal duty of directors. In recent years, that principle has been eroded as directors have sanctioned a more aggressive approach to profit realisation and shareholder distributions.

We give the recommendations of the consultation document a cautious welcome because they take an important step towards re-establishing the importance of capital maintenance as an object of directors' legal duties; as a guide to accounting rules on profit realisation and distributions, and as a principle that auditors should police with conviction. Specifically, we note that the White Paper recommends:

1. Assigning responsibility for the definition of realised profits and losses to ARGA either through guidance or binding rules (paras 2.2.8 and 2.2.9).

2. The disclosure of a *parent company's* distributable reserves, whether known or estimated (para 2.2.14 and 2.2.15).

3. The disclosure of the *consolidated group's* estimated distributable reserves, or at least their 'dividend paying capacity' (para 2.2.17). This would be supported by organograms of group structure which shows where those potential distributable reserves lie within the subsidiary network (para 2.2.18).

4. Greater accountability by mandating that directors produce a statement that dividends are compliant with capital maintenance rules and will not threaten the solvency of the firm over the next two years (para 2.2.21).

5. Fuller narrative disclosures about dividend policies and capital allocation strategies (para 2.2.28)

6. That the Audit and Assurance policy extends to the 'alternative performance measures' (APMs) and 'key performance indicators (KPIs) that feature prominently in

[17] https://www.legislation.gov.uk/ukpga/2006/46/section/830

> the 'front half' of the annual report. That process, we suggest, should involve the input from a stakeholder committee that we propose in our answer to question 58 in the attached appendix. Whilst an extension of rules is important, they cannot be written in sufficient detail to capture all PIE organisational outcomes. The acknowledgement of some flexibility to direct the auditor on particular company matters is thus welcome.

The report also includes recommendations to improve internal controls, presented as a series of options of varying strength which are designed to increase director accountability. These new obligations would be further buttressed by new disclosure requirements - a proposed Resilience Statement and Audit and Assurance Policy - designed to make directors' resilience planning more transparent to all stakeholders and to incentivise strategic action in the wider public interest (Chapter 3 *passim*).

However, there are a number of issues raised in the consultation document which confuse this effort and have the potential to make matters worse, not better. Specifically paragraphs 2.2.16 to 2.2.19 describe a scenario entirely at odds with the experience of recent corporate collapses. Paragraph 2.2.16 for example states,

> *'In some group situations, the disclosure of the parent company's own distributable profits (as proposed above) would understate the potential overall capacity to pay future dividends'.*

This can happen, it is argued, when subsidiaries do not fully pay up all potential dividends to the parent company. However, the fundamental capital maintenance problem is not that parent company reserves are often less than the consolidated group reserves, but quite the opposite – that parent company reserves are much higher than consolidated group reserves. And it is this that undermines capital maintenance when parent companies distribute more in dividends than the consolidated group has reserves. This was a key feature of many recent corporate collapses.

Furthermore, the White Paper argues that:

> *'The Government's second proposal would address this weakness by, in addition, requiring a parent company to estimate and* ***disclose the amount of potential distributable profits across the group*** *that could, in principle, be passed to the parent company for the purpose of paying future dividends to shareholders'.* Para 2.2.17 (my emphasis)

And that,

*'The Government envisages the reporting requirement giving companies **a degree of discretion about how to present these estimates** and to allow parent companies to select, on a reasonable basis, **which group companies to include in the assessment**.'* Para 2.2.18 (my emphasis)

It concludes:

*'The new proposed disclosure requirements will be of value primarily to external investors who will, as a result, have more information about the **legality** and potential future sustainability of dividends'*. Para 2.2.19 (my emphasis)

Three risks emerge as a consequence:

1. That there is a slippage from the identification of potential distributable profits to the payment of dividends or other forms of distribution to shareholders from those 'potential' profits. The efficacy of policy often stands or falls on such small caveats – paras 2.2.16 to 2.2.19 may allow directors to <u>*extend*</u> the distributable capacity of the firm on a discretionary basis which would work to the detriment of capital maintenance.

2. Directors would also be handed discretion as to which group entities to include in this calculation. This may encourage corporations to create profit overloads in individual subsidiaries through transfer pricing and other creative accounting techniques, leaving swathes of the subsidiary network with negative net asset balances. If the profit-overloaded companies are included in the analysis of latent distributable reserves and the loss-making subsidiaries are not, then this would present a very skewed picture of the distributable potential of the parent, to the detriment of capital maintenance and reducing transparency for investors and other stakeholders.

3. The wording of para 2.2.19 is also worrying because it implies that it is the responsibility of investors to adjudge the putative legality of dividends. In a context of only partial transparency where directors are given discretion as to which group entities to include in their summary of the latent distributable capacity of the parent, it would be very difficult to form this kind of view if only the upside of the corporate network were being disclosed.

A revised policy ask on capital maintenance

In our opinion the following issues need to be taken into account to develop a capital maintenance regime that is fit for purpose, if we are to build fairer, more productive, more resilient and socially responsible enterprises:

- We support the idea that companies should be obliged to report their 'distributable reserves' and to account for how they were calculated; this should separate income arising from trading and those arising through other sources.

- We support the recommended improvements to going concern assessments, which examine the effects of distributions on capital maintenance, both within the accounting year and beyond.

- We support the idea that the definition of what counts as 'realisable profits' and thus what forms the distributable reserves of an entity should be handed to ARGA.

- We support the idea that distributable reserves should be reported at group level.

In addition, we would recommend:

a. That distributable reserves are <u>*determined*</u> at group level rather than parent company level, to avoid the gaming whereby parents take the dividends paid up by their profitable subsidiaries and avoid impairments on their loss-making subsidiaries, so that the retained earnings of the parent exceed the retained earnings of the group by some measure.

b. That the effects of climate change are considered in the context of the capital maintenance regime. These need to be properly costed and legally enforced to prevent companies from paying out dividends now, and not having the reserves to finance carbon reduction targets.

- A return to goodwill amortisation, to gradually decrease the holding value of intangibles and thus avoid procyclical 'impairment shocks' – large, unexpected writedowns which coincide with declining profits from trading which put capital at risk.

- Reviewing the tax deductibility of interest payments - it is an incentive for firms to build capital structures that put capital maintenance at risk.

- Group entities should also be required to place the accounts of all their subsidiary entities on public record, free to access, wherever they might be incorporated or trade, together with a group organisation chart, so that the structures used to distribute reserves upwards from subsidiaries to the group parent company, and its durability, can be appraised, and the scale of undistributed losses within the group can also be ascertained as a measure of risk as to future availability of payment of shareholder returns.

8. Concluding comments

The above noted issues are of over-riding importance to us and as such inform all the other observations that we make in this submission. To emphasise this point we provide our comments in response to your consultation in another appendix to this letter.

We shall be pleased to meet with you to discuss the issues that we address.

We provide our consent for this submission to be published by you.

Yours faithfully

Prof Adam Leaver

Prof Richard Murphy

Appendix 1

Detailed responses to your consultation document

Note: In this appendix we reproduce your summary of the questions asked and address them in turn. On occasion as add an 'additional comment' on an issue where you have not asked a question but where we think your discussion requires that a comment be made.

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1 The Government's approach to reform

1.1 The government's approach

1.2 The timetable for change

1.3 Resetting the scope of regulation

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

We suggest that the approach that you are adopting, which implies that the nature of the ownership of an entity is of primary concern when determining whether an entity is a PIE or not, is inappropriate. What determines whether an entity is a PIE or not is, we suggest, its impact on its stakeholders.

The assumption that you make of a duty to shareholders having primacy in reporting considerations is also, we suggest, inappropriate in that case.

In our opinion there are six stakeholder groups with regard to any reporting entity. They are:

A. All those who provide capital to the company

This group does include the company's shareholders. It also includes those who provide it with loan capital as well as banks, hire purchase, factoring and leasing companies and those who provide credit card facilities.

We note that this second group is given little overall consideration in your comments, although in practice accounting standards setters do consider them to be amongst the primary users of financial statements. This does, in itself, suggest that the focus of your attention is too narrow.

B. Those who trade with the company.

Most obviously this group includes those who sell to the company who are at risk that they may not be paid if, as is commonplace, those goods or services are supplied on trade credit terms with payment required after delivery. The group does, however, also include customers. They too can be creditors of the company, either because of deposits paid or because of guarantees offered which the company has an obligation to fulfil. All those who trade with a company have a right to know the risk that they face from doing so.

We note that there is welcome discussion in the White Paper on improved disclosure on payment practices within the financial disclosure of a reporting entity, but given the diversity of activity within such entities and the very large number of subsidiaries many will have, spread over a wide range of locations, we do not think that the needs of this user group have been adequately taken into account within your review.

C. Employees of the company.

Employees are at risk if their employer fails as very few employees are paid in advance. As a result this risk affects almost every employee of every company except on the day that they are paid. But there are also other risks. Some pay is deferred, for example. Bonuses fall into this category. And there are also pension obligations to consider. All companies have a duty to account to their employees as a result.

However, excepting the fact that frequent reference is made to the number of employees being one of the criteria for determining whether or not a reporting entity might be a PIE, almost no reference to the particular information needs of employees is made within your White Paper, and there is no apparent extension of audit responsibility to them. This is disappointing given that in very many cases employees stand to suffer most upon the failure of a PIE, whether as a direct consequence of the loss of employment, or as a result of the indirect consequences of a loss of pension rights. It is not enough to suggest that an entity be a PIE because of the number of employees that it might have: it is also necessary that the resulting obligation that arises upon it should be addressed and your White Paper does not do that.

D. Regulators

Regulators can lose as a result of the existence of limited companies, and most especially PIEs. This is not least because the larger an entity might be the more likely that it is that companies may be formed so that those setting them up can avoid their obligations to a society imposed by its regulators, knowing that they will have either no or very limited personal risk arising as a result. The risk of this happening has to be identifiable within the reporting of a PIE as a consequence.

Regulators are also at risk because when they find fault the chance exists that any penalty can be evaded by a limited company simply ceasing to trade. In this way regulators suffer an even greater loss, which is to their overall credibility as enforcers of the law. There is no indication that your White Paper has taken these issues into account.

E. Tax authorities

Tax authorities are at risk from the existence of all companies. Some of this might be mitigated if the tax rates due by companies were the same as those owing by individuals undertaking similar transactions. This, however, is rarely the case, with the bias being in favour of companies. That means that many companies are specifically created to avoid tax. That gives a tax authority a very good reason to be interested in them.

In addition, the ability of companies to cease trading leaving tax liabilities owing without any possibility of recourse to the owners of the company who may have gained from this outcome means that limited liability companies are always a threat to the revenues of tax authorities. These risks exist the ability of some to manipulate limited companies to mitigate their tax liabilities e.g. by relocating profit to locations where little or no profit is payable, is taken into account. It is known that this risk is especially prevalent in PIEs as country-by-country reporting for tax purposes is now revealing.

All these factors make tax authorities stakeholders who face a high degree of risk from the activities of limited companies, and PIEs in particular. Despite that fact the particular needs of tax authorities for data on the nature and extent of risk within a PIE is not addressed within your White Paper: this stakeholder of PIEs has been excluded from consideration as a consequence.

F. Civil society

Civil society in all its many forms, may suffer a loss from the existence of a company. That company may pollute the atmosphere. It may corrupt the political environment. It could disrupt communities by its divisive activities. It may discriminate. It could promote activities that undermine communities. It may sell harmful products. And it might not disclose any of these activities when or where they occur, leaving a legacy that persists long after it has ceased to exist, with its owners taking their profits long before the consequences of the actions that gave rise to them were appreciated. These are very real, and to the company, unaccountable costs which civil society needs information to appraise.

These risks are not noted as an issue in your White Paper and as a result are not used to indicate whether an entity is a PIE or not. This is an omission from your considerations.

Recent examples that your suggestions would not address

There are two recent examples that your suggestions would not address.

The first is with regard to the companies within Sanjeev Gupta's GFG Alliance that collectively generate billions of pounds in revenue. These are not grouped. Serious doubts as to the appropriateness of their audit arrangements have been raised as a result[18]. These companies are very obviously PIEs. There is, however, no indication that they would be brought within the scope of your proposals, suggesting that the arrangements you are proposing are insufficient.

[18] https://www.ft.com/content/125d7319-70c5-4e50-b305-a2ed9ddc4474

Second, there is the issue with regard to potential tax abuse within NHS Track and Trace outsourcing. It is thought that up to 48,000 companies have been used to avoid tax liabilities within this process[19]. The reasonable expectation is that this process is of public concern and so the activity of a PIE, but the proposal you have made would not bring the activity of these companies within the definition of a PIE and that suggests that once again your proposal is insufficient.

Meeting the needs of all stakeholders

We have made previous submission to the Financial Reporting Council (FRC) on what we think the information needs of the stakeholders of PIEs might be and attach this suggestion as Appendix 1 to this letter. It is our suggestion that unless these needs are addressed by PIEs that the White Paper that you have proposed will not succeed in creating change that meets the needs of society for information from PIEs, and that the audits of that information that those entities do supply will be deficient as a consequence.

It necessarily follows from the observations that we have made that we think that large private companies should be capable of consideration as PIEs. We elaborate are suggestion in answer to Question 2, below.

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

We would prefer option 2 of those that you present to option 1, because we think that any entity with at least 500 employees must be a PIE because of its potential impact on the economy.

However, we do not agree that both turnover and employee conditions need to be met to be a PIE. We think one of these conditions needs to be met: we consider both sufficient in themselves to indicate that an entity is a PIE.

In addition, we think greater thought needs to be given to this issue. You appear to presume that a company is for the purposes of defining a PIE a single entity parent company plus those subsidiaries that it considers should be consolidated within its financial statements.

As is apparent from the comments we have made in response to your question 1 this seems inappropriate, and is bound to be subject to abuse. Entities, and most especially those outside the public sector, might be split to avoid such a definition. In addition, companies

[19] https://www.theguardian.com/business/2021/may/10/tax-dodging-concerns-over-small-firms-used-to-pay-nhs-test-and-trace-workers

might outsource their payrolls to avoid meeting the criteria for being a PIE. Both outcomes are completely foreseeable and already give rise to abuse, as we have noted.

As a result we suggest that the definition of a PIE should be as per your option 2 but that ARGA should have the discretion to decide that a PIE should for these purposes also include all entities under common control, whether formally grouped or not, and that employee numbers might include outsourced employees engaged by contractors to meet the PIE's contractual obligations and who usually work under the PIE's direction and control even if not its direct employees. We stress that this discretion is essential if gaming of any rule is to be avoided.

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

Yes: the protection of shareholder and other stakeholder interests requires it. Any company seeking to make its capital available on public markets should be a PIE whatever its size as the risk of moral hazard arising from the exploitation of third-party capital that has no access to management always increases in such cases.

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?

We do not agree with this proposal. If a company is ready to be quoted and can manage the massive workload and documentation involved in that process then it can also handle the accounting requirements from being a PIE. No exemption is required.

We stress that we think that the superordinate object of audit is to deliver sufficient transparency to users. We do not think that this can be compromised by competition policy and suggest that it would be dangerous that potential audit quality be compromised for this reason.

Such an exemption would in any case be dangerous to the entity, to the stakeholders and to the market: the risk that new market entrants might have opportunity to abuse each of these groups by reason of this exemption is a risk too big to be taken.

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

Yes. Although little known outside the financial world Lloyd's Syndicates are key to the London insurance market, the effective operation of the City of London as a financial services centre, and to all those who rely upon the insurance that they provide. They should be treated as PIEs as a consequence since the risk of failure of any Syndicate is too great for them to be considered otherwise.

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

We believe that any entity meeting any of the definitions of a PIE (including having 500 employees) should be a PIE whichever sector it works in. This will consequently include:

- The government;
- Devolved governments;
- Local authorities;
- Government departments and agencies;
- Semi-autonomous government agencies such as The Bank of England, Network Rail and Great British Railways;
- NHS trusts;
- Academy school trusts;
- Charities;
- Universities.

In all cases the stakeholders of these entities have the right to information on the risks that they take by engaging with them and as such they must be considered to be PIEs.

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

£100 million may be appropriate, but the condition for being a PIE should also be met by having 500 employees, which we think likely to be more significant. See our answer to question 2 on this issue.

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

Entities that are not necessarily incorporated as companies should also be considered to be PIEs. This would, for example, include partnerships, limited partnerships, limited liability partnerships and trusts.

We also believe that the definition should be extended to the UK parent company of an overseas-owned group if that UK parent company would, if its accounts were to be consolidated, meet the criteria for a PIE. In the event that there is no single UK parent company for an overseas group's holdings within the UK then the test should be made for a

UK based designated member of that group which would then become a PIE if a consolidation of the UK activity of the group entities within the UK showed that to be necessary.

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

We hope that the impact would increase demand for UK audit services, but are not confident enough to predict that would be the case.

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

A period of two years at most would seem to be sufficient for this process. Anything less might mean that comparative accounting data might not be available. Anything more is not necessary: PIEs survive because of their ability to adapt, including to demands such as this.

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

No. See our answer to question 10.

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

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?

There is already legislation requiring that UK company directors keep appropriate records. It worth noting that section 386 of the Companies Act 2006 says[20]:

> *(1)Every company must keep adequate accounting records.*
>
> *(2)Adequate accounting records means records that are sufficient—*
>
> *(a)to show and explain the company's transactions,*
>
> *(b)to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and*

[20] https://www.legislation.gov.uk/ukpga/2006/46/section/386

(c)to enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).

(3)Accounting records must, in particular, contain—

(a)entries from day to day of all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place, and

(b)a record of the assets and liabilities of the company.

(4)If the company's business involves dealing in goods, the accounting records must contain—

(a)statements of stock held by the company at the end of each financial year of the company,

(b)all statements of stocktakings from which any statement of stock as is mentioned in paragraph (a) has been or is to be prepared, and

(c)except in the case of goods sold by way of ordinary retail trade, statements of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.

(5)A parent company that has a subsidiary undertaking in relation to which the above requirements do not apply must take reasonable steps to secure that the undertaking keeps such accounting records as to enable the directors of the parent company to ensure that any accounts required to be prepared under this Part comply with the requirements of this Act (and, where applicable, of Article 4 of the IAS Regulation).

If section 2(b) is to be compiled with, in particular, it is hard to see how an effective internal control system is not already required by law within the UK, and by extension throughout UK controlled groups of companies.

We suggest that stronger regulation is not required. Instead, what we suggest is required is a regulator of UK company law.

There is no such regulator at present.

It is not clear that the changes that the consultation document proposes will deliver such a regulator, at least with universal application when that is what is very obviously needed when there are 4.7 million companies registered in the UK at present[21], to all of whom this legislation applies.

We strongly recommend that the focus of attention on this issue be upon much enhanced enforcement of existing company regulation rather than the creation of new regulation that will, like that which already exists, be unenforced if the current absence of a universal company regulator continues.

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

We find the proposals that are being made to be confusing. It is likely that all audit failure involves some degree of failure in internal control. However, as we note in our previous answer, existing Companies Acts provisions already require that an entity maintain records sufficient to ensure that such risks can be identified. But the likelihood that frauds leading to audit failure would be detected by imposing a new level of internal control on companies is low: by definition high-level fraudsters have worked out ways to circumvent such controls for at least a period of time. We therefore question the reasons for the attention to this issue in your consultation document.

We most particularly do this in the light of the legislation we have noted in our previous answer and in the light of our awareness that existing auditing standards do quite explicitly require that auditors appraise the internal control and other systems of their client. They should thus already be appraising the directors of a PIE (or any other entity) to meet their obligations as laid down in law to produce accounts showing a true and fair view of the results of the entity for which they are responsible during each of its periods of trading.

In that context, whilst we note the government's preferred course of action, and have no problem with it, we suggest that it would be of greater use to allocate more resource to the enforcement of existing regulation, accepting that it is principle based, rather than create new regulation matched with little or no resource to ensure its effective use.

We must particularly note the importance of there being an effective regulator of UK company law when there is no such regulator at present. If ARGA Is to be given this role then it must be extended to all limited companies and similar entities and not just to PIEs.

[21] https://www.gov.uk/government/statistics/incorporated-companies-in-the-uk-january-to-march-2021/incorporated-companies-in-the-uk-january-to-march-2021

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

All PIEs.

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?

We note the two options proposed and prefer the course of action we note below. Of the two options the second is better: there must be regulation and not guidance on this issue.

Please note our comments in our covering letter on this issue.

In our opinion the following issues need to be taken into account to develop a capital maintenance regime that is fit for purpose, if we are to build fairer, more productive, more resilient and socially responsible enterprises:

- We support the idea that companies should be obliged to report their 'distributable reserves' and to account for how they were calculated; this should separate income arising from trading and those arising through other sources.

- We support the recommended improvements to going concern assessments, which examine the effects of distributions on capital maintenance, both within the accounting year and beyond.

- We support the idea that the definition of what counts as 'realisable profits' and thus what forms the distributable reserves of an entity should be handed to ARGA.

- We support the idea that distributable reserves should be reported at group level.

In addition, we recommend:

a. That distributable reserves are *determined* at group level rather than parent company level, to avoid the gaming whereby parents take the dividends on their profitable subsidiaries and avoid impairments on their loss-making subsidiaries, so that the retained earnings of the parent exceed the retained earnings of the group by some measure.

b. That the effects of climate change are considered in the context of the capital maintenance regime. These need to be properly costed and legally enforced to prevent companies from paying out dividends now, and not having the reserves to finance carbon reduction targets.

c. A return to goodwill amortisation, to gradually decrease the holding value of intangibles and thus avoid procyclical 'impairment shocks' – large, unexpected writedowns which coincide with declining profits from trading which put capital at risk.

d. Reviewing the tax deductibility of interest payments - it is an incentive for firms to build capital structures that put capital maintenance at risk.

e. Group entities should also be required to place the accounts of all their subsidiary entities on public record, free to access, wherever they might be incorporated or trade, together with a group organisation chart, so that the structures used to distribute reserves upwards from subsidiaries to the group parent company, and its durability, can be appraised, and the scale of undistributed losses within the group can also be ascertained as a measure of risk as to future availability of payment of shareholder returns.

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 concept of capital maintenance is key to the reporting of all entities preparing accounts. It is not specific to the determination of distributable profits for the payment of dividends alone. Instead it refers to the maintenance of the capacity of the entity to undertake its chosen activity on the assumption that it is a going concern, which is, again, implicit within the corporate reporting of almost all PIEs, whatever their nature.

It is for this reason that we refer in our previous answer to the inclusion of measures with regard to sustainability in our suggestion for a suitable capital maintenance concept to be used in future accounting, and not just for dividend distribution purposes. It is our opinion that compliance with net-zero carbon requirements will be an essential feature to be reflected in the going concern concept in the near future.

The likely cost of preparing the data that is required to determine group distributable profits is, we suggest, minimal.

The benefit comes from extending the protection intended to be provided by section 831 of the Companies Act 2006 to the group as a whole. Since the primary financial statements that the shareholders of a PIE will receive are its consolidated accounts we think that the changes that we propose are not just logical, but are necessary, since those shareholders do not necessarily receive an income statement for the parent company of a PIE and as such they are unable to determine whether its own trading activities are appropriately recorded or not as the basis for dividend distribution.

We think that these requirements should be extended to all companies, whether they are PIEs or not. That necessarily means that AIM companies should be covered by them.

If the definition of a PIE that we propose is accepted it is important to note that there will be many such entities that do not have shareholders. However, for the reasons that we note in the first paragraph of this answer, the concept of capital maintenance is just as important when there are no shareholders in a PIE as to those occasions when there are and as such we think that the matters that we have noted on this issue should apply to all PIEs

17. Would an explicit director 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 support the inclusion of a statement of this sort in the accounts of all companies making dividend distributions, whether they are PIEs or not. We would recommend that significant penalty be attached to the making of a false, reckless or knowingly risky statement of this nature, with unlimited personal liability for the dividend inappropriately paid as a consequence being attributable to all the directors of a company making such a statement.

We suggest that variation on this disclosure might be required in the case of some PIEs e.g. charities, where it might be possible for the PIE to over-distribute the funds available to it, putting the future of the entity at risk as a result. We recommend that further consideration be given to this issue, and in particular how the rules around recognition as a PIE might be gamed to prevent an entity having to comply with issues of this sort. Some types of PIE, e.g. those that are within the private equity sector, might be most especially vulnerable to this gaming and might require special consideration to prevent abuse.

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?

We are familiar with Companies Act 2008 Section 414 CZA which introduced the section 172 (1) statement requirement. We do not think this was sufficient to remedy the defects in the drafting of section 172 as a whole, which still makes clear that the company is run for the primary benefit of the shareholders when it is clear that the interests of all stakeholders should be taken into account.

We cannot see why this statement should provide the clarity that you imply it might. Section 172 needs to be redrafted to make clear that all stakeholders should have equal concern placed upon their interests by the directors of a company and a separate requirement for a company to explain its distribution and capital allocation policies should be introduced on a statutory basis.

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?

We note the government's proposals and support them with one notable exception. We note that the proposals are not specific with regard to the ability of a company to adapt to climate change which we now consider to be one of, if not the biggest, threat to the ability of most companies to be treated as going concerns.

It is our belief that a company should now be required to make full provision on its balance sheet for the costs of adapting its business to the demands of a net-zero carbon business environment by 2050. A company has no choice but to do so given that the UK government has committed to achieve this goal by 2050 at the latest. The requirements for a provision does, therefore exist: an existing business model has to be closed and be replaced and that is the justification for the provision being made now[22].

A Resilience Statement should refer to this provision and the means that the entity has to fund this transition and the technical feasibility of it doing so. If that technical feasibility

[22] This is explained in more detail here. http://www.corporateaccountabilitynet.work/projects/sustainable-cost-accounting-the-essential-guides/ We refer to this provision as sustainable cost accounting

cannot be proven, or it is dependent upon technology that does not yet exist or offsets that cannot be proven to be available then these facts should be highlighted in the Resilience Statement. If the company cannot see a way to funding the transition to being net-zero carbon it should declare itself carbon insolvent and prepare for an orderly winding up of its affairs by 2050. We hope that the government might add these requirements to the list referred to.

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

We welcome the Task Force on Climate-related Financial Disclosures (TCFD) and the proposals from the International Financial Reporting Standards Foundation (IFRS) for Sustainability Standards based upon them but do have major reservations as to the value of the information that they will supply. This is because the TCFD and IFRS proposals have an inherent flaw within them. They both presume that sustainability matters should not be accounted for on the balance sheet of an entity. As such they perpetuate the wrong-thinking economic assumption that sustainability can be treated as an externality, when it is in fact an issue that has to be embedded at the core of it if any company is to remain as a going concern in the future.

We do not therefore see the TCFD or IFRS proposals as an adequate response to the threats created by the climate crisis. As noted in our previous answer we do instead think that a company should now be required to make full provision on its balance sheet for the costs of adapting its business to the demands of a net-zero carbon business environment by 2050 as explained by sustainable cost accounting[23]. We believe that it is sustainable cost accounting and not the TCFD requirements that should be reflected in the requirements of the Resilience Statement.

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?

We do not agree with these suggestions. If a company can manage being a PIE it can manage these demands, and has a duty to all its stakeholders to both do so and report upon them.

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?

[23] http://www.corporateaccountabilitynet.work/wp-content/uploads/2019/12/SCANov2019.pdf

There is an inherent flaw in the logic that underpins the suggested Audit and Assurance Policy, and that is that voluntary assurance selected by the directors of the entity might be sufficient for the purposes of providing the assurance that the users of the financial statements of an entity desire.

It is already apparent that much of the weakness within the current audit arrangements is based upon:

a. Directors' control of the audit relationship, implicit within the power to appoint.

b. An audit remit that is too limited in scope.

c. A resulting expectation gap on the part of the user of the financial statements.

It would seem that the Audit and Assurance Policy is designed to embed these weaknesses within auditing rather than address them. It continues to give directors control of the audit relationship, and define its scope. An expectation gap will necessarily arise as a result. We do not think any form of shareholder vote is sufficient to address this issue: directors also have significant control over the conduct of general meetings and too often secure the control of proxy votes meaning it is very difficult for contrary opinion to be offered to those advanced by any board of directors.

For this reason, we think that as a matter of fact the scope of audit should be extended, by statute, to the entire content of the financial statements produced by a company. We think this should also extend to its sustainability report and any other statements required by statute e.g. its gender pay gap and modern slavery reports. We think that this policy should apply to all companies that are subject to audit and not just PIEs, although all PIEs should be covered by the arrangement, for the elimination of doubt. We cannot see any other way in which the required assurance can be provided.

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?

Please refer to our answer to question 22 which suggests that an entirely different approach is required.

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

Please note our answer to question 22 which suggests that an entirely different approach is required.

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?

We suggest that preparing this information at a group level is almost meaningless and of very little use at all to the trading partners of the trading entities that comprise groups. Almost no trading partner of a group trades with its parent entity and payment practice will vary from company to company, and jurisdiction to jurisdiction.

In an appendix to this letter we note that the trading partners of PIEs need this data:

- Which entities make up the PIE so that they can be sure with whom they are really dealing;
- Which entities are related to the PIE but are not, for accounting purposes, included within its boundaries so they can be sure what relationship a PIE might have with its trading entities;
- Where the accounts of those entities might be found, free of charge, in full and on public record if not provided by the PIE itself so that they can secure local trading data relevant to their circumstances;
- What the financial results of the PIE as a whole might be within the territory in which the trading partner is located given that in many cases the accounts of no one entity will provide this data, for which purpose country-by-country reporting can provide the necessary data;
- Details of the average period of credit taken by the PIE from its trade creditors within the jurisdiction in which the trading partner is located;
- Details of the average time taken by the PIE to resolve customer disputes within the jurisdiction in which the trading partner is located.

We see no reason why this information cannot be published online by any PIE. The proposals made fall short of this standard.

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?

We suggest that this matter should relate to all PIEs with more than 500 employees. However, we reiterate the point already made that there must be discretion around the recognition of a PIE, on the part of the regulator. In this case that discretion might be required to prevent a PIE transferring people under its effective management and control off payroll to avoid disclosure being made. Too rigid an application of definitions must be avoided to ensure that the object of new regulations is fulfilled.

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?

All the argument noted in the consultation document supports the introduction of such a statement.

The arguments surrounding the relevance of section 172, Companies Act 2006 and the obligations that it imposes makes it very clear that reporting on how those duties are fulfilled is essential. We note ways in which we think that this could be done in an appendix to the letter and have submitted comment to the Financial Reporting Council on this issue. We believe that the extension of corporate reporting to address the needs of all stakeholders is essential if any of the expectation gaps that exist with regard to audit and accounting are to be closed. In that case we find it inexplicable that the government has decided not to proceed with tackling this issue now. This failure undermines the whole process of audit and accounting reform on which it is supposedly engaged and sends out a very clear message that existing accounting and auditing priorities are all that matter still, with all else, including the vital issue of corporate reporting embracing issues relating to climate change, being considered to be of entirely secondary interest.

4 Supervision of corporate reporting

4.1 Background

4.2 Stronger powers for the regulator

4.3 Measures to strengthen corporate reporting review activity

4.4 Influencing the corporate reporting framework

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

Whilst broadly welcoming the reforms, we note that whilst the work of ARGA is to be expanded to cover the whole of the financial statements (which we think appropriate) this conflicts with continuing limitations in the scope of audit work and we see no reason for the inconsistency between the two approaches. We think ARGA should have this responsibility, and consider in that case that auditors should also report upon the whole of the financial statements.

We note ARGA will seek to influence the corporate reporting framework (section 4.4.). However, we note no reference being made to it considering changes to UK GAAP as a result, or to changing the application of IFRS within the UK to achieve this goal, as will be within its remit. We are surprised to note these omissions and would suggest that regulation should place an obligation on ARGA to undertake reviews of the relevance of all standards operative in the UK on a regular basis to make sure that they continue to provide information that meets the needs of all users of financial statements.

We note the emphasis on brevity (section 4.4.). We consider this misplaced in a digital age. It is now very easy for any user of the financial statements to search accounts for the particular information that they supply. The logic of brevity presumes that there is a shortage of a resource (presumably paper) that requires rationing of information, bit this is not true. The pursuit of brevity as an objective would be profoundly damaging to the aim of producing financial statements that provide a true and fair view for the benefit of all stakeholders and as such we think this objective should be dropped from future work.

5 Company directors

5.1 Enforcement against company

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

We have already noted that the real deficiency in much of the UK's company regulation is the absence of any regulator to enforce action until far too late. In this case, dependence on this Insolvency Service to impose regulation is a case of too little, far too late, and with little incentive to act being provided.

No change in regulation is going to have any real impact without a proper regulator with enforcement powers. So the real question is, who is to have the unambiguous responsibility for enforcing any regulation on directors? Until that question is answered no proposal for reform makes much sense since most cases will simply fall between the cracks or default onto patterns of informality, deference and club governance that have proven to be so ineffectual in recent years. We would suggest that this regulator should be ARGA, and that the responsibility should be extended to all companies, without exception, whether PIEs or not.

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

We think that the statutory duties of directors relating to corporate reporting and company audits should be extended to include:

- The sufficiency of group retained reserves to enable the payment of dividends;
- Accounting for the impact of climate change on their entity;
- Accounting for the activity of their entity on a country-by-country basis;
- Their entity's gender pay gaps;
- Their entity's ethnicity pay gaps;
- The tax that their entity actually owes, reconciled to the financial statements as a whole;
- The payment details with regard to trading partners as noted in our answer to your question 25.

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?

See our answer to question 30 for additions. We do not suggest any exclusions.

We would add a condition that directors should have a specific duty to override the accounting framework if that is necessary to deliver a true and fair view of the accounts of an entity for the period in which financial statements are prepared.

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?

We note the suggestions in paragraph 5.1.24 and agree with it.

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

Yes. We suggest that these powers be extended to all companies and that, unless another company regulator is created, ARGA has a duty a to apply them to all companies.

5.2 Strengthening claw back 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?

We suggest that the minimum conditions referred to in paragraph 5.2.5 refer to a breach of any of the statutory duties of a director with regard to accounting and audit including those we propose in our answer to question 30, above.

6 Audit purpose and scope

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?

For the reasons that we note in our covering letter we propose that the audit be should be redefined so that:

> *The purpose of the audit of a public interest entity (PIE) is to firstly report on whether the financial statements on which the auditor offers an opinion deliver relevant, reliable and sufficient information to users of those statements and to secondly, where there is a shortcoming, remedy that shortcoming or, if it is not possible to do so, to report why that is and what its consequences are.*

We do not agree with the Brydon Review's recommendations on the purpose of audit, which is as follows:

> *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.*

We think this to be inward looking when the purpose of the audit should be outward looking with regard to the impact that the entity has on those with whom it engages. This thinking underpins our proposal.

Nor do we agree with the focus of the Brydon's Reviews statement that:

> *auditing should provide information that is useful to present and potential investors, lenders, creditors and other users in making rational investment, credit and other decisions and assessments about the company.*

It is our opinion that the ordering of this sentence privileges the suppliers of capital to a company: a broader interpretation must be read into it if it is to meet the requirement to meet stakeholder need that we think appropriate. The focus on shareholder and market need within the current auditing framework has led to so many of its failings.

In addition, as we have already noted, this focus cannot be appropriate in the discussion now being had about audit and PIEs when so many PIEs will not have shareholders and will not ever be subject to market-based investment decision making where the audited financial statements will be the only data available to the decision maker. As such this focus has to be wrong because it is inconsistent with the definitions adopted elsewhere in the consultation document.

Our definition places upon the auditor a duty of care to the user of the financial statements, whoever they might be, and a duty to ensure that they receive all that information that they might reasonably require from the PIE to enable them to make the reasonably likely decisions that they might wish to make, many (and maybe most) of which will have little to do with investment or the granting of credit. We propose this definition in place of that you recommend as a result. We think that our suggestion would also permit a general definition to be applied to all audits, including those of public sector entities. We do not think that there should be a difference.

The consultation government says (para 6.1.8) that '[h]aving a clear and unambiguous statement as to the purpose of an audit could help people understand the outcomes that are expected from the audit process.' We suggest that our proposal as to the purpose of audit achieves this objective and should have a statutory basis.

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 think it appropriate that a new purpose for audit be adopted by the regulator. The suggestion for the purpose of an audit that we have suggested embraces this idea.

Our proposal includes a specific performance criterion, which is that the auditor ensures that information required by the users of the financial statements is made available to them within the financial statements or is instead supplied by the auditor.

We think that for reasons already noted that audit opinion should apply to the entire financial statements, including those additional statements that we have suggested should be supplied in fulfilment of new statutory duties. If the auditor fails to ensure that information is supplied then they will not have succeeded in meeting their statutory duty. We believe that in that case what we propose suggests how the test of the effectiveness of an audit could be undertaken.

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?

We are familiar with the Brydon Review's recommendations as summarised in para 6.2.2.

As noted previously, we do not agree with the suggestion from the Task Force on Climate-related Financial Disclosures, International Financial Reporting Standards Foundation and others that critical decision useful information be supplied outside the financial statements. We do instead suggest that climate change mitigation costs be recognised on the balance sheet of PIEs[24]. We also believe that there should be public country-by-country reporting[25].

If these measures were addressed and the audit covered the whole of the financial statements, and statutory duties were extended as we have previously noted, the need for wider auditing services would be addressed: all audit requirements would fall within the remit of the auditor of the financial statements. As it is, the need for those wider auditing services is a clear indication that existing financial statements, and audit, are not meeting the needs of the users of those accounts.

In this context by all means bring those who are required to audit what existing auditors refuse to accept to be their responsibility within the scope of audit regulation, but it would be much better to address the deficiencies in both financial statements and their audits then make up for their deficiencies in the way proposed.

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?

Please note our answer to question 37.

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[24] See http://www.corporateaccountabilitynet.work/wp-content/uploads/2019/12/SCANov2019.pdf

[25] See https://www.globalreporting.org/about-gri/news-center/momentum-gathering-behind-public-country-by-country-tax-reporting/ and https://dwtyzx6upklss.cloudfront.net/Uploads/u/m/t/investorsignonletteronpubliccbcr_signatories_final_758353.pdf as indication of investor demand.

Those comments being noted, we believe that any required audit regulation should extend to all who supply audit services, and for all companies, without exception, whatever the size of the audit client serviced.

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

ARGA should be lobbying for the reform of International Financial Reporting Standards, which as they stand are not fit for purpose within the required new audit framework.

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 aim for audit? Do you agree that the principles suggested by the Brydon Review would be a good basis for the regulator to start from?

We think that the Brydon principles are appropriate if used within the framework that we suggest with the audit purpose that we propose, which gives them an appropriate framework for use.

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?

Subject to the point made in the previous answer, and to the purpose of audit that we propose elsewhere in this submission, we think that the proposals made by the government are appropriate. These caveats are, however, of significance.

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.

We think the approach sufficient.

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.

We are not convinced by these proposals. They assume that the user of financial statements has a detailed knowledge of auditing, the use of sampling techniques and the methods used for the appraisal of audit evidence. The vast majority of stakeholders will not have detailed knowledge on these issues and as such the additional information that it is proposed be supplied will add very little to their understanding of the audit of the entity, or their understanding as to whether that audit might be considered appropriate or not.

We think that this problem arises from the failure to understand the purpose of audit implicit throughout the consultation document. As previously noted, the focus of the audit that you propose remains inward looking, and is a process focussed activity. This is not what we propose, as noted in our covering letter where we suggest that the purpose of accounting should be:

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.*

This then feeds into our proposed definition of the audit, as noted in our answer to question 35.

On the basis of that suggested purpose for audit we think that if the auditor is to offer more information on the appraisal of i) risks and ii) director conduct, as set out in the section 172 statement, then they should be obliged to disclose what information they considered for inclusion within the financial statements that was not originally supplied, and why they thought it unnecessary to require that the data in question be disclosed. This is intended to provide the user of the financial statements with the greatest possible confidence that all the information that they might need for their purposes has been delivered to them. This will, of course, necessarily require that the auditor state what information they think that the stakeholder might require. We refer you to our appendix to this letter on this issue.

43a. Market Abuse Regulations

We note your discussion of Market Abuse Regulations (MAR) in which you say:

> *The FRC's review of its auditor reporting standards will examine the need to address any ambiguity regarding auditors' ability to disclose new information about the company. The proposal that auditors be required to disclose in their report certain information meeting a materiality test in terms of its likely value to users if the directors decline to do so gives rise to issues regarding its consistency and compatibility with requirements under the MAR for the handling and disclosure of inside information.*

This suggests a conflict with our proposed statement on the purpose of audit:

The purpose of the audit of a public interest entity (PIE) is to firstly report on whether the financial statements on which the auditor offers an opinion deliver relevant, reliable and sufficient information to users of those statements and to secondly, where there is a shortcoming, remedy that shortcoming or, if it is not possible to do so, to report why that is and what its consequences are.

We suggest that information disclosed in an audit report automatically be excluded by MAR as it is produced in a report published by the reporting entity. This then removes this conflict.

6.6 True and fair view requirement

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

We do not agree with this suggestion. We think that departures from an agreed financial reporting framework must be necessitated by the need to provide a stakeholder with sufficient relevant and reliable data to meet their needs. The over-riding duty of the auditor is to the stakeholder, in our opinion. In that case the process driven approach is inappropriate. It is the auditor's own exercise of judgement that should permit departures from the agreed accounting framework, all of which must however be justified by a note in the financial statements as to the stakeholder need that is met by doing so. This will, of course, then be subject to potential regulator review. We have noted our opinion on what 'true and fair view' might mean in the context of our proposed purpose of audit in our covering letter.

We make clear that in our opinion the purpose of auditing is not to uphold accounting frameworks, or auditing standards. It is to ensure that the information needs of stakeholders are met. We think that your approach to this issue is inappropriate as a result: the focus must be on ends and not means, which you appear to be promoting.

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?

As previously noted we think that the audit should extend to all items in the financial statements and not selected additional items. As such APMs and KPIs should be within the normal scope of audit in our opinion.

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?

We do not have the necessary experience to comment on this issue.

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?

We think that an error is being made here: the objective of achieving high quality audit is of much greater significance than that of achieving competition in the audit market. Audit quality is a public good. Audit competition is merely desirable, if achievable. And audit quality should never be compromised for the sake of competition, which idea appears implicit in the question.

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.

As our definitions of accounting and audit suggest, it is professionally impossible to differentiate accounting and audit: they both require a fundamental understanding of the way in which accounting data can be used to inform decision making.

This said, many accountants have skill sets that never require them to prepare financial statements for publication, let alone be part of an audit process. These accountants are involved in finance and management accounting, both of which are most likely to have a specific focus on reporting to management within an organisation, and not financial reporting which must have an external focus on meeting the needs of stakeholders for information about the reporting entity.

In our opinion dedicated training in the skills required to deliver sufficient relevant and reliable information to meet stakeholder's needs is vital. We do however think that this requires those involved in the process of delivering financial statements to understand both the accounting and audit needs of these processes and that it is vital that the two comprehend each other to ensure effective delivery of single sets of financial statements that meet stakeholder needs.

As a result we do think that those who are to be professionally engaged in both tasks must have training suited to this purpose. We stress that this does not alter our view that auditor firms should not be able to provide anything but audit services: what we are suggesting is that they must also be trained to understand the issues that arise in preparing financial statements, and that this is a broadly based requirement.

However, once qualified within the accounting profession we think that the auditor must developed suitable post qualification skills in audit. Such post-qualification focus in training is normal within most professions. We think that attendance at dedicated programmes of post qualification continuing professional education as well as programmes of reaccreditation at set intervals to ensure that these skills are maintained will be essential. We suggest that ARGA should focus its attention on these issues. Instead of the creation of a new professional body for auditors. That said, we think a new professional focus on audit is required. It is our suggestion that this goal can be achieved by the creation of dedicated audit and repotting faculties within existing accounting institutes, or, preferably, one faculty shared between them. We do not think that a separate corporate entity is required.

We would stress that there is a strong theoretical reason for suggesting this. As we note in our answer to question 61, there is always risk in accounting where boundaries are encountered. In our opinion training auditors to have skills distinctly different to those who have the job of preparing financial statements would create a boundary between the two professions where significant audit risk as a result of misunderstanding between the parties as to objectives that each are seeking to achieve could arise. We think that this risk must be avoided.

We do, however, think that separate continuing professional education distinct from that for other accounting activities will be required; that separate rules for practising certificates might be required, and that very clear evidence of continued fitness to practice (which might involve re-examination on a regular basis) might be appropriate to demonstrate a clear and developing understanding of reproving requirements on both sides of the financial reporting divide. This we think much more important than the establishment of a separate professional body that might have attached to it an implicit assumption that evidence of competence on a single occasion as proof of admission to membership is sufficient evidence of ongoing ability.

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?

We refer to our answer to question 48.

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

We refer to our answer to question 48.

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

We refer to our answer to question 48.

7 Audit Committee Oversight and Engagement with Shareholders

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?

We think that this is inappropriate if our recommendation on the appointment of stakeholder audit committees referred to in answer to question 58 is adopted.

We doubt that ARGA will have the ability to predict all this issues that may arise in audit committees. We think stakeholder monitoring of those that might arise more effective than monitoring by ARGA. We think this more consistent with the objectives of audit that we have suggested in this submission.

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?

See our answer to question 52. We think stakeholder audit committees address the areas of concern.

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 companies audit; when a company has partnered with its auditor

outside the normal rotation cycle; and when there has been a meaningful shareholder vote against an auditor appointment)?

As we note in our answer to question 52, we think that the appointment of stakeholder audit committees can overcome these issues. They should be able to address these issues, seeking advice from ARGA if required, and having the statutory right to seek.

55. To work in practise 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?

In our opinion there is, as such, no effective audit market in the UK.

If, as we think appropriate, all audits of PIEs should be undertaken by firms whose sole purpose is to provide audits to such entities then the limited numbers of firms involved will all, necessarily, be under the regular and persistent review of ARGA. To be able to offer audit services these firms will have to agree to that. They will also have to agree to accept appointment to an audit if ARGA requires that they do so, subject only to an appeal procedure based solely on their lack of technical ability to accept an appointment. There would, in other words, be a 'bus stop' principle in place, as is familiar within the legal profession.

In the event that no appointment might be possible (and such a scenario is imaginable) the National Audit Office must be able to act as a 'backstop auditor' for PIEs given that their continued operation without an auditor is not conceivable.

This 'backstop auditor' role reflects the fact that there is no audit market as such. There would simply be regulated third party firms willing to take on a regulated function required by the state to ensure the smooth operation of markets with the state acting as guarantor that this function can be fulfilled, come what may.

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?

In the light of our previous answers we do not think that this issue should arise unless the National Audit Office is appointed to such a role when we think special consideration of the audit is going to be required as a matter of course.

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 companies 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)?

Please note our answer to question 55 which addresses the point.

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?

We note this proposal but doubt it will have any meaningful consequence. We also suggest it inappropriate since shareholders are just one of seven stakeholder groups that we identify who have an interest in the audit process. Whilst not rejecting the proposal made, we suggest that it needs to be expanded in two ways.

Firstly, the right to make representations should not be restricted to shareholders. Consultation on audit issues should be open to all stakeholders, and the consultation process should be widely advertised as such on the PIE's website. The submissions from all parties should be given equal weight, and be responded to.

Second, we note that in liquidations it is quite common for creditor's committees to be formed representing the interests of all those impacted by the insolvency of a company. If it is possible to form stakeholder committees in such circumstances then we see no reason why it should not be possible more generally. It is our suggestion that stakeholder committees be formed for all PIEs and that it should be ensured that there is diverse representation from all stakeholder groups on such committees, also ensuring that gender and ethnic balances are considered and that employees are given special rights of representation. This objective would help address the lack of diversity on audit committees at present. A company should be duty bound to train those appointed, if required, and to remunerate those appointed at reasonable market rates for their time expended in undertaking such work. Care to avoid bias in appointment should be taken: third party monitoring should be engaged to ensure that this is the case. Audit plans should be discussed and agreed with this committee, who should also have regular access to the audit committee of the board of directors. They should be permitted opportunity to publish their opinion on the approach chosen by the auditor and it must be published by the PIE. The auditors should be required to respond if they disagree with that opinion. We believe that this would be considerably more effective than the proposals made in the consultation document.

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?

We do not agree because the AGM is for shareholders only and we believe that the auditors should be accountable to all stakeholders. The consultation document appears to be failing its own stated broad remit by making such proposals which do not broaden the approach to stakeholders.

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?

It is disappointing that there are continual relationships to a particular relationship between auditors and shareholders when audit reform is dependent upon expanding the scope of auditor responsibility to all stakeholders.

We believe that an auditor should be provided with legal immunity for comments made on resignation as an auditor to ensure that they have the chance to whistle blow, which is the duty that they owe to the stakeholders of a company on that occasion. It is entirely reasonable to rely on professional ethics to prevent any abuse of this privilege.

8 Competition, choice and resilience in the audit market

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?

We understand the government's motivation in making this proposal but have major reservations with regard to it.

Accounting risk always exists on boundaries i.e. at those places where an asset changes state (e.g. ownership, or its nature, when for example it moves from inventory to work in progress). The same is true of audit. The exercise of judgement required by the person who signs an audit report requires a successful transmission of knowledge from each person within a large audit team to that singular individual whose task it is to finally form an opinion upon the financial statements that are presented by a PIE. The more transfers of knowledge that are required, and the greater the difference in systems within that transmission process then the higher is the audit risk that the person signing the ultimate audit report must accept.

So, for example, if, as is commonplace, there are differing generally accepted accounting principles in use across a PIE that necessarily increases audit risk. Likewise, if there are differing audit standards in use that, again, increases audit risk.

One of the principal reasons for the existence of multinational auditing firms is the mitigation of this risk. Because all firms within their structures are usually required to adopt one single audit approach the ultimate audit partner does not, as part of their own audit process, have to consider the risk inherent within data crossing boundaries within the single multinational audit entity. It is precisely for this reason that both joint audits and the use of third-party firms for subsidiary audits are sources of audit risk. As a result, they have largely disappeared from the audit market (some national exceptions being noted). These practises increase the risk of audit failure.

In our opinion the use of Challenger firms is likely to create risk of this sort. It is very unlikely that it will be cost effective for a Challenger firm to either learn, or adopt, the audit approaches of all those lead firms with whom they might cooperate in undertaking audits. Nor is it likely that those lead firms will be willing to share their systems with Challenger firms because they will seek to protect their own intellectual property. It would not be reasonable to expect them to do so in that case. In that case despite the fact that that there are common UK auditing standards issued by the Financial Reporting Council there are significant differences in the audit approaches that firms use within the UK, most especially when it comes to sampling, the use of data analytics and the documentation used to record audit opinion. Unless these differences are comprehensively understood, and compensation is made, the use of Challenger firms will, almost by definition, increase audit risk within the UK.

We reiterate that we think that an error is being made here: the objective of achieving high quality audit is of much greater significance than that of achieving competition in the audit market. Audit quality is a public good. Audit competition is merely desirable, if achievable. and audit quality should never be compromised for the sake of competition.

We note that the two largest potential challenger firms have now said that they are unwilling to partake in this Challenger process. We suspect that the remaining potential Challenger firms are too small to do so. In that case we think that this policy of using Challenger firms is very likely to fail simply because of lack of market capacity, whether or not there is willing to do so. As such we have difficulty in answering this question.

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?

Please see our answer to question 61.

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?

We do not expect the Challenger firm initiative to succeed. In that case we do not see how a market cap mechanism can work unless the proposal that we make in our answer to question 55 for the National Audit Office to accept a share of the audit market is adopted.

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?

We are of the opinion that there should be a total separation between audit firms and those firms offering other services to PIEs. We cannot see another way in which higher audit quality can be achieved without compromise being made with conflicting interests. As such we have no comment to make about the detail of your proposal.

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?

We agree with this proposal but think that the same information should be made available in the audited financial statements of audit firms themselves so that all stakeholders might have access to this information so that they too can appraise the risk to which they are exposed as a consequence of the behaviour of any single audit partner who is responsible for the work on the PIE whose affairs they wish to review.

Whilst we think it is important that a UK based audit firms should publish a separate audited set of financial statements, we are also concerned that the multinational associations of firms of which they are a part do not at present produce consolidated audited financial statements even though it is clear that they operate under common management and control with other similarly named entities in other jurisdictions. We think that ARGA should require the production of such audited consolidated worldwide financial statements for the conglomerations of firms that now dominate the audit market and are likely to do so in the future.

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?

Please note our answer to question 64. We do not think that there is any realistic prospect of the so-called Chinese Walls that your proposal envisages being effective and that the risk of audit conflicts of interest might even increase as a result of them, whilst the attractiveness of audit as a professional career will be reduced by them when there is internal competition for staff within one firm.

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 first thing to note is that because of the way in which the multinational firms of auditors are organised[26] there will be no significant international risks to requiring the separation of their UK activities between separately owned, managed and controlled firms, one covering audit and the other the rest of their commercial activities. This will be the case even if this split is not replicated elsewhere. These firms are already quite loose conglomerations of entities with broadly common interest but without shared ownership, albeit that there are common standards in use in them all covering some aspects of their work, including audit.

Second, we suggest that it is unlikely that these loosely conglomerated firms will refuse membership to a separately owned UK firm that only supplies audit services, even if this structure is not replicated elsewhere. Given that all these firms are already deeply segregated by business activity (usually along the lines of audit, tax and consulting) there will be nothing particularly unusual about the UK audit firm being separate from the UK commercial firm, even if there is no common ownership between the two.

In summary then, we very much doubt that there are any real commercial impediments to the separation that we think will eventually be required to deliver the increase in audit standard that is the government's objective.

We do, however, see a regulatory dimension to the remaining association between the resulting audit firms in the UK and the entities outside the UK that will be contracted to audit the overseas subsidies of the PIE. It is very likely that these auditors outside the UK will remain within the conglomerated firms with which the UK audit entity is either newly associated, or of which it was previously a part. There will in that case remain potential conflicts of interest which will require careful and close monitoring, to in particular prevent

[26] See https://research.cbs.dk/en/publications/the-big-four-a-study-of-opacity for details

there being cross-selling from overseas entities within that grouping of firms to replace the services previously bought in the UK to then create conflicts of interest within the subsidiary audits of the PIE.

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?

As noted in are answer to question 55, we believe that it is essential that the National Audit Office be available as an alternative auditor within the UK PIE audit market to ensure that there is no risk arising from the lack of resilience amongst existing audit firms.

8.4 Additional competition proposals from the CMA

9 Supervision of audit quality

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 of determining whether individuals and firms are eligible for appointment as statutory auditors of PIEs?

We agree with this proposal.

As noted in our answer to question 48, we also think it important that the regulator imposes conditions to ensure that the auditors of PIEs continue to be aware of the obligations imposed upon them, and that they must be required to evidence this awareness.

9.2 Monitoring of audit quality

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

There is an obvious conflict of interest if ARGA is to publish data on the quality of audits undertaken by individual firms based upon reviews of the actual audits that they have undertaken but then wishes to anonymise or redact the information published so that flaws in individual audits cannot be identified. It would not be possible for the regulator to express an opinion stating, for example, that a percentage of audits reviewed did not meet the required standard set by the regulator and not then disclose which audits are involved without it creating a general lack of confidence in the audit opinions expressed by any firm on all the audits of PIEs that it had undertaken. Since at present all firms appear to be subject to quite significant criticism of the quality of their work confidence in audits across the board is already prejudiced by this process.

We do not suggest as a result that AQR data it is not published. We do instead suggest that ARGA will have to accept that it is itself an auditor required to express an opinion, with evidence to support its conclusions necessarily being placed in the public domain so that its stakeholders can form an opinion upon the conclusions that it reaches. This will necessarily mean that individual audits that do not meet acceptable standards must be identified with sufficient reason being given as to the basis for this conclusion. If this is not done the stakeholders of the PIE that has suffered a deficient audit service, as well as the PIE itself, will be left not knowing that the audit on which they are relying has not met the required standard and within the required approach to audit that the government is now promoting that must be unacceptable. In this context we do not think that exemptions from disclosure are appropriate.

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?

We suggest that this question is inappropriately framed. An auditor will have a legal obligation to cooperate with their regulator. It is not the duty of a regulator to protect the auditor. It is the obligation of a regulator to protect those who depend upon the audit opinion that an auditor must express. The entity whose audit is deficient needs to know this, as does its stakeholders. The regulator must put in place a mechanism to ensure that they are informed. It is not their duty to protect the auditor on this situation.

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?

We draw attention to our answer to question 67.

We think the proposal made is appropriate subject to the pints made in our answer to question 67.

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?

We agree that it is problematic if documents that the auditor reviewed as part of their audit are unavailable to the regulator because of the audited entity's legal professional privilege. If this is the case then we suggest that an auditor should be obliged to state that their client has not maintained the necessary books and records that are necessary for an audit opinion to be prepared given that the preparation of that audit opinion is, necessarily, dependent upon the availability of the audit files to their regulator. Since no PIE would wish it to be stated that they did not maintain adequate books and records for audit purposes this approach would resolve this problem.

10 A strengthened regulator

10.1 Establishing the regulator

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

We note that the FRC suggested that a replacement regulator have this objective:

> *To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards.*

We broadly agree with this objective. It would seem to embrace our view as noted in our covering letter that there are seven classes of stakeholders of PIEs.

We regret that the government is proposing that the objective be stated to be:

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

We regret that there remains within this statement the implication that investors have a potentially superior interest in the financial statements of a PIE, with which we do not agree. We prefer the FRC's proposed definition.

Additional comment

We note that it is proposed that ARGA should be created as a company limited by guarantee. We think it an agency of the government and as such should be constituted as such. This would guarantee that it be subject to Freedom of Information requests. The ambiguity as to status that has plagued the FRC should be removed in the case of 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 note that the proposed regulatory principles are:

General objective

1. *To protect and promote the interests of investors, other users of corporate reporting and the wider public interest.*

Quality objective

2. *To promote high quality audit, corporate reporting, corporate governance, accounting and actuarial work.*

Competition objective

3. *To promote effective competition in the market for statutory audit work.*

Regulatory principles (for ARGA to 'have regard' to).

4. *Promoting innovation in statutory audit work, corporate reporting and corporate governance.*
5. *Promoting brevity, clarity and usefulness in corporate reporting.*
6. *Working closely with other regulators from the UK and internationally.*
7. *Anticipating emerging corporate governance, reporting or audit risks by being forward-looking and acting proactively where possible.*

We have already commented about objective one in our answer to 74 and have suggested it inappropriate.

We believe that objective 2 is appropriate and look forward to the way in which ARGA seeks to reform UK accounting standards for the reasons noted in our covering letter since we would suggest that they are not at present fit for purpose.

We do not agree with objective 3 and think that the objective may well be in conflict with the goal of improving audit quality. It is already giving rise to the proposal for Challenger firms that we think has little prospect of succeeding for reasons noted in our answer to question 61. We think that it more important that ARGA focus on audit quality than promoting competition in the audit market. This objective should, we suggest, be deleted.

We are content with objective 4.

We believe that objective 5 is inappropriate; conflicts with the objective of improved audit quality; conflicts with the requirement that audited financial statements should present a true and fair view (as we have defined it); patronises the users of financial statements and conflicts with the objective of meeting the needs of all stakeholders. In the digital era when all users of financial statements can also search those accounts for the information that they require we also think the objective outdated. We believe it essential that this objective be deleted as it undermines all the others.

We are content with objective 6 and 7.

We suggest an additional objective top replace objective 5:

f. Promote the publication of all that information that is required to ensure that the information needs of all the stakeholders of the entity are met.

10.2 Governance

Additional comment

In our opinion the Board of ARGA should be specifically required to reflect the interests of all users of financial statements and as such should be required to include representatives from:

- Smaller companies that are likely to trade with PIEs;
- Employees;
- Pensioners;
- Civil society in all its forms, including those specifically engaged on issues relating to transparency and accountability

These roles should all be openly advertised, be appropriately remunerated, have training provided if required, and be fixed term. We think this essential for the accountability of ARGA.

10.3 Funding: a statutory levy

Additional comment

We note how ARGA is to be funded. We would also draw attention to our comments in answer to your question 52 on the role ARGA should have on audit fees and their settlement by levy.

11 Additional changes in the regulator's responsibilities

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 balance of risk suggests that this is appropriate.

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

Appeal to a minister, who would have the right to appoint an arbitrator, would be appropriate.

78. Should the regulator's enforcement powers initially be restricted to the 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 regulator's enforcement powers should extend to all those engaged in the production of the audited financial statements of PIEs, and most especially to all those engaged in the audit process, whether members of a professional accounting body or not. It would undermine the credibility of regulation if some should escape regulation for reason of not holding a professional qualification when others undertaking similar talks with such qualification would fall within the remit of regulation. As such comprehensive coverage of all those engaged within regulated audit firms is required.

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?

We note that the consultation document suggests that:

The new code of ethics would merely aim to standardise the variations between the core elements of each ethical standard, based on the International Code of Ethics for Professional Accountants, so that consistent standards apply across the profession.

We note that the International Code of Ethics for Professional Accountants[27] says that its overriding concern is[28]:

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable professional accountants to meet their responsibility to act in the public interest.

The Code itself say that there are five fundamental principles of ethics for professional accountants[29]:

(a) Integrity – to be straightforward and honest in all professional and business relationships.

(b) Objectivity – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.

(c) Professional Competence and Due Care – to:

1. *(i) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and*
2. *(ii) Act diligently and in accordance with applicable technical and professional standards.*

(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.

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[27] https://www.ifac.org/system/files/publications/files/IESBA-English-2020-IESBA-Handbook_Web-LOCKED.pdf

[28] Page 13

[29] Page 17

(e) Professional Behavior – to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

If this is to be the basis of the Code of Ethics that is to be adopted there are major gaps within what is proposed:

1. The public interest is not mentioned in the five principles;
2. Instead obligations implicit in contract relationships are the basis for the five principles;
3. The obligation to not breach the law or regulations in section (e), which is the only part that might refer to the public interest, is framed within the context of not discrediting the profession, but not within any framework of duty to the public at large. Given that the auditor will have a contractual relationship with the profession of which they are a member this is also, therefore, couched solely within the framework of contractual obligations.

What is apparent is that this Code is not, in that case, about the public interest. Nor is it particularly about ethics. It is a code of conduct, which is something quite different. At best it can be suggested to be about a contextual ethic, with that context being that of the particular duty of the accountant to the client within the context of not bringing the broader profession into disrepute. This creates a form of moral relativism that we suggest inappropriate within accounting ethics where the obligation should be to produce a moral imperative to act in the broader public interest.

This moral imperative is clearly necessary when considering the relationships that exists between stakeholders and PIEs. The auditor has a contractual relationship with the PIE and not with the stakeholder. This is why it has always proved so difficult to bring any legal action against an auditor before an entity has entered into liquidation, when the status of the parties changes. This restricted contractual framework, that is implicit in the noted Code of Ethics that it is proposed that ARGA use as the basis for its work, does not in that case reflect the stakeholder obligations that are implicit in the new audit relationship that we understand that ARGA envisages.

What is required is a code of ethics that reflects that the auditor should have an obligation in tort (i.e. non-contractually, but nonetheless legally) with the whole stakeholder community of a PIE. The code of ethics should then be written within a framework that imposes a duty of care to all who might be impacted by the auditor's work, and not solely to dictate a protective duty towards some who have a contractual relationship with the auditor.

We support the regulator having the right to create a code of ethics subject to it being in this form.

A breach of duty within the context that we propose is implicit within our definition of the purposes of accounting and audit, to which we draw attention in our covering letter. As we make clear there, we consider:

> *The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.*

From this we conclude that:

> *The purpose of the audit of a public interest entity (PIE) is to firstly report on whether the financial statements on which the auditor offers an opinion deliver relevant, reliable and sufficient information to users of those statements and to secondly, where there is a shortcoming, remedy that shortcoming or, if it is not possible to do so, to report why that is and what its consequences are.*

These definitions can frame the required code of ethics. We suggest that the auditor who expresses an inappropriate opinion or who fails to ensure that the sufficient, relevant and reliable information that users of those statements can reasonably expect is made available, or who fails to remedy that defect, most especially when put on notice to do so by a stakeholder, will have failed in their professional obligations and that remedy is then due.

We would suggest that ARGA will have to be an active participant in such issues. An auditor put on notice by a stakeholder that they expect information to be supplied that the auditor thinks it inappropriate to deliver will only be able to avoid liability, we suggest, by seeking regulator approval not to do so. ARGA will therefore have a role in resolving such issues in the public interest. It would have to do so publicly, with reasons stated.

A new era of professional ethics with regard to audit requires much more than the minimal rewriting of existing statements on professional ethics. We believe that this framework should now be developed as this process develops.

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?

We do not have the expertise to answer this question.

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

We do not have the expertise to answer this question.

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

We do not have the expertise to answer this question.

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

We do not have the expertise to answer 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?

We do not have the expertise to answer this question.

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

We do not have the expertise to answer 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?

We do not have the expertise to answer 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?

We do not have the expertise to answer 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?

We do not have the expertise to answer this question.

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

We do not have the expertise to answer 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?

We do not have the expertise to answer 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?

We do not have the expertise to answer this question.

92. Should the regulators 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?

We do not have the expertise to answer this question.

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

We do not have the expertise to answer this question.

11.3 Investor stewardship and relations

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?

We have covered our issues of concern elsewhere in our responses.

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?

We believe that auditors should have a statutory protection from a breach of duty claim when reporting to their regulator issues that they believe to be of concern. We believe that this would be of benefit to reporting and improve the quality of audit and audit regulation.

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

We do not express an opinion on this issue.

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

Yes.

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?

We think that these will become apparent with experience.

11.5 Local audit

Additional comment

In our opinion local authorities are PIEs because they have macroeconomic significance and as such they should be audited in accordance with the new framework that is under discussion here.

11.6 Independent supervision of the Auditors General

11.7 Whistleblowing

Additional comment

We believe that whistleblower protection is essential and support the call for a review on this issue.

Appendix 1

The information needs of the stakeholders of Public Interest Entities (PIEs)

It is our opinion that the information needs of the stakeholders of PIEs in paragraph 2c of our letter are as follows:

a. **Suppliers of capital, including shareholders, but recognising that some of these groups have differing interests**

Background comments

We refer to our covering letter which provides comment on the background to the issues referred to in this section.

We draw particular attention to the fact that we differentiate the information needs of shareholders from those of the providers of other capital when considering this issue. Shareholders have a particular interest in the trading and other activities of the parent company of a PIE in its own right that is unlikely to be of concern to almost any other stakeholder of the entity, but which should be provided for their benefit.

In contrast, the other providers of capital are the only stakeholder group of the PIE for whom it can definitely be said that the consolidated accounts provide the most objective measure of the interests that they might have in the activities of the PIE because one of its singular purposes is to provide an indication of the scale of the assets under the control of the PIE that might be available for pledge as security for loan finance.

Both groups do, however, also have very particular reasons for wishing for information on the trading activities of the subsidiary entities of the PIE. In the case of shareholders this is because the dividends that each of those subsidiaries might be able to route to the parent entity are the singular source of their potential economic gain from engagement with the PIE, which is otherwise remarkably limited.

In the case of the other providers of capital, the balance sheets of those subsidiary entities indicates the assets available to the PIE to be pledged as security for borrowing and therefore the scale, location, and existing charges within those subsidiaries are all matters of particular concern to lenders meaning that even though they have most interest in the consolidated accounts that view is insufficient by itself to satisfy their information needs by itself.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located
The return on capital requiring disclosure of: • An operational review; • An income statement and related statements on other movements in equity, if appropriate; • A cash flow statement; • A balance sheet; • Appropriate notes to the accounts to explain the foregoing; • Disclosure of the name, place of incorporation, place of trading and trading activity of each of the subsidiaries of the PIE, also indicating that place where the accounts of the subsidiary in question might be found, free of charge, on public record for further inspection; • An organisation chart demonstrating lines of control within the PIE so that the means of establishing its boundaries are made clear; • Country-by-country reporting data with an explanation for its basis of preparation and a reconciliation with the other financial statements; • On balance sheet accounting for the impact of climate change on the reporting entity, with supporting data to enable appraisal of the sufficiency of the provisions made[30];	• Information on the constituent members of the PIE trading within each jurisdiction in which it trades, as preciously noted; • Information prepared on a country-by- country basis showing the consolidated trading activities of the PIE within the jurisdiction prepared on the basis of the recommendations of the Global Reporting Initiative (GRI) with the addition of: o Data on intragroup sales and purchases, with indication of the locations with which those transactions occur without materiality limit being applied; o The total cost of employment incurred within the jurisdiction split between gross pay, employer social security and pension costs and other liabilities incurred; o A country-based tax reconciliation; o Total sums due in each year in each location in which the PIE trades with regard to sales taxes, taxes on employment and taxes on profit as well as land taxes and taxes due from the extractive industries, with comparators

[30] See http://www.corporateaccountabilitynet.work/projects/sustainable-cost-accounting-the-essential-guides/

• Disclosure of inherent but unprovided risk, including that arising from: o uncertain positions; o taxation whether current or deferred; o risk created by intra-group transactions; o geographic and supply chain risk; o legal non-compliance; o climate related risks; o related party transactions and o political donations. • A parent company balance sheet, income statement and cash flow statement with full supporting notes to those accounts; • Reserves split between those available for distribution: o As shown within the group accounts; o As shown within the parent company accounts; o Available for distribution to the parent company within the subsidiaries of the PIE.	sufficient to appraise the reasonableness of the data supplied being made available in each case; o A tax reconciliation for each year for each major tax liability showing opening liability owing; charges accrued during the year; tax paid and closing balances due.

b. Trading partners of the PIE, including both customers and suppliers

Background comments

Appraising the financial viability of the entity with which they engage is a key issue for trading partners, for which they reason they require the data reasonably expected by the suppliers of capital to the company, already noted. However, many will also want data to appraise supply chain and other risks for social, environment and governance reasons.

There is a very particular aspect to the needs of this stakeholder group though, which is that few, if any trading partners of a PIE trade with its parent entity. Instead, they deal with a subsidiary of that PIE in the place that they, as a stakeholder are located. For that reason trading partners have significant needs for local information with regard to the transactions of the PIE.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located
• Details of the average period of credit taken by the PIE from its trade creditors; • Details of the average time taken by the PIE to resolve customer disputes; • Data on credit worthiness, solvency, cash flow, lines of credit, compliance with banking and other loan covenants and risks inherent in contingent liabilities that may have impact upon ability to pay not otherwise readily apparent within the balance sheet; • Assurance that the entity is not distributing reserves in a manner likely to prejudice the interests of its trading partners, and creditors in particular.	• Which entities make up the PIE; • Which entities are related to the PIE but are not for accounting purposes included within its boundaries; • Where the accounts of those entities might be found, free of charge, in full and on public record if not provided by the PIE itself; • What the financial results of the PIE as a whole might be within the territory in which the trading partner is located, for which purpose country-by-country reporting can provide the necessary data; • Details of the average period of credit taken by the PIE from its trade creditors within the jurisdiction in which the trading partner is located; • Details of the average time taken by the PIE to resolve customer disputes within the jurisdiction in which the trading partner is located.

c. Employees, past present and future

Background comments

This section deliberately notes that employees past, present and future might all have interest in the financial reporting of the PIE.

All are likely to have an interest in the overall state of the finances of the PIE as a whole because the credibility of the pension funds to which they have contributed, and the benefits that they might have been offered, will very often be dependent upon the overall financial credibility of the PIE. As such they are interested in the consolidated financial statements of the entity in the same way that the external providers of capital to the PIE might be, not least because in very many cases they share a perspective with those external providers of finance because their pension funds will, quite often, be creditors of the entity as a whole and they will be seeking security for the shortfall in contributions due to it.

This overall point having been noted, there are other issues of concern to employees. In particular, many will wish to identify with their employer's contribution to society, and as a consequence they will wish to be able to assess this this means that they will have concern about what are often called environmental, social and governance issues.

Employees will also, and quite obviously, have concern about the financial risks that they take in working for the entity. Of all the stakeholders of any PIE it will normally be the case that the employees have the highest overall level of financial risk inherent in their relationship with the organisation because for many of them this entity will be their sole source of income, and no other stakeholder is likely to be in that position. For that reason the supply of information to meet their very particular needs is a matter of priority if stakeholders are to be at the centre of future corporate reporting.

What is particularly important to note in this context is that very few, if any of the employees of the PIE will be employed by the parent company of that concern. They will instead be employed by a local subsidiary. They do therefore have very particular local needs for information, based upon both the company which engages them and the overall activities of the PIE within the jurisdiction in which they work.

It is also important to note that the information that employees require will not just be with regard to their position as creditors, which has conventionally been assumed to be the case, although separate disclosure of information as to liabilities owing to staff, and related obligations with regard to tax, have rarely, if ever been separately disclosed within financial reporting despite the fact that the risk that employees face as suppliers of capital has been recognised. The additional data that employees (and their representatives) will also require will embrace average and comparative pay information, both within their entity, and between PIE entities. It will also require disclosure of data on social aspects of employment, including gender and other pay gaps which are of significance. The nature of these other pay gaps may vary by location, but they could, for example, relate to pay gaps by ethnic group where differentiation on this basis could be a cause for social or economic friction, as well as discrimination.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located
Information on: • The number of employees an entity has, providing analysis of: o Their gender split; o Their geographic location; • Their aggregate pay, analysed by: o Gender; o Geographic location; With analysis split between: o Gross pay; o Benefits in kind; o Social security contributions; o Pension contributions; • Their average pay, split by: o Gender; o Location; o Gender by location; • Gender pay gaps; • Other pay gaps if deemed appropriate; • Outstanding wage liabilities o In total; o By location; • Outstanding pension liabilities o In total; o By location; • The surpluses and deficits of all pension funds related to the PIE and in particular the means by which any deficits are to be made good, and when; • Outstanding tax liabilities due with regard to employment related liabilities and whether any of these might be subject to recourse from the employees if not paid by the entity itself.	• Information as required for the PIE but split by: o Jurisdiction; o Subsidiary.

d. Regulators

Background comments

Much of the data that regulators might require can be demanded by them from those from whom they require it, but sample selection of those they wish to investigate requires data in addition to that already noted.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located
• The data noted previously on the entities that constitute the PIE is critical to regulators; • So too is data on intra-group transactions since these are the way in which many PIEs seek to avoid regulatory responsibilities; • For this reason the subsidiary entities of PIEs must be required to record their intra-group transactions as if they are related party transactions (which as a matter of fact they are).	• In this case likely to be covered by that noted for the PIE as a whole.

e. Tax authorities

Background comments

The data required by tax authorities is to some extent similar to that required by the trading partners and regulators of PIEs. There are however additional information requirements peculiar to this sector if they are to properly appraise the risk that they face when engaging with PIEs. The same data will also be of use to many in civil society who wish to appraise the contribution that PIEs make to their communities.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located

• Total liabilities owing in a period for critical taxes (sales taxes, payroll taxes, land-based taxes, corporation taxes on profit); • Comprehensive data on the drivers of these liabilities (sales, payroll costs, land use, profits); • Cash flow data on the settlement of these liabilities; • Clear balance sheet disclosure on these liabilities, by tax; • Full country-by-country reporting as a mechanism to promote change in corporate behaviour; • Full disclosure of group structures since this information is not available to all tax authorities as yet; • The accounts of all subsidiary companies on public record since these are not available to all tax authorities; • The disclosure of intra-group transactions by subsidiaries.	• Total liabilities owing in a period for critical taxes (sales taxes, payroll taxes, land based taxes, corporation taxes on profit) by location; • Comprehensive data on the drivers of these liabilities (sales, payroll costs, land use, profits) by location and subsidiary; • Cash flow data on the settlement of these liabilities subsidiary; • Reconciliations of tax liabilities owing by the entity, by tax; • Clear balance sheet disclosure on these liabilities, by tax by location and subsidiary.

f. **Civil society including local authorities, concerned individuals, journalists, academics, researchers, politicians and others**

Background comments

Civil society has been the most ignored group within financial reporting. The reason is, almost certainly, that the identity of the PIE is defined by contractual relationships, whilst accounting is almost entirely focussed upon measuring the transactions that cross the boundaries of that PIE as defined for contractual purposes, with auditing supposedly substantiating the truth and fairness of the consequences that arise from those transactions. In varying ways all the other stakeholders previously noted share contractual relationships with the PIE. Civil society does not.

The whole point about civil society, and the way in which it is defined within this context of stakeholding is that it is constituted by those that are interested in the PIE without having a contractual reason for doing so. Theirs is a relationship based not on contract, but on an awareness of tort. Tort is the branch of law where protection is sought from harm caused to a person by a party with whom they do not have a contractual relationship. The vast majority of civil society interest in the action of PIEs arises because of concern about the risk of such harm happening. The most common way in which such harm might happen would be as a consequence of what an economist might call an externality i.e. as a result of an unpriced third party consequence to an otherwise legal contact for which compensation is not paid contractually. Other abuses might arise from the abuser following the letter but not the spirt of the law.

The information that civil society wants from a PIE is, as a consequence, varied, and much has been covered by other concerns already noted e.g. with regard to the extent of the PIE, its local activities, its taxes paid, and liability to employees and those it trades with. There are, however, other requirements, as noted below.

Information needs

For the PIE as a whole	For the jurisdiction in which the stakeholder is located
• Accounting for the consequences of climate change; • Data on actions to indicate mitigation of racial, gender, orientation and age bias; • Compliance with international conventions e.g. on trade, the environment and other issues. • Context specific information relevant to the activity of the PIE; • Contingent liabilities and inherent uncertainties within the accounting of the PIE.	• Location specific data on the issues noted for the PIE as a whole.