Deloitte.

Appendix I: Summary response

Restoring trust in audit and corporate governance

July 2021

Appendix I: Summary response

1. The Government's approach to reform

Definition of Public Interest Entity

1.1 The Public Interest Entity (PIE) definition should cover entities that are of public interest and reforms should be applied on a proportionate basis in a way that does not unduly burden entities or stifle innovation and the competitiveness of UK markets.

1.2 Our preference is for the government to extend the PIE definition as set out in Option 1 (more than 2,000 employees or a turnover of more than £200m and a balance sheet of more than £2bn at a group level), as this aligns with the existing definition of an Other Entity of Public Interest ("OEPI"). Large Alternative Investment Market (AIM) companies should be PIEs but the suggested thresholds are low and should be denominated in pounds sterling.

1.3 Depending on the type of entity and its size, some of the proposed new PIE requirements may be disproportionate and require appropriate adaptation or later adoption, so there needs to be consideration of the implementation of reforms on a segmented basis. PIE market segmentation should not be based purely on size but also on the nature of the entities and their public interest impact. Within market segments there should be consistent application of reforms.

1.4 The limits should look at an entity and its subsidiaries – i.e. downwards, not upwards. Careful consideration should be given to each of the PIE requirements in a group containing multiple PIEs – some may make sense to apply for each PIE; others may only make sense to apply to the largest group headed by a PIE.

1.5 Suitable transition periods are needed for entities newly captured by the extended definition when it is implemented and those that breach the threshold.

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

Requirements for Sarbanes-Oxley Style arrangements in the UK

2.1 We support the introduction of Sarbanes-Oxley style arrangements for PIEs in the UK, including an annual statement by the directors on the operating effectiveness of the company's internal controls over financial reporting.

2.2 Directors should have a choice of internal control framework so long as it is an internationally recognised one. There will need to be robust guidance and practical examples to allow for a risk-focused and proportionate implementation.

2.3 This statement by the directors should be subject to independent external assurance by the auditor and enforced through rigorous regulatory oversight. This will ensure a robust adoption of the requirements giving stakeholders better confidence in the disclosures made.

Capital maintenance

2.4 We support a stronger definition of distributable reserves and a requirement to disclose such a figure. However, we recognise that defining a precise figure is not straightforward and therefore propose this is disclosed as 'no less than X'. As we have previously set out, we continue to favour a more fundamental review and a move to a solvency model instead.

3 New corporate reporting

Resilience Statement

3.1 We support the concept of the Resilience Statement, including links to the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). However, this should not replace the need for separate TCFD disclosures, which we strongly support.

Audit and Assurance Policy (AAP)

3.2 We support the AAP but believe it should not just cover corporate reporting matters but also the risks and controls associated with those matters and the level of assurance obtained (or not) for each area.

3.3 We recognise practical challenges with implementing the AAP. We consider an annual advisory vote by shareholders to be too frequent. There needs to be consideration for how investors will engage with the AAP, especially in investment houses that invest in very large portfolios of entities. Private entities that are PIEs may need an alternative mechanism as they do not have shareholders as such to engage with.

Supplier payments

3.4 We support the inclusion of supplier payment disclosures as part of the annual Strategic Report but recommend that duplicate disclosure requirements through the Payment Practices Reporting Duty are removed.

Proposal not to introduce a requirement to publish an annual Public Interest Statement

3.5 We support this decision as we believe that the existing requirements under s172 of the Companies Act are suitable as they stand.

4 Supervision of corporate reporting

Strengthen corporate reporting review function

4.1 We believe the proposed scope is reasonable and support the publication of correspondence so long as there is clear guidance and expectations set on what will be disclosed by the regulator, and an open and transparent processes for appeal if a company feels the regulator has made an incorrect conclusion.

5 Company directors

Strengthen regulation of director activities

5.1 We support regulation extending to directors' corporate reporting and audit-related duties but there must be careful consideration of areas of dual regulation, and an appropriate avenue for appeals. Appropriate guidance will need to be developed by the Audit, Reporting and Governance Authority (ARGA) to set clear expectations for directors.

Behavioural standards for directors, malus and clawback

5.2 We believe these can be covered through enforcement of the current requirements in s171-177 of the Companies Act 2006 (independent judgement, exercising reasonable care, skill & diligence and considering long term and wider stakeholders).

5.3 We support remuneration committees having suitable powers of clawback where directors have failed in their duties.

6 Audit purpose and scope

A purpose for audit

6.1 We support a clear purpose for audit that builds on a clear purpose for corporate reporting more generally. The broadening of the scope of audit is an important reflection of increasing stakeholder demand for non-financial information and its assurance.

Requirement to consider wider information

6.2 Auditors must already include the information they find out as part of their procedures in the risk assessment of their audits. Consideration must be made of how far an auditor should be reasonably expected to go to seek out wider information. Guidance will be needed on the sources of information the auditor should reasonably be expected to consider. This information must be relevant to the financial statements (and the users thereof) and be of reputable quality.

ARGA to regulate wider services under AAP

6.3 We support services provided via the AAP being subject to oversight by the regulator. The regulator should have means to challenge the entity if they do not believe the AAP to be appropriate, either because it is lacking content, or justification for the assurance decisions made, or because it disagrees with those decisions.

Principles for corporate audit

6.4 We support there being principles for corporate audit but there must be clear safeguards from challenge if the auditor or another assurance provider, in good faith and in the public interest has departed from the auditing standards to uphold the principles. All providers of assurance should adhere to these principles.

6.5 A fundamental principle must be the financial independence of the providers of assurance from the entity, to support trust and confidence in the provider's work.

Audit reforms relating to fraud

6.6 We support the reinforcement and clarification of the responsibilities of both directors and auditors in respect of the detection of fraud. The prevention and detection of fraud must be considered alongside the measures taken to strengthen the internal control environment, as these matters are closely linked. A clear definition of 'material fraud' is required, particularly as there is judgement in defining fraud that is material by nature.

Specific assurance on Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs)

6.7 This should be obtained via the AAP.

Liability and use of Liability Limitation Agreements (LLAs)

6.8 LLAs are not used at the moment as companies and their shareholders will not agree to them. Liability reform is needed to strike a fair balance of risk between the auditor and others, to encourage challenger firm participation in the market and to improve audit market resilience.

6.9 Whether LLAs are used or otherwise, suitable safe harbour protections are needed to encourage innovation of the audit product in the public interest and to encourage more companies to enter the audit and assurance market with suitable regard for the public interest and improving audit quality.

Establishing a professional body

6.10 A professional body for audit and assurance will help the industry if it has a clear vision and purpose. This body should cover all auditors and assurance providers in the wider sense and not be limited to PIE auditors only.

7 Audit Committee oversight and engagement with shareholders

Oversight of engagement with shareholders

7.1 We agree that ARGA should have oversight of the actions of the Audit Committee, including its interactions with shareholders and how effectively it discharges its duties internally.

Power given to ARGA to appoint an auditor in particular circumstances

7.2 ARGA should only use this power in very limited circumstances – in practice where the shareholders or directors have failed to appoint an auditor themselves. No firm should be forced to accept an appointment as auditor if it goes against the ethical values or reasonable risk tolerance of an audit firm. Where ARGA has appointed an audit firm, the regulator should agree auditor liability limitation conditions on behalf of shareholders.

8 Competition, choice and resilience in the audit market

Managed shared audits (MSA)

8.1 We recognise the need for greater choice and resilience in the market for audits of very large companies and the appetite within the government and regulator to achieve this.

8.2 However, we are concerned that MSAs may not attract a sufficient number of challenger firms to step up to take on subsidiary audits in the FTSE 350.

8.3 Even if they were to participate, having a set of smaller firms running subsidiary audits will not solve the issue of the lack of choice or resilience among group auditors.

8.4 Our preferred alternative is market share caps, which can be implemented even if only one or two challengers step up. The remedy can be targeted at specific sectors where challengers can grow real expertise as FTSE 350 group auditors. Measures can also be put in place to prevent cherry-picking of the most attractive companies by the Big Four. The caps should be subject to review and sunset clauses once the initial market dislocation is addressed.

9 Supervision of audit quality

Disclosure of AQR reports

9.1 We support the desire for greater transparency but are concerned about unintended consequences of full disclosure of AQR reports. Inspections focus only on part of the picture of audit quality. Currently inspection reports focus on findings without enough context or inclusion of agreed remediation which may lead to a risk of misunderstanding. Such reports may lead to commercially sensitive information being divulged. A clear framework is needed.

10 A strengthened regulator

ARGA's powers to extend beyond members of professional bodies

10.1 ARGA's powers should be limited to those areas within the profession where there is a public interest need. With the extension of powers to gain oversight of directors and audit committees, there are likely to be few public interest cases that are not covered. Any extension would need to be carefully justified in the public interest. Any extension in the scope and remit of the auditor will need to be matched with additional and complementary skilled resource at the regulator.

Oversight of the actuarial profession

10.2 The principle of oversight of the actuarial profession should be to ensure that the objective of their work is to provide information that supports decision making in the public interest. This is covered by the Actuaries' Code and overseen by the Institute and Faculty of Actuaries. ARGA's involvement should be to complement this work to meet the objective set. Care must be taken to avoid duplication of oversight.

Protection from breach of duty claims in relation to relevant disclosures to the regulator

10.3 Auditors are not dissuaded from reporting issues to the regulator out of fear of retaliation under the existing PIE regime. However, aligning with the PRA/FCA position under FSMA 2000 (where there is protection for auditors that have acted in good faith) would avoid the perception that auditors might pull their punches.

Deloitte.