

CONSULTATION RESPONSE

BEIS CONSULTATION RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

July 2021

This response represents the view of the PRI Association and not necessarily the views of its individual members.

PRI Association

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United Nations
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An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is now a not-for-profit company with over 4,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US \$100 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

The PRI welcomes the opportunity to respond to BEIS' consultation on restoring trust in audit and corporate governance. We believe the UK is well placed to set high standards of audit and corporate governance standards, keeping at the forefront of international best practices, and setting examples to other markets.

ABOUT THIS CONSULTATION

The proposed reforms in this consultation address the findings of three independent reviews undertaken in 2018 and 2019: Sir John Kingman's Independent Review of the Financial Reporting Council (FRC), the Competition and Market Authority (CMA)'s Statutory Audit Services Market Study and Sir Donald Brydon's Independent Review of the Quality and Effectiveness of Audit.

The Independent Review of the FRC found that the regulator lacked the necessary clarity of purpose and powers to hold auditors and directors sufficiently to account. The Brydon Review concluded that statutory audit needs to become more informative, and that higher expectations should be placed on both directors and auditors to deliver more useful information to the users of reports. The CMA Market Study showed an unhealthy dominance of the statutory audit market for larger companies by a small number of audit firms and called for new measures to increase quality, competition and resilience in the delivery of audit.

This consultation includes proposals in relation to four key areas, as follows:

- **On directors** – for new reporting and attestation requirements covering internal controls, dividend and capital maintenance decisions, and resilience planning to 'sharpen directors accountability' in recognition of weaknesses in reporting and accountability and the fact that the FRC does not have any powers to enforce directors' duties other than when a director is a member of a professional accountancy body;
- **On auditors and audit firms** – that audit should be established more formally as a separate profession (from, for example, accountancy) with its own governing principles, qualifications and standards as well as new regulatory measures to increase competition and reduce potential for conflicts of interest;
- **On shareholders** – for companies to publish an audit and assurance policy on which there would be an advisory shareholder vote and a formal opportunity for shareholders to propose areas of emphasis to be considered within the auditor's annual audit plan, to encourage asset managers and asset owners to engage on audit as a key part of their stewardship activities for the quality, accuracy and reliability of reports;
- **On the regulator** – for new statutory objectives and functions to establish the Audit, Reporting and Governance Authority (ARGA); responsibility for deciding which individuals and firms should be approved to audit Public Interest Entities (PIEs); a new statutory levy to replace the existing voluntary levy; competition powers; and new powers to strengthen the corporate reporting review function, oversight of audit committees and to enforce corporate reporting duties of directors.

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KEY RECOMMENDATIONS

The PRI welcomes BEIS' following proposals:

- For a statutory requirement for companies to publish an Audit and Assurance Policy and the proposed minimum content.
- To strengthen malus and clawback conditions on directors' remuneration arrangements and the proposal for minimum conditions that would trigger these provisions.
- New statutory requirements on auditors to consider relevant director conduct and wider financial or other information in reaching their judgements.
- To adopt the Brydon Review's proposed purpose of audit as a broad ambition for its own programme of reforms, and to ask the new regulator to incorporate accordingly.
- To allow shareholders greater opportunity to engage with risk and audit planning.
- That workers should have legal protection for whistleblowing disclosures made to audit firms and audit partners, and that this should extend whistleblowing protections to anyone with a direct economic relationship to the audited entity.
- The introduction of TCFD-aligned disclosures into company reporting, provided they are sufficiently robust.

The PRI recommends that the regulator:

- Provides greater clarity on the content and structure of the Audit and Assurance Policy.
- Provides guidance on the definition of the minimum triggers of the clawback and malus provisions.
- Requires reasonable assurance on wider audit information.
- Undertakes analysis on which international assurance standards the assurance of wider information will be based on, and the merits of limited versus reasonable assurance with respect to cost and usefulness for investors.
- Conducts a review of the existing whistleblowing framework in a timely manner.

RESPONSES TO SPECIFIC QUESTIONS

3 NEW CORPORATE REPORTING

Question 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?

One proposed new reporting requirement for directors of PIEs is an annual Resilience Statement which would consolidate and build on existing going concern and viability statements, and set out how

directors assess companies' prospects and address challenges to its business model over the short, medium and long-term.¹

The PRI supports the inclusion of meaningful, forward-looking and globally comparable company disclosure of material information alongside other financial data in the financial statement. Investors view climate change, cyber security and supply chain issues among many others as decision-useful and material to their investment decision making alongside traditional financial information, and the proposed Resilience Statement is a pertinent place to report on ESG related financial risks to holistically assess the viability of a company in the long term.

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

The proposed Resilience Statement could serve as an appropriate location for disclosures against the TCFD framework. With the inclusion of any TCFD reporting in the Resilience Statement or elsewhere, it is essential that disclosure is aligned with industry standards. We note that in a recent consultation BEIS proposed that PIEs, UK registered companies with securities admitted to AIM and with more than 500 employees, and UK registered companies and LLPs which have more than 500 employees and turnover of more than £500m would be required to disclose climate-related financial information in line with the 4 TCFD pillars of governance, strategy, risk management, and metrics and targets.² The PRI welcomes BEIS' proposals on enhancing climate-related reporting requirements. However, in their current form, they will fail to provide the comprehensive and comparable disclosures for market participants to adequately manage exposure to climate risk and recommend that the proposals are strengthened to align with the 11 disclosures under each of these four pillars, as outlined in PRI's written response to the consultation.³ We note that the Resilience statement is a proposal for PIEs only, as opposed to a broader scope of companies to which, for example, the Streamlined Energy and Carbon Reporting (SECR) applies. The PRI recommends alignment of any company TCFD reporting with this scope. We also note that there is currently a consultation underway on the TCFD framework⁴ that will be influential in even further building on and advancing current standards of reporting, to which the PRI will respond.

¹ Matters that the consultation paper proposes might be included in the Resilience Statement include; threats to liquidity, solvency and business continuity in response to a major disruptive event (such as a pandemic) which disrupts normal trading conditions; Supply chain resilience and any other areas of significant business dependency (e.g. on particular markets, products or services); digital security risks (both including external cyber security threats, and the risk of major data breaches arising from internal lapses); the business investment needs of the company to remain productive and viable; the sustainability of the company's dividend and wider distribution policy; and climate change risk.

² BEIS [Consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships \(LLPs\)](#), March 2021

³ [PRI response to BEIS consultation](#) on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships (LLPs), May 2021

⁴ TCFD seeks public comment on two documents: [Proposed Guidance on Climate-related Metrics, Targets, and Transition Plans and the associated Measuring Portfolio Alignment: Technical Supplement](#), July 2021

Question 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?

PRI welcomes the statutory requirement for companies to publish an Audit and Assurance Policy. We also agree with the proposed minimum content of the policy covering: the amount and quality of assurance obtained by companies; a description of internal auditing and assurance processes; information on the policies covering external assurance; and an explanation of whether shareholder and employee views have been taken into account in the formulation of the policy.

Such an Audit and Assurance Policy would serve as a useful starting point for investors to assess a company's approach to internal control frameworks; audit and independent assurance, including the rationale for engaging a particular firm for assurance purposes that might or might not be the statutory auditor; as well as how stakeholders' views have been considered.

We recommend that the regulator provides clarity on the content and structure of the policy to create consistency that will better enable investors to make assessments and comparisons between companies.

4 SUPERVISION OF CORPORATE REPORTING

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

The PRI welcomes the work underway by government to apply the European Single Electronic Format (ESEF) Regulation for some issuers with securities on UK regulated markets,⁵ which require appropriate tagging and appropriate machine-readable formats that correspond to existing financial reporting, to provide an easily accessible, holistic picture of financial and sustainability information.

We recommend BEIS consider the development of a common, publicly accessible data space for companies' financial and sustainability information, which builds on digital tagging required by the ESEF Regulation. A single access point for corporate information can enhance data accessibility, help investors to identify ESG risks and opportunities and provide better insights into companies' sustainability performance in the context of disclosure obligations, and social and environmental goals. Such a platform is currently being considered by the European Commission as part of efforts to reform Europe's Non-Financial Reporting Directive (NFRD).⁶

⁵ Policy paper: [The UK government's position on the effect of the ESEF Regulation](#), updated 9 December 2020

⁶ The European Commission's [Targeted consultation on the establishment of a European single access point \(ESAP\) for financial and non-financial information publicly disclosed by companies](#), January 2021

5 COMPANY DIRECTORS

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

The PRI welcomes the proposals to strengthen malus and clawback⁷ conditions on directors' remuneration arrangements and the proposal for minimum conditions that would trigger these provisions, provided further guidance is given by the government on the definition of these conditions.

Remuneration plans do not currently systematically promote sustainable value creation, which is in the interest of companies, investors, and stakeholders. This lack of alignment is concerning for long-term investors.⁸ Bonus-malus pay structures can incentivise executives to take precautions to mitigate risks to the company; discourage negligent management; and increase focus on sustainability issues by aligning pay with performance and long-term strategy to protect and create value.

We therefore welcome the introduction of a list of minimum conditions that would trigger clawbacks and malus provisions, namely: material misstatement of results or an error in performance calculations; material failure of risk management and internal controls; misconduct; conduct leading to financial loss; reputational damage; and unreasonable failure to protect the interests of employees and customers.

We agree that companies should be encouraged to add to these conditions to reflect company specific circumstances; in aggregate, more information on minimum conditions to trigger malus and clawback would allow investors to better assess how executives are held accountable and incentivized to ensure long-term performance. We welcome proposals to revise the Corporate Governance Code with respect to clawback and malus which should be accompanied with guidance to support companies and investors' understanding and application of the proposed minimum conditions.

We also recommend that the regulator undertake further research to establish whether the proposed minimum period of application of clawbacks should extend beyond the now proposed two years after an award is made, given that the effects of poor performance or oversight of sustainability issues may manifest in the longer term, and that the Government consider this as part of their planned review on extension to all listed companies.

⁷ As defined in the [Restoring trust in audit and corporate governance](#) document, malus is the ability to withhold pending awards in directors' remuneration and clawback is the ability to recover remuneration already paid to directors.

⁸ PRI [Integrating ESG issues into executive pay](#), June 2012

6 AUDIT PURPOSE AND SCOPE

Question 35: Do you agree that a new statutory requirement on auditors to consider wider information, amplified by detailed standards set out and enforced by the regulator, would help deliver the Government's aims to see audit become more trusted, more informative and hence more valuable to the UK?

The PRI welcomes the new statutory requirements on auditors to consider relevant director conduct and wider financial or other information in reaching their judgements. The PRI is supportive of enhanced reporting and audit processes for well-informed investor decision-making and engagement with companies and sees companies' sustainability information as necessary to take into consideration with respect to risks and opportunities. These can help ensure that the necessary policies, processes, and disclosure practices are in place to deliver the right information to stakeholders so they can assess performance and seek to address issues.

The PRI supports BEIS' proposal that information about the process companies undertake on assurance should be included in the Audit and Assurance Policy to improve accountability and clarify responsibilities, facilitating investors' understanding of companies' risk management.⁹

The PRI recommends that the regulator aligns the assessment and assurance of wider and financial information, as well as guidance on managing potential conflicts of interest in cases where the auditor also provides assurance services. The PRI also recommends that the regulator undertakes on which international assurance standards the assurance of wider information will be based on, and the role of limited versus reasonable assurance with respect to cost and usefulness for investors as the intended audience. Further guidance from the government is crucial as the existing frameworks and current capacity of potential providers of assurance in these areas are still developing.¹⁰

Question 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?

The PRI welcomes BEIS' proposal to adopt the Brydon Review's purpose of audit as a broad ambition for its own programme of reforms, and to ask the new regulator to incorporate that ambition across the relevant parts of its work, consistent with its statutory objectives.¹¹ We also agree that it should be non-binding to allow for the evolution of the concept and the mechanisms for effective implementation.

The proposed new purpose is valuable to clarify the results that are expected from the audit process. For example, while investors may expect that audited reports and accounts include assurance on the effectiveness of internal controls, detection of fraud, and the future viability of the business - and

⁹ The ICAEW's [Developing a meaningful Audit and Assurance Policy: A policy for progress](#), March 2021

¹⁰ OECD Business and Finance Outlook 2020, Sustainable and Resilient Finance, 3 [Corporate governance and the management of ESG risks](#)

¹¹ The Proposed new 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." [Restoring trust in audit and corporate governance](#) document, July 2021

indeed these aspects are considered by auditors in forming their opinion on the truth and fairness of the financial statements - there is no statutory requirement for them to provide assurance on these.

7 AUDIT COMMITTEE OVERSIGHT AND ENGAGEMENT WITH SHAREHOLDERS

Question 58: Do you agree with the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning? Are there further practical issues connected with the implementation of these proposals which should be considered?

The PRI supports proposals to allow shareholders greater opportunity to engage with risk and audit planning, but note that this should not serve as a substitute for shareholder voting on the appointment of competent and skilled boards of directors and audit committees as the primary mechanism by which to influence audit quality. Audit must function effectively irrespective of shareholders' opportunity to suggest areas of focus as proposed.

11 ADDITIONAL CHANGES IN THE REGULATOR'S ACTIVITIES

On Whistleblowing (general comments from the PRI)

We support recommendations from the Brydon review both that workers should have legal protection for whistleblowing disclosures made to audit firms and audit partners, and that whistleblowing protections extend to anyone with a direct economic relationship to the audited entity, which should include shareholders, suppliers, customers, and other creditors.

PRI's report on investor-company engagement on whistleblowing¹² demonstrates that robust commitments and policies respect confidentiality and anonymity, offer protection against non-retaliation, and ensure a transparent and independent investigation process, including providing follow-up and feedback to the employees who raise concerns. These elements should be included for employees and other relevant parties.

The PRI recognises that making whistleblowing disclosures to audit firms will require auditors to have more resources, however we consider that this is well aligned with the intention of the present review to build more credibility in the auditing processes and the proposal for auditors to consider wider information in their assessments.

The PRI's report also highlights that robust whistleblowing systems should enable employees to raise concerns, even when bound by a non-disclosure agreement, loyalty or confidentiality clause. The report also shows that establishing legal protections for whistleblowers is critical to encourage employees, customers and suppliers to speak up and many companies only seek to make a reporting channel feasible when they have a legal requirement to do so.

Therefore, the perceived risks on the potential disclosure of commercially confidential information should not be considered a barrier to enabling whistleblowing disclosures to be made to audit firms.

¹² PRI [Whistleblowing: Why and How to Engage with your Investee Companies](#), December 2020

The EU Whistleblowing Directive¹³, for example, clarifies that such clauses and agreements will be void if it is necessary to provide confidential information to reveal a breach, and we recommend the UK government consider such provisions when reviewing the whistleblowing framework.

As noted by the government, expanding the scope protections from employees to other parties with an economic relationship to the audited entity will require adjustments to the existing whistleblowing framework and welcome the government's intention to review the whistleblowing framework in due course. We encourage that the review is conducted in a timely manner to encourage whistleblowing reporting, also taking into consideration that such reports enable companies to better mitigate the risks associated with unethical or illegal conduct which, if left unchallenged, can lead to significant corporate failures and loss of value.

The PRI has experience of public policy on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of BEIS to improve trust in audit and corporate governance in the UK.

Question or comments related to this response can also be sent to policy@unpri.org.

¹³ [The European Union's Whistleblowing Directive](#), October 2019