RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

BDO CONSULTATION RESPONSE

JULY 2021

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EXECUTIVE SUMMARY

BDO welcomes the opportunity to comment on the government's white paper, 'Restoring trust in audit and corporate governance', issued on 17th March 2021.

Reliable corporate reporting is vital to well-functioning financial markets, safeguarding investors, stakeholders and the general public from the damaging implications of corporate mismanagement. Risk capital is an inherent component of a capital market and hence corporate failure can and will happen, but it should never come as a surprise. Following a number of high-profile corporate failures in the UK and the findings of the Kingman, Brydon and CMA reviews, we wholeheartedly support the government's proactive market intervention intended to restore trust in audit and corporate governance.

This consultation provides an unprecedented opportunity for UK plc to enhance its position as a world-class destination for investors; with directors, Audit Committees, audit firms, shareholders and the regulator all having an important part to play. The holistic package of proposed reforms will require significant investment to be made by companies and audit firms, but inevitable growing pains identified through this consultation process should not deter the government in its pursuit of meaningful change. Previous attempts at incremental reform have not resolved the long-standing corporate governance issues in the UK – robust action is now required.

For these proposals to be successful in their objectives while avoiding unintended consequences, pragmatic prioritisation and swift but responsible pace of change is necessary. In our consultation response, we have aimed to set out where we perceive the biggest challenges lie and where particular thought must be given to the timing of implementation.

BDO is the largest audit firm outside of the Big Four, with a gross revenue in the UK of £660m. Our independent and sustainable audit practice generates £247m revenue, and employs more than 2,000 auditors, which is double the size of the next largest Challenger firm. Over the last few years, BDO has evolved from being the number one auditor to AIM listed businesses to the number one auditor to FTSE premium list companies outside of the FTSE 350. We intend to continue to build skills and capacity, enabling us to deliver an increasing number of high-quality, complex listed audits in addition to the 18 FTSE 250 companies that we presently audit.

BDO will work with the market interventions that the government proposes, which, as by far the largest Challenger firm, will be important to its success. However, we will be discerning and will not extend into areas where we do not have the capacity or capability to deliver to the highest quality. In implementing these proposed reforms - particularly those which relate to managed shared audits (MSAs), internal controls, and a new strengthened regulator - the government must give particular thought to the number of skilled people it will take to deliver these reforms and be realistic about the existing capacity in the market.

Although many of the proposals in the white paper remain in the early stages of design, BDO is broadly supportive of the direction and balance of the recommended reforms. We have provided responses to many of the specific questions set out in the consultation but wish to emphasise the following key themes, which we believe will be vital to the success of the proposed market reforms.

1. ALL ACTORS SHOULD APPEAR ON THE STAGE, WITH ONE SCRIPT

These proposals are far more extensive than reform of the audit market and require all those involved in the stewardship or governance of the entity and the preparation of financial statements to appear on the stage, taking accountability for their respective roles.

Audit firms, companies, Audit Committees, shareholders and the regulator will all play an integral part in driving and supporting meaningful change. In many instances, short-term, individual self-interest will need to be set aside in order to enhance the resilience of the system as a whole.

To ensure the effectiveness of this entire package of corporate governance reforms and to avoid asymmetry of regulation, the government should avoid disproportionately diluting its proposals in respect of any one stakeholder group. A clear vision and legislative timetable is now required to drive momentum.

2. THE MARKET NEEDS A SINGLE, SIMPLIFIED DEFINITION OF PUBLIC INTEREST

This consultation focuses on reforming audit and corporate governance in relation to Public Interest Entities ("PIEs"). Following a number of high-profile corporate failures, we support a broad definition of public interest which protects a diverse group of stakeholders unjustly impacted in cases of corporate collapse. Where public interest was previously determined predominantly by market capitalisation, we support a move to identify other criteria that are more indicative of when a corporate failure will impact large numbers of employees, pension holders, public services and those within a company's supply chain. As well as supporting the introduction of large privately-owned companies into the definition of PIE, we also propose revisiting the role that market capitalisation plays in determining public interest. Whatever reforms are implemented, the government should look to ensure the prescriptive and burdensome requirements designed for the largest enterprises do not stifle high-growth entrepreneurial companies which may otherwise be deterred from listing on the UK's AIM market.

3. MARKET CAPS ARE OUR PREFERRED OPTION FOR PROMOTING CHOICE, COMPETITION AND RESILIENCE

As outlined in our response to the CMA's Market Study in 2019, BDO supports positive market intervention to increase choice and resilience in the FTSE 350 audit market. The impact of proposed intervention in this area has already translated to increased demand from Audit Committees to consider the appointment of Challenger firms. Between January 2020 and May 2021, 14 FTSE 250 companies changed audit firms because of mandatory tendering requirements, and of those, seven Audit Committees chose to appoint a Challenger firm. This is in comparison to 2018, prior to any reform proposals, where 13 new auditor appointments were made in the FTSE 250, and all were awarded to Big Four firms.

To create longer-term resilience in the FTSE 350 market, where notably all FTSE 100 audits are undertaken by the Big Four, we see some merit in Managed Shared Audits. Managed Shared Audits provide a vehicle for Audit Committees at the largest listed companies to engage with Challenger firms and for those firms to build confidence and the required skillset to deliver high quality PIE audits.

However, we foresee two fundamental challenges to the success of Managed Shared Audits (MSAs). The first is existing capacity in the market, and the number of audit firms and auditors that will be required to deliver these audits. We encourage the government to consider whether enough capacity for MSAs to represent a viable intervention. Secondly, the nature of MSA will also have the effect of creating a two-tier audit profession, with distinct primary (Big Four) and secondary (Challenger) divisions. This raises the question of whether MSAs will give confidence to Audit Committees to appoint Challenger firms to the UK's largest audits, and whether those firms will be in a position to build the necessary skills and capacity in the course of their engagement as secondary auditor to deliver the primary audit.

Within the MSA proposal, the Challenger exemption is fundamental to supporting Challenger firms to step up into the role of sole auditor when they have built the requisite skills and capacity to do so. BDO will support MSA if it is the market intervention which is chosen by the government, however our well-established view is that long-term resilience relies on increasing numbers of audit firms operating as sole auditors in the FTSE 350. In our view, the best method for achieving this is the introduction of market caps. We acknowledge that market cap is the most interventionist remedy, but in the context of the original CMA objectives we believe it is the only one that will achieve meaningful change in a desirable timeframe.

4. WE ADVOCATE EFFORTS TO MODERNISE CORPORATE REPORTING

In restoring trust in audit and corporate governance, we cannot overlook the importance of developing a new model of corporate reporting which serves the needs of all users and not just financial experts. Cited in our response are many cases where the complexity or ambiguity of the current corporate regime impedes the ability of shareholders and broader stakeholders to understand the key risks faced by a business. This is an opportunity for UK plc to reflect upon the role of the annual report, financial statements and presentations made to shareholders and ensure they are fit for the future.

BDO is supportive of the introduction of the Resilience Statement to address the limitations of the binary nature of going concern reporting and ineffectiveness of the viability statement. This will also serve to contextualise the role of the auditor, particularly in relation to corporate fraud. In addition, we support measures including the annual publication of the Audit and Assurance Policy and a solvency-based approach to the distribution of capital maintenance.

CONSULTATION QUESTIONS & ANSWERS

SECTION 1: PIES

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

Yes.

The consultation states that the UK's current PIE definition is too narrowly drawn and excludes entities whose audit arrangements are a matter of public interest. We agree, and recognise that the businesses that influence and impact public confidence are not simply those which are publicly traded.

In our view, the primacy of capital at the dominant determining factor in measuring 'public interest' is outmoded. There is an increasing need to recognise the interests of broader groups of stakeholders, including employees, pension schemes and public services. Where the failure of a company unduly impacts a diverse group of stakeholders, they should fall within the scope of PIE. This will inevitably encompass a number of large, privately owned companies.

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

We are supportive of company size being used as an appropriate proxy for public interest, considering the balance sheet and number of employees. In our view, Option 1, which identifies companies with a larger number of employees and is broadly aligned to the Wates corporate governance principles as well as the Other Entity of Public Interest (OEPI) definition, is the most suitable PIE definition.

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

BDO supports the use of Option 1 as a single and simplified definition of public interest in the UK.

We are not of the view that a public listing, on its own or even at all, equates to being of public interest. Within the AIM market there are a number of successful, entrepreneurial businesses whose failure would not materially impact a broad stakeholder group or the UK economy - we therefore would not consider it appropriate to extend the definition of PIE to encompass those businesses.

The AIM market is the most likely market to suffer from the unintended consequences of higher regulation, including the risk of deterring high-growth businesses from listing in the UK. AIM companies with a market capitalisation of more than EUR 200m currently fall within the OEPI definition and are subject to additional corporate governance provisions. In line with the prioritisation of public interest over the primacy of capital, we would remove market capitalisation as a test for public interest. Irrespective of a company's ownership structure, we propose a single PIE definition across all companies, and our preference is Option 1.

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 deem it appropriate to extend a temporary exemption to newly listed companies. In order to ensure that the new requirements do not act as a deterrent for companies looking to list, we propose that an appropriate timeframe is applied to all relevant proposals in this consultation so that the UK retains its reputation as a gold standard investment market without deterring new participants.

5. 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?

In our view, undertakings with an obvious 'public interest' which are not currently included as PIEs - such as large private sector pension schemes, large charities, and large fund managers – should be considered in scope where they meet the appropriate criteria as set out in question two.

However, while our preferred approach to defining PIEs centres around a single and universally applied definition, we recognise that there are nuances within certain regulated sectors, such as charities that ought to be considered to ensure any intervention is appropriate, balanced and proportionate. Within the charities sector, the government must consider the role of the Charity Commission, the existing regulation in place and the scope of trustees.

6. 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 right?

As per question one, we believe broader metrics including employee numbers should be applied when determining whether an entity is brought into scope. This is a more appropriate proxy for public interest than capital.

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

Over the last few years, the number of audit firms operating in the PIE market has slowly increased. However, the cost of being a regulated audit firm is significant, requiring dedicated resource which would make it economically and/or operationally unattractive for audit firms to deliver just a small number of PIE audits.

If the government's intention is to introduce those firms not currently operating within the PIE audit market, it will need to ensure that undertaking PIE audits is an attractive proposition. As well as ensuring that the market is truly open to those bidding for work, smaller firms must be offered seat at the Audit Committee table and fair share of fees. The costs and reputational risks of operating as a PIE auditor ought to be considered so that they are not unjustly burdensome and have the effect of discouraging high-quality participants from operating in this market.

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

Yes.

We are broadly supportive of the government's proposals and would not want to see BEIS' ambitious plans curtailed because of limitations on what companies are able to implement immediately. Prioritisation and the adoption of an appropriate timetable will be fundamental to the success of these reforms.

The government's Impact Assessment estimates that Option 1 (BDO's preferred option) will bring 2,066 new companies into the scope of the PIE definition. For these companies to be able to prepare, an appropriate pace of change will be vital for companies and audit firms to build the requisite capability and capacity.

The government's consultation is wide ranging and reforms such as the proposed internal controls regimes will place significant demand on the market for experienced company directors as well as audit and assurance professionals, of which there are a finite number. Time is needed for PIE companies and their audit and assurance firms to adapt and prioritise audit quality. As per Question 11, phasing may be helpful, introducing corporate governance requirements first to the largest UK companies and those which have the greatest impact on public interest.

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

As set out in Question 10, the new PIE definition will bring a number of entities into scope, requiring a large investment by those companies in order to achieve the necessary levels of corporate governance. As already identified throughout the consultation paper, there will be some companies, such as those within the FTSE 100, which are well-placed to adopt the reform proposals, while others will have further to go. We support a phased approach, with many of the reforms seeing early adoption by the UK's largest businesses phasing down through the market to ensure proportionality.

SECTION 2: DIRECTORS ACCOUNTABILITY FOR INTERNAL CONTROLS, DIVIDENDS AND CAPITAL MAINTENANCE

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?

Yes.

It is in the public interest that companies are well-governed and controlled and we welcome a strengthened internal control regime taking into account lessons from the US, particularly over the last twenty years. Improving the control framework in the UK will led better managed companies through increased investment in their internal controls and corporate governance. It will also have the impact of making company directors accountable to the effectiveness of their control framework.

However, there are some disadvantages to consider, including increased bureaucracy, and the requirement of a significant cost investment by PIE entities, which may in turn impact the overall attractiveness of listing in the UK. The US initially saw a number of companies move away from using their capital markets following the introduction of Sarbanes-Oxley.

Any proposed regime needs to be proportionate and reflective of the existing control framework in the UK. There is insufficient detail in the consultation as it stands to comment on the specific implementation and effectiveness of these regimes, but providing there is proportionality and compatibility with similar overseas regimes so as to not duplicate effort and an appropriate cost benefit for companies, we are broadly supportive of the principles behind reform options A and C.

Any of the proposed options present a big step for UK corporate governance but both the pace of change and phasing will be key. There will be an increased demand for internal risk professionals within companies, audit firms and the wider market will need time to build capacity.

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

We are strongly supportive of an internal controls regime where improved quality is driven through the accountability of directors. It is worth noting that, in the context of the US system, robustness and consistency have been driven through the third party attestation. Without this, the outcome of this remedy is likely to fall shy of the government's intentions.

There is an inherent risk with making third party attestation optional, which is that poorly managed companies with the greatest need for proper internal control are perhaps the most likely to choose not to have assurance over their controls framework. If we see the future corporate failure of a PIE who has chosen to opt out of auditor attestation, this will no doubt lead to negative ramifications for the government and UK capital markets.

We are strongly against Option B, which seeks to address issues through an extended role played by the external auditor. This consultation in part seeks to better define the scope of audit and there is an inherent risk with the adoption of option B that its effect is to increase, rather than resolve, the issue of the expectation gap over the audit profession.

We accept that in order to ensure the market is able to respond to proposed regulation, the government should commence with its preferred option, moving in time to full attestation, or that a

phased approach is taken starting with the UK's largest companies. In our view, consistency is important and all companies should adopt the same framework.

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

We support the government's preferred approach to apply the internal control provisions first to premium listed companies and then to all other PIEs following a two-year period.

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?

These proposals focus on the accurate measurement of an accounting balance, distracting management and investors from what should really be driving dividends, which is liquidity and solvency within an overall context of capital adequacy. The proposed intervention is not a good measure for determining whether paying a dividend is in the interests of the company and stakeholders. In light of the shortcomings of the existing regime, BDO supports moving to a solvency-based regime with director attestation, similar to the principles for the reduction of share capital within s642 of the Companies Act 2006.

Any capital adequacy regime should ensure that the dividend does not place undue stress on working capital and attestation should apply to a companies' dividend policy as well as individual decisions made by management.

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 public interest requires that information relating to the legality and affordability of paying dividends is available in a company's annual report. In line with the public interest sentiment of the consultation, this should be a requirement for all PIEs. Through the nature of paying dividends to shareholders at the expense of - or increasing the risk to - other stakeholders, all PIEs should be required to give formal consideration to their dividend policy, irrespective of ownership structure. Any focus should be placed on the affordability against future solvency and the policy rather than just an individual dividend allocation.

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

Yes, and to all PIEs

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?

As to the first part, no.

While the focus of s172(1) and related disclosures may have helped some boards discharge their duties, the quality and depth of the information provided by companies varies greatly. Indeed some companies disclose little if any information.

In the absence of a new corporate reporting requirement, it is unlikely that there will be the required level of transparency for stakeholders from the board in the section 172(1) statement. So as to the second party, a strong yes.

SECTION 3: NEW CORPORATE REPORTING

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?

Recent corporate failures and a lack of signposting have led to the requirement of a Resilience Statement within a company's annual report. BDO is supportive of the introduction of the Resilience Statement to address the limitations of the binary nature of going concern reporting and ineffectiveness of the viability statement. It will also help to contextualise the role of the auditor, particularly in relation to corporate fraud.

Users of the financial statements need a clear understanding of the risks that companies face and how these could translate into threats to the financial resilience of the business, as well as how mitigating actions within management controls could be used to soften those impacts. The Resilience Statement should start with this objective in mind to give users greater visibility over the health of the business to responsibly manage future challenges.

Users must be informed in order to make intelligent decisions in relation to emerging risks. This includes detail around the short-term availability of working capital to meet debt covenants, through to longer-term challenges about the viability of the business model. For stakeholders to understand the extent of the resilience, the statement must also consider black swan type events such as Covid-19 and the ability of the business to absorb those shocks.

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

The Resilience Statement should not become the vehicle in the annual report for all TCFD disclosures.

To the extent that TCFD is a material risk to a company's business model, it should of course appear in the Resilience Statement. However, in the absence of climate change representing a material threat to the resilience of a business, there should be no requirement for its mandatory inclusion.

Where further disclosures need to be made by companies in relation to TCFD, we believe that they should fall outside 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?

All companies that meet the PIE criteria should be expected to report on their resilience and we can identify no reason to scope out recently listed companies. For those companies which are not premium listed, we are supportive of phased implementation.

This information is important for both the investors and users of the financial statements it should be applied to all PIEs including large, privately owned companies.

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?

Yes.

The purpose of Audit and Assurance policy is to clarify which elements of the Annual Report have been subject to audit and other levels of assurance. Many users of the annual report do not understand the different forms of assurance as it stands and we support the requirement for further clarity and guidance to be given within the Audit and Assurance policy to avoid misunderstanding.

In addition to the Audit and Assurance policy, proposed reforms should focus on how to incentivise shareholders to engage with the content of the policy before it is subject to a vote.

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?

Yes, and annually. We acknowledge that this will place an additional burden, but nevertheless, if we are to increase engagement then this mechanism is necessary.

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?

We agree with Brydon's proposal that shareholders and broader stakeholders should be aware of how a company's activities are impacting matters of public interest. However, we support BEIS' recommendation not to introduce a statutory requirement at this time. It is important that any statement made by a director does not create duplication with other existing company reporting or become boilerplate. More clarification is needed to ensure a consistent, robust and meaningful approach is taken and we do not believe we have this at this time.

SECTION 4: SUPERVISION OF CORPORATE REPORTING

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

We are supportive of the corporate reporting review regime (CRR) and agree with the proposals set out in the consultation to extend CRR to preliminary results and investor presentations. We propose that the speed at which CRR is undertaken ought to be accelerated to be effective. We also welcome the extension of supervision by the regulator over the whole annual report document.

In relation to pre-clearance, we accept there are a number of difficulties with implementation, including the necessary legal considerations. However, we support the principle that a regulatory environment should allow participants to gain comfort that they are doing the right thing in circumstances where there is doubt over this. Leaving regulator opinion to post application regulatory inspection is insufficient. This is particularly the case in the current and recent commercial environment where financial innovation is a given.

In relation to novel or unusual transactions, or an area of accounting where it is thought that there are divergences in practice, active engagement with the accounting community and pre issuance clearance gives the regulator the opportunity to have early visibility and allows the preparer to develop an accounting policy that the regulator is comfortable with. We are supportive to this approach, which provides the regulator with foresight and gives confidence to the preparer on the basis of the engagement with the regulator.

SECTION 5: COMPANY DIRECTORS

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

BDO agrees the regulator must have the explicit power to take action against directors who knowingly or recklessly make statements to auditors that are misleading, false or deceptive.

We are supportive of the government's approach including to extend the regulators including enforcement powers over directors who are not accountants, although there is insufficient detail at present to comment further on e.g. timescales, sanctions and appeals procedures.

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?

Yes and yes.

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

Yes.

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 are supportive of the government's proposals in relation to malus and clawback.

SECTION 6: AUDIT PURPOSE AND SCOPE

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?

We agree there is a need to provide further clarity over the role of auditors and that this is not only fundamental for the audit profession but is also important to broader stakeholders to remedy any expectation or delivery gaps which have emerged over time.

Where the consideration of wider information is brought into the scope of external audit, ARGA must produce a clear and specific framework and set of standards which will be supported by the regulator's supervision role and where necessary subsequent enforcement.

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 are supportive of the evolution of the scope of audit to consider broader information. However, we are unclear as to what broader information will mean over and above the requirements of existing auditing standards such as ISA 720, 315 and the Ethical Code.

It is against the interests of all stakeholders if auditors are challenged in hindsight as to the wider information that they should have considered through the scope of an audit. With the current level of detail provided, there would be too much speculation as to the meaning of wider information in the context of an 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?

Yes, providing there is the relevant framework with a set of standards and enforcement available and there should be consistent regulation irrespective of who is performing these services.

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?

Yes. As above, with a requirement for a framework, standards, supervision and enforcement.

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

First, the role is too wide. If ARGA takes on the roles of setting, supervising and enforcing standards, we will be faced with an inherent conflict of interest. Thought should be given to having appropriate checks and balances in place to ensure ARGA does not become judge, jury and executioner. We have previously recommended in our response to Kingman that standard setting is separated.

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

We do not believe that a new corporate audit profession ought to be a priority for ARGA at this time. Instead, we suggest that time should be given following the enactment of proposed regulatory and legislative changes such as the introduction of MSAs and reformed internal controls regime to assess their effectiveness. ARGA may revisit the need for a corporate audit profession should these reforms not have their desired impact.

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?

This is a significant undertaking and we do not believe that defining a new corporate audit profession should be a priority for AGRA. It is important to attract the right individuals and firms to play a role as PIE auditors, and this could easily act as a deterrent.

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.

Yes. We agree with the Brydon Review that the responsibilities of auditors in relation to fraud are some of the most complex and misunderstood. Greater clarity around the role of auditors and directors is needed.

These proposals should focus on material, often management-driven fraud, which is separate from small or even trivial operating fraud. Auditors should present plans to the Audit Committee that include the principal types of management fraud they have identified as being relevant and the procedures they intend to execute in order to mitigate these fraud risks.

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

The consultation proposals around an auditor's duty to consider wider information are high level, making it difficult to provide a detailed answer in relation to this question.

Although we are supportive of the principles behind Brydon's recommendations, there are risks associated with the government's proposed approach, where auditors are expected to give consideration to factors which fall outside of the existing accounting or auditing standards. There is a real risk that without an appropriate level of specificity, hindsight could be used against the profession and auditors are held to standards which they are unable to meet - this may lead to an increased expectation gap in relation to the scope of audit.

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

This subject needs proper detailed guidance based on a full consultation process. It is increasingly rare for any form of true and fair overrides to the standards to be utilised. Increasingly, accounting standards are written for the purposes of full compliance rather than with overrides in mind. Adopting an approach which falls outside of the accounting standards creates risk and exposure for both preparers and auditors.

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?

Yes, and there should be a clear standard on this.

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?

There has been a strong resistance from directors and audit firms have not held a consistent line. The resistance from directors does relate to fiduciary duties.

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 encourage auditor reports to be more informative, bespoke and, at times, more opinionated. If they are to be more opinionated, there must be safe harbour provisions to give comfort to auditors that express opinions which are not entirely supported by factual evidence.

There is a lack of appetite from auditors to go beyond auditing standards which brings about inherent risk and exposes this work to third party liability.

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.

We do not consider that this should be a priority for ARGA, and have not yet seen any evidence which suggests that a new professional body would drive audit quality. We would instead like to see ARGA focus on the successful enactment and implementation of other reforms in this consultation before taking steps to create a professional body for corporate audit.

SECTION 7: AUDIT COMMITTEE OVERSIGHT AND ENGAGEMENT WITH SHAREHOLDERS

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?

Yes

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?

It would be inappropriate and unnecessary for the regulator to conduct periodic reviews of most Audit Committees in a way that equates to the approach applied to audit firms. However, if there is a basis for concern within ARGA that an individual Audit Committee is not fulfilling its duties, we support ARGA having this power but believe it should be held in reserve for extraordinary cases.

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

In all but extraordinary circumstances, the appointment of an auditor should be undertaken by the Audit Committee. Where Audit Committees are struggling to make such an appointment, it is likely to be because of poor corporate governance and the subsequent reputational impact to an audit firm by taking on the entity in question. We believe the regulator should look first to those companies to address governance issues before appointing a new audit firm to carry the burden. If one of the objectives of the consultation is to create a larger pool of PIE audit firms, the government must consider the attractiveness of the profession, including the expectation on audit firms to carry such risk.

However, it is an important part of the capital markets function that all companies have an auditor, so in extreme circumstances, it should be within the regulator's power to appoint an audit firm to prevent a capital market failure. This appointment should be made with the expectation that the appointed audit firm will qualify and modify their audit report if not satisfactory and the FRC should look to mitigate the risk of reputational damage and significant repercussions for an audit firm in relation to these audits.

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

This power should only be used in extraordinary circumstances where a company is unable to identify a suitable auditor.

It will require ARGA to work with the incoming auditor to ensure there is a full understanding by all parties of the specific issues and risks. If the audit is subsequently reviewed by the AQR then the grade and findings should be separately identified as resulting from an audit where the appointment was made by ARGA.

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?

Given this power is only to be used in extraordinary circumstances, there does not need to be any specific revisions or amendments to the normal regulatory oversight regime. However, we would like to see the separate identification in AQR reports of the findings and grades relating to an ARGA appointment.

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

This is for disclosure in the Audit Committee report where the company should explain why the issue occurred, what steps and challenges they faced in remedying the situation, and how they are satisfied they have now appointed an appropriate auditor that can deliver a robust audit in line with stakeholder expectations.

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?

Yes. Increased engagement with shareholders around the scope of an audit is undoubtedly beneficial. However, it is important in considering this question that a distinction is made between large institutional investors and individuals.

We are concerned that historically, shareholders have not been eager to engage with the company and incentives may need to be considered to drive engagement. The distinction between large intuitional investors and individuals should be made to ensure that any amendments to the Audit and assurance policy as a result of shareholder engagement focus on key risks. This should not allow individuals with a personal agenda to influence the company's audit and assurance policy, distracting from the real risks to the resilience of the business.

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?

Yes, however, the Covid-19 pandemic has clearly demonstrated that AGMs can work remotely, and consideration to the format of the AGM should be given to ensure that any proposal is not outdated.

We note that in other markets, such as in the Netherlands, that there is already greater participation at the AGM. We should look for lessons that could be learned from other markets to support this objective.

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

The existing resignation letters are often very carefully worded and debated with the company with a requirement to be factually correct and not based on opinions. However, shareholders want a full understanding of auditor departure. This will include opinion and therefore, as outlined above, there must be safe harbour provisions for auditors that make opinionated statements.

SECTION 8: COMPETITION, CHOICE AND RESILIENCE IN THE AUDIT MARKET

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

The 'meaningful proportion' definition ought to be flexible, however, we propose that there is a minimum level of no less than 20%. If this remedy is to reach its objective of creating resilience in the market, this level should increase over time so that Challenger firms are able to build capacity and experience to take on the role of primary auditor. There will need to be a transition phase, particularly for audits of the UK's largest listed companies to ensure that audit quality is not compromised because of the introduction of MSAs.

In order to support the long-term objective of increasing players in the FTSE 250 and FTSE 100 market, there does need to be a transition plan which supports Challenger firms in getting to a point where meaningful proportion is significant enough to give confidence to audit firms and Audit Committees that Challenger firms can deliver high quality primary or sole audits. Innovative solutions may be sought such as allowing the secondary/Challenger auditor to become the primary auditor at the time of mandatory rotation.

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?

BDO supports positive intervention to increase competition and resilience within the FTSE 350 audit market, and will play its part in MSA should the government decide that this is the best remedy available.

MARKET CAPS

In our consultation response to the CMA's Statutory Audit Market Study, BDO cited market caps as the most effective remedy to increase audit quality by creating competition and resilience in the FTSE 350 market.

While we prefer MSAs to the previous Joint Audit proposals, we are mindful that they will not, on their own, resolve issues of competition and resilience, and this proposal presents a number of complex challenges.

Much of the market commentary around competition and resilience bifurcates the UK audit market into two branches; the Big Four and Challenger firms with the assumption that at present, only the Big Four have the experience and capacity to deliver large, FTSE audits.

However, BDO currently audits 18 FTSE 250 companies and has built experience and capacity through the AIM and FTSE main market outside of the FTSE 350, where we are now number one auditor. In the past 24 months, the appointment of Challenger firms has increased, with BDO, Mazars and RSM being appointed as sole auditor in 50% of auditor firm changes in the FTSE 250. We consider that this existing market momentum, brought about in anticipation of proactive intervention by the regulator, would best be cemented through the introduction of market caps.

MANAGED SHARED AUDIT

There is increasing commentary in the market that the introduction of two firms participating in a group audit presents a risk to UK capital markets. Although MSAs will be new to the UK audit market, component audits are already tried and tested under ISA600 - BDO participates in a number of these.

The success of MSAs in the UK relies on capacity in the audit market and enough Challenger firms deeming the role of PIE auditor as well as secondary PIE auditor to be an attractive proposition. We are conscious that experienced PIE auditors are a finite resource and that the introduction of any of the proposed internal controls regimes as well as the ambitious growth plans for the regulator in this consultation will place heightened demand on this already limited pool of resource.

We are also concerned that MSAs have not been tested as a viable regime for auditing listed companies, and to do so in the UK's capital markets represents a risk which could impact the attractiveness of the FTSE market. We are aware that others suggest a pilot study, but our view is that whilst this will reduce risk, it will significantly slow momentum and impede meaningful change, particularly if it is eventually deemed that MSAs are not practical or effective.

For MSAs to be attractive to Challenger firms, they must be clearly defined, consist of a meaningful percentage of the audit fee, and provide a seat at the table with the Audit Committee. The regulator should also seek transparency from Audit Committees, requiring them to outline how they have undertaken and implemented MSAs. Audit Committees should be required to invest time with Challenger firms to understand their capability and capacity to eventually deliver the primary audit. These requirements will not only be fundamental to the attractiveness of an audit, but also to achieve the highest levels of audit quality in the future.

With the government's aim to increase competition and resilience in the FTSE 350, our view is that the Challenger exemption within this proposal is fundamental to promoting short to medium term resilience in the market by incentivising audit firms and committees to take on a share of FTSE 350 sole audits where they have the capacity and capability to do so. One of the clear issues with the MSA remedy is that it creates a two-tier audit market, with the Big Four taking on the primary auditor role, and smaller firms acting as component auditor. A primary concern of the CMA in its study was in the case of a Big Four firm exiting the market, there would not be enough skilled and capable auditors in the market to deliver the required number of high-quality audits. We are not convinced that the creation of a two-track audit market will mitigate this concern.

If they have the capacity, skill and experience to do so, it is important that Challenger firms are appointed as primary or sole auditors in order to create real competition and resilience in the market. Without this exemption, we consider that the attractiveness of the remedy is reduced for the larger Challenger firms and the likelihood that the government will need to fall back on market share caps is inevitable.

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?

BDO supports the government's proposed market intervention to increase competition and resilience in the market through an MSA regime if that is its preferred option. However, as set out in Question 62, whilst MSAs will increase the number of players operating in the FTSE 350 market, it is in the context of primary (Big Four) and secondary (Challenger firm) audits. This model emphasises a two tier audit market and should therefore be a vehicle for initial change rather than a comprehensive answer to increasing competition and resilience.

BDO has long advocated for managed market caps as a powerful intervention and the only way to ensure a truly resilient market. This is the most interventionist option and will require monitoring and safeguards. However, the introduction of market share caps would directly introduce new entrants into the FTSE 350 in the role of sole or primary auditor within a relatively quick timeframe, increasing resilience, competition and, fundamentally, supporting audit quality from the outset.

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?

While not a requirement for non-Big Four firms, BDO is voluntarily adopting some of the best practice operational separation proposals as set out by the government. We will monitor how this works in practice but are generally supportive of operational separation as a method to increase independence and professional scepticism.

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?

In relation to this question, we would like the government to be more transparent around the issue it is trying to resolve so that we are able to respond as to its effectiveness.

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?

Any future split profit pool arrangement would need to be made over an extended period of time recognising the need to invest and without discouraging investment across the firm. Provisions must also be made to account for unexpected costs, acknowledging that audit has the support of the wider 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?

We perceive that the issues referred to in this section of the document are primarily targeting the Big Four accounting firms.

We have previously stated that we do not support a full structural split and remain of this view. Aside from the significant additional costs/loss of cost-saving synergies, we do not believe it would improve quality but would instead make audit firms less resilient.

Auditors draw upon the expertise of other specialists across the firm to deliver comprehensive audits as well as when considering investment and innovation for the future. We need the weight of the whole firm to support significant investment in areas such as audit technology and in some cases this innovation drive derives from the non-audit parts of the business. Full legal separation will also cause unnecessary complexity for UK firms which are part of international networks.

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?

In order to take forward the issue of lack of resilience in the audit market, the regulator could look at non-financial enforcement options as part of this remedy.

SECTION 9: SUPERVISION OF AUDIT QUALITY

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

We do not consider this to be a major issue.

In relation to the registration of firms, we do not perceive that there are sufficient issues with the current regime to warrant immediate reform and are concerned that to do so would result in unnecessary duplication.

In relation to individual PIE auditor registration, we believe that it should be left to audit firms to decide who has the necessary expertise to deliver PIE audits rather than introducing a formal PIE auditor registration process which may act as a deterrent.

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

Clearly, it is not beneficial to disclose commercially prejudicial information and we understand the current stance of excluding sensitive information from AQR reporting. However, the impact of AQR reporting is extensive, and misinterpretation can cause alarm among shareholders which may translate in a fall in share price. This should also be avoided.

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?

AQR reports must be fully understood by readers in order to avoid misinterpretation which can carry unwarranted implications for audit firms, particularly in relation to reputational risk. There is an inherent issue with the redaction of sensitive information, if it introduces complexity or ambiguity for the reader.

Within the US system, company level information is only given after an audit cycle has been completed and the issues have been remedied. This reduces the risk of inefficient capital markets.

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

No. We propose that it should be for regulators to utilise a Memorandum of Understanding in cases where information needs to be shared cross border, rather than leaving this to the audit firms to facilitate and organise, which will only lead to inconsistent outcomes.

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?

Further information being sought in relation to this question.

SECTION 10: A STRENGTHENED REGULATOR

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

Yes

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?

Yes, we support these regulatory principles. It is important that ARGA has at its core that it is an improvement regulator and it's able to fulfil this role of improvement.

SECTION 11: ADDITIONAL CHANGES IN THE REGULATOR'S RESPONSIBILITIES

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?

Yes and yes

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

Yes, the regulator's enforcement powers should initially be restricted to members of professional accountancy bodies. Should they find cause, we support the regulator revisiting this in time but we do not currently see a clear enforcement gap in respect of other accountants.

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

The profession generally relies upon the ISEBA Code of Ethics and, to introduce another code of ethics would add unnecessary complexity. We do not believe this is an issue that requires any immediate resolution through the course of these consultation reforms.

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?

Reporting to the regulator should focus on the core issues of the resilience and viability, material and management fraud, qualified opinions due to disagreement, limitations of scope and reasons for resignation. There should also be more comprehensive reporting on resignations out of the ordinary cycle of mandatory retendering.

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?

Yes and yes

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

Two days. It depends on the nature and context however in most situations a rapid response within 48 hours would be beneficial in fast moving situations.

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

In most cases, issues arising should be resolved through informal proceedings, however as a fallback position there should be the ability to publish where it is in the public interest.

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

In exceptional cases, we support the power to recommend removing or replacement of individuals.

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