



# Restoring trust in audit and corporate governance

Formative views on the  
Government's consultation

June 2021





## Foreword

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EY welcomes the Government's publication *Restoring trust in audit and corporate governance: consultation on the government's proposals, March 2021* (Consultation). It embraces what we have long advocated: the need for a holistic set of reforms to the business ecosystem (i.e., corporate governance, reporting and auditing).

We regard it as one of the most eagerly anticipated initiatives by the Department for Business Energy and Industrial Strategy (BEIS) in recent years, and given its importance we are pleased to review its proposals and offer comments. We hope you are also considering the proposals and developing your responses at this time.

We shall respond in the normal way, formally and in writing; however, to finalise our views will take time. The depth and breadth of the proposals are significant and ambitious, and they require nothing less than our full attention and close scrutiny. So although we cannot share our final comments with you now, our formative views are emerging and we thought it would be of interest to share examples of them here. Accordingly, some of the opinions in this brochure might change, as we expect that some of yours might evolve before you submit them to BEIS by the 8 July 2021 deadline.



## Internal Controls over Financial Reporting

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### BEIS's proposals – examples of areas EY supports

- ▶ Directors to carry out a review on the effectiveness of their company's internal controls over financial reporting (ICFR) each year and to provide a statement to that effect, including their conclusion on the effectiveness of the controls, details of the benchmark system they used to perform the assessment and how they assured themselves that it was appropriate to make the statement.
- ▶ In limited circumstances, mandatory assurance by external auditors would be required (e.g., where serious and demonstrable failure of ICFRs or

where material ICFR weaknesses have persisted over several years).

### Examples of EY's formative views

- ▶ There is merit in learning from the experience of other jurisdictions, and considering an approach tailored to the UK market which is directionally aligned with that adopted in the US through SOX.
- ▶ We support the approach of requiring auditors to express a formal opinion on the directors' assessment of the effectiveness of the internal controls. Direct experience and evidence-based analysis demonstrates that external assurance provides the levels of scrutiny and accountability required

to ensure investors and the public are able to depend on the reliability of corporate financial reports.

- ▶ If the Government decides not to require external assurance by law, it should be mandatory for the evidence supporting the design and operating effectiveness of ICFR to be retained to an auditable standard. The decision on whether to request external assurance should at least rest with the audit committee and be informed through the Audit and Assurance Policy, by the shareholders' vote.

## Scrutiny of audit committees by the regulator

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### BEIS's proposals – examples of areas EY supports

- ▶ The Auditing, Reporting and Governance Authority (ARGA) to set additional requirements as to the audit committee's role in the appointment and oversight of auditors to ensure the committee acts effectively as an independent body responsible for safeguarding the interests of shareholders and other users of accounts.
- ▶ It's proposed to empower ARGA to monitor compliance with these

requirements, 'including through a power to require information and/or reports from audit committees, and a power to place an observer on audit committees if necessary', and to enable ARGA to take remedial action 'against the company directors and/or the audit committee for breaching the requirements'.

### Examples of EY's formative views

- ▶ ARGA should have the power to set minimum standards for audit committees and to monitor their

compliance, but we advocate extending these powers beyond the appointment and oversight of external auditors, as we do not see any logic in limiting the regulatory scrutiny of audit committees to a narrow area of their overall remit.

- ▶ Audit committees should also have access to an updated set of FRC guidance notes, first published in 2017. They outline best practice procedures for managing tenders and selecting external auditors. Feedback from this Consultation could be used



to augment this guidance, which in our opinion should be repositioned as a set of operating procedures against which audit committees could be assessed by the regulator.

- ▶ Audit committee tender selection reports could be made available to

investors ahead of the AGM vote on auditor selection, to help inform their voting decisions. The reports could follow a standard format and be publicly available post-AGM, accepting that confidential information may be redacted by companies. ARGAs should review a sample of these reports

annually to assess audit committees' degree of involvement in the tender selection process and whether sufficient emphasis is placed on audit quality, and the overall robustness of the tender selection processes (benchmarked against tender selection operating procedures).

## Clarity on the auditor's role in the detection of fraud

### BEIS's proposals – examples of areas EY supports

- ▶ Directors of Public Interest Entities (PIEs) to report on the steps they have taken to prevent and detect material fraud. The intention behind this is to reinforce directors' primary responsibility for fraud prevention and detection. The Government hopes this will also enhance their focus on the risks relating to fraudulent financial reporting.
- ▶ Other notable developments would include a legislative requirement for auditors of PIEs (as part of the statutory audit) to 'report on the work they performed to conclude whether the proposed directors' statement, regarding actions taken to prevent and detect material fraud, is factually accurate.'

### Examples of EY's formative views

- ▶ Material fraud often involves the override of controls and collusion with others inside the company being audited, and/or third parties. This means improvements in preventing and detecting fraud have to be achieved holistically involving various stakeholders, including company directors, audit committees and auditors. Requiring company directors of PIEs to report on the steps they have taken to prevent and detect material fraud is a positive step in mitigating the risk of fraud in the future.
- ▶ We suggest the requirement on auditors to report on whether the directors' statement is factually accurate is drawn widely; in particular to allow the reader of the financial statements to distinguish between

those audited entities which have proactively and positively engaged with fraud risk, and those which have approached the statement in a minimalist or mechanistic way, i.e., those who have engaged with the spirit of the legislation rather than just the letter.

- ▶ Consideration should also be given to how the directors' and auditors' reports on fraud interact with each other. For instance, whether additional steps that auditors consider necessary are indicative of a deficiency in the directors' approach. Also, whether the risk of a board-level management override is to be reported on by the auditor only (as boards would be manifestly conflicted from testing this themselves).



## Audit and Assurance Policy

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### BEIS's proposals – examples of areas EY supports

- ▶ PIEs to produce an Audit and Assurance Policy (AAP). This would provide a holistic view (on a rolling three-year basis) of a company's audit and assurance requirements over its reported information. For quoted companies, it would be subject to an annual shareholder advisory vote. The AAP would also provide an opportunity for companies to explain their approach to internal audit and to their tendering policy for external audit services.
- ▶ At a minimum, the Government suggests that the AAP include details of independent assurance sought on the annual report and other company disclosures, outside the remit of the statutory audit. This would cover an explanation of any type/

level of assurance on the Resilience Statement (in part or whole), and the directors' attestation on ICFR effectiveness.

### Examples of EY's formative views

- ▶ We support the introduction of an AAP, but our view on what its minimum content should include differs from the Government's. For example, providing a description of the policies a company may have in relation to the tendering for external audit services is inappropriate. This is because the objective of the AAP is to explain whether, and if so how, a company plans to obtain assurance on its reporting beyond that which is required by the company's audit.
- ▶ Also, given that PIE audits are tendered every ten years, an annual disclosure of this nature would be

unnecessary. An audit tendering policy should be disclosed in the preceding period before a tender takes place (e.g., in the eighth or ninth year of an audit firm's tenure/ audit cycle).

- ▶ An AAP should detail the company's policy to engage: the external auditor to provide other assurance and non-audit services on matters that are currently outside the remit of the external audit; other external assurance providers (other than the statutory audit provider); and challenger audit firms (in the event that mandatory managed shared audits are introduced in the external audit), with details of the board's rationale for allocating aspects of the audit to challenger firms.

## Resilience Statement

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### BEIS's proposals – examples of areas EY supports

- ▶ Companies to produce an annual Resilience Statement (RS) (combining the going concern statement, and a medium and long-term risk outlook). This would include uncertainties that the management team considered to be immaterial during their going concern assessment (e.g., due to

mitigations), with a mandatory five-year risk horizon as the medium-term outlook.

### Examples of EY's formative views

- ▶ It would be of greater value to shareholders and other stakeholders if all listed PIEs adopt the RS, rather than just premium listed PIEs. The RS should also include greater

specificity in its disclosures compared with current viability statements, with the addition of a stress test.

- ▶ We agree with the Government's proposal that RSs should also include a reverse stress test scenario. Companies should decide the types of risk most likely to cause their businesses to fail, and the number



of corresponding reverse stress tests to be undertaken. COVID-19 has shown the value of companies making specific disclosures about the outcomes of their stress testing, including reverse stress tests.

- ▶ We support the requirement for assurance on a company's RS 'in part or whole', but this needs careful consideration and drafting. It would be more appropriate for companies to clarify which constituent elements

of the RS they are seeking assurance on, to avoid the misconception by stakeholders that the external assurance provider is assuring the long-term resilience of the company (i.e., its survival).

## Improvements to corporate reporting

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### **BEIS's proposals – examples of areas EY supports**

- ▶ The regulator would extend Corporate Reporting Review (CRR) scrutiny to the entire annual report and expand the volume of CRR activity on reporting by PIEs. The Government would also give the regulator powers allowing it to publish correspondence entered into during the course of a CRR review, as well as summary findings.
- ▶ ARGAs would have the power to order amendments to company reports directly, rather than requiring a court order. The Government also plans to ensure that ARGAs have the necessary power to provide a pre-clearance service, including a statutory exemption from liability where it offers this service.
- ▶ Pre-clearance would apply in situations where a company is confronted with 'novel and contentious matters' when interpreting accounting standards.

One condition of a company making a pre-clearance application may be that the auditor would have to confirm that it accepted the proposed accounting treatment. It will be for the regulator to decide whether it will offer such a service.

### **Examples of EY's formative views**

- ▶ More powers for the regulator's CRRs could have an impact on companies and auditors, including their reputations and overall public image. Therefore, if new powers are to be granted (e.g., a pre-clearance service, which we support) they must come with safeguards: to ensure fairness, a right of appeal for companies, and the avoidance of any harm to reputation and the public's confidence in the capital markets. These powers should therefore mirror the US SEC protocols for handling the public release of correspondence and other types of confidential information. A pre-clearance service should have controls in place to prevent

companies from using this to settle disagreements with their auditors.

- ▶ We have no objection if CRR is extended to the entire annual report, but if it is, then various issues must be considered and resolved first. For example, against what reporting standards would the regulator conduct the review? It's also essential that the reviewers have sufficient experience, expertise and industry knowledge to conduct this exercise effectively.
- ▶ It's unclear how the regulator would mitigate the risk of non-financial disclosures becoming boilerplate, as some companies become more wary about making these disclosures if the regulator is going to judge them, without any right of appeal. Reviews must not be done with the benefit of hindsight, they should be carried out with knowledge at the time of reporting.



## A strengthened regulator

### BEIS's proposals – examples of areas EY supports

- ▶ ARGA to have the powers to act on serious concerns relating to corporate reporting and the audit of PIEs. This would include requiring a rapid explanation from companies about reasonable concerns identified by the regulator relating to a PIE's compliance with its corporate reporting or audit obligations.
- ▶ ARGA should also be the regulator for the actuarial profession, setting legally binding technical standards against which actuaries' work can be monitored and enforcement actions taken as necessary.

### Examples of EY's formative views

- ▶ A new regulator with greater powers is to be welcomed, but safeguards need to be put in place to ensure

fairness and proportionality (e.g., that companies would have the right of appeal if instructed to restate their accounts, and the full disclosure of audit quality inspections are only made when there is a high level of confidence in the inspection process).

- ▶ There is also the challenge of managing regulatory overlap. We note the recent introduction of the Regulatory Grid, published on 7 May 2021 by the Financial Services Regulatory Initiatives Forum. This provides an overview of new regulatory initiatives and consultations, and it indicates areas of potential overlap. Although it focusses on the financial services sector, it includes the FRC and we think this – or something similar – should be developed for governance and auditing matters

more generally, perhaps sponsored by BEIS or a consortium of Government Departments.

- ▶ We agree that ARGA would be the most appropriate body to undertake oversight and regulation of the actuarial profession. We also believe that a body separate from the Institute and Faculty of Actuaries to undertake oversight and regulation of the actuarial profession is in the public interest. Given the overlap between audits and certain aspects of actuarial work, ARGA is likely to benefit from its existing knowledge and understanding of both activities.







## Mandatory Managed Shared Audit

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### BEIS's proposals – examples of EY's areas of concern

- ▶ ARGA to be empowered to introduce Mandatory Managed Shared Audits (MMSA) for UK-registered FTSE 350 companies (with limited exceptions).
- ▶ Under this regime, a non-Big Four auditor would carry out 10% to 30% of the group's statutory audit and their liability would be limited to the work on that component. The Big Four group auditor, by contrast, would bear overall liability. The requirement would be phased in for companies at the time an audit contract is re-tendered, with the tender process requiring audit committees to appoint the group and component auditor independently and concurrently. The regulator would have enforcement and sanctioning powers against companies that fail to comply.
- ▶ In the event that MMSA does not bring about the desired change to the FTSE 350 market, the regulator

would be empowered to implement a market share cap (i.e., a limitation on the number of FTSE 350 companies that any one of the Big Four firms can audit over a given period of time).

### Examples of EY's formative views

- ▶ Whilst we strongly support the aim of increasing auditor choice and thereby improving audit market resilience, we do not believe that MMSA or a managed market share cap will achieve the stated objective of delivering greater choice and resilience. If introduced, it will instead lead to a significant risk of adverse unintended consequences, including increased risks to audit quality and audit firm resilience.
- ▶ It's important to note that expanding the PIE definition, as the Government proposes, will naturally create new and meaningful opportunities to enhance the experience and credibility of challenger firms without the risks to audit quality,

audit firm resilience and long-term competition associated with either MMSA or a managed market share cap. This does not appear to have been fully considered as part of the Government's assessment of measures to improve choice.

- ▶ We urge that the potential positive impact on competition and choice, of an expanded PIE definition, should be seriously examined prior to proceeding with measures that could be perceived as manipulating the audit market.
- ▶ Expanding the PIE definition will have a profound impact on audit firm capacity, and therefore the need and appropriate timing for introducing further measures. It will also provide opportunities for challenger firms to enhance their chances to audit larger and more complex entities, a fundamental aim of both MMSA and a managed market share cap.

## Expanded definition of a PIE

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### BEIS's proposals – examples of EY's areas of concern

- ▶ The Government proposes that most of the new regulatory measures related to audit, corporate reporting and corporate governance should

apply to the same pool of entities. The consultation therefore proposes to amend the definition of PIEs and widen its scope to capture large companies, regardless of their ownership status and whether or

not they are admitted to trading on a regulated market. The two options of proposed size thresholds align to other existing corporate requirements.



### Examples of EY's formative views

- ▶ The PIE definition should be expanded, with a corresponding level of consistency in reporting thresholds. This is because the governance and conduct of companies that meet a 'significant size and public interest criteria' have an important impact on the economy and a wide range of stakeholders. Therefore, by ensuring that they

all have the same obligations, and are subject to consistent levels of regulatory scrutiny, the Government is one step closer to achieving its objective of restoring trust in business.

- ▶ Of the two thresholds proposed by the Government, we prefer the higher one (>£500 million turnover and > 500 employees). This would capture fewer entities, cause less onerous

pressure on the PIE audit market, and therefore provide a more realistic and acceptable approach. However, a more detailed review of thresholds is needed to simplify and align them for different reporting requirements.

## Attractiveness of the accounting and auditing profession

### BEIS's proposals – examples of EY's areas of concern

- ▶ The Government proposes that Audit Quality Review reports should be published without the need for consent from either the audit firm or the audited entity. The regulator would also have full discretion to decide whether to publish an individual inspection report in full, or as a summary.
- ▶ Other proposals include further information in audit reports (e.g., disclosing updates on key audit matters reported in the previous

two years). Other disclosures by the auditor would include risks omitted from the directors' Risk Report which the auditor considers to be significant, and whether the company's section 172 statement reflects observed reality, from the auditor's perspective.

- ▶ The Government acknowledges that Liability Limitation Agreements (LLA) are unused, because directors raised concerns that seeking shareholder approval to introduce an LLA would be a breach of the directors' duties. The Government clearly states in the Consultation that this is incorrect.

### Examples of EY's formative views

- ▶ The statutory audit should be expanded to help meet the Government's objective, by providing assurance over more relevant corporate reporting. We want the audit to be focussed on the measures that matter to stakeholders, reflecting the idea and principles associated with corporate auditing.
- ▶ However, we urge the Government to consider the liabilities associated with an expanded scope of audit, and the unintended consequences of other proposed measures



(e.g., the regulator making full public disclosures on individual audit inspections).

- ▶ It's important that any increases in regulation and oversight are fair and proportionate, and that audit firms are able to manage the risks associated with a wider scope of audit. If this cannot be achieved,

individuals once destined to become auditors or those intending to pursue their careers in the auditing profession, might change their plans.

- ▶ Deterring individuals from pursuing a career in accounting and auditing, apart from affecting the capacity of both larger and smaller firms to audit an increased number of PIEs,

could also impact on the number of individuals who would otherwise have trained and practised as auditors before moving on to senior finance roles in companies; their talent pools could be jeopardised just as much as ours.

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