Restoring trust in audit and corporate governance

The AIC's response to the white paper

The Association of Investment Companies (AIC) is the trade body for the closed-ended investment company sector. We represent 361 investment companies, holding assets of over £234 billion. The AIC's members are predominantly Premium Listed companies on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

The AIC's members include investment trusts, Venture Capital Trusts, UK REITs and non-UK companies. Our non-UK members are usually incorporated in Guernsey and Jersey.

Closed-ended investment companies are collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return. Investments include listed securities, private equity, debt, property and infrastructure.

The AIC is pleased to respond to the government's consultation on restoring trust in audit and corporate governance.

Introduction to investment companies

Investment companies are very different to other trading companies, typically they:

- Are operationally very simple, with limited or no physical presence;
- Have independent boards comprised of non-executive directors. The substantial majority do not have executive directors or employees and do not have internal audit functions. Instead, they outsource the day-to-day running of the company to third party service providers. This includes appointing an investment manager to make the day-to-day investment decisions;
- Do not provide goods or services (and therefore have no turnover) and have no trading activity or customers. They are investment vehicles for their shareholders, but do not provide services to those shareholders;
- Have no turnover, so are not within scope of regulations such as the Modern Slavery Act 2015 or the Energy Savings Opportunity Scheme Regulations; and
- Have suppliers which are typically professional advisers or regulated firms.

Investment companies do not have complex group structures, international divisions or complex accounts. The audits of investment companies are relatively simple when compared to that of a trading company. For example, a key issue underpinning an investment company audit is valuation of the assets. Many investment companies invest in listed securities, where valuations are publicly available. This significantly simplifies the overall audit process.

Audit fees of investment companies are typically much lower than trading companies. For example, the largest investment company by total assets is Scottish Mortgage Investment Trust PLC, which is in the FTSE 100. Its annual report and accounts for the year ended 31 March 2020 shows fees paid to the auditor for audit services of £45k.

The majority of investment companies report against the AIC Code of Corporate Governance (AIC Code) which has been tailored to reflect the characteristics of the sector. The AIC Code is endorsed by the Financial Reporting Council (FRC) as an alternative means for members to meet their obligations in relation to the UK Corporate Governance Code (UK Code). It is widely used by investment companies and valued in the market. The AIC **recommends** that ARGA continues to endorse the AIC Code.

Headline approach

Whilst there have been a number of recent high profile corporate failures, the government should recognise that audit and corporate governance concerns are not pervasive. They have tended to be the exception rather than the norm.

The AIC recognises the need for robust and effective regulation where problems have been identified. We welcome measures targeted on known issues that will improve the market as a whole and give companies, their shareholders and stakeholders more confidence in the audit process. The principles which form the basis of the AIC's response to this paper are that we seek to achieve:

- **Proportional and effectively targeted regulation** of corporate reporting, focused on the areas of greatest risk for investors, stakeholders and the public interest recognising that some companies are less complex, such as investment companies;
- A **better quality** corporate reporting environment providing investors and stakeholders with the information they want in a clear and concise manner;
- A **competitive and resilient audit market** that enables companies to have the greatest choice in appointing a high-quality provider; and
- A **statutory regulator** with a clearly defined role which prevents regulatory creep without any increased benefits.

In this context, the AIC is concerned that many of the proposals are not sufficiently focussed on specific causes of regulatory risk. They are too scattergun. This threatens a disproportionate regulatory response. Where changes are required, they should be proportionate to the problem. The cost of implementing reforms should also not outweigh any benefits that may arise.

The AIC has set out in **Appendix 1** a summary of the key themes of our response along with a summary of our key recommendations.

Achieving proportionality

The AIC **recommends** that the proposed reforms must have regard to proportionality and balancing the costs and benefits of regulatory action. Proportionality is one of the principles of good regulation that regulators (such as the Financial Conduct Authority (FCA)) in scope of section 21 of the Legislative and Regulatory Reform Act 2006 must have regard to. The AIC **recommends** that this Act be amended to include ARGA.

The Independent review of the FRC also recommended that ARGA be required to act in a proportionate way, "*having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action*".

The Department of Business, Energy and Industrial Strategy (BEIS) identified the benefits of proportionate regulation in its Growth Duty: Statutory Guidance paper published in March 2017. This states that:

> "*Regulatory enforcement that is not proportionate and risk-based imposes unnecessary costs on business, creates uncertainty and undermines investment. So, our priority is clear: we will cut £10 billion of regulatory burdens over the lifetime of this Parliament and will make sure that enforcement regimes work to support, rather than hinder, legitimate business. This new growth duty for regulators is a vital step towards achieving our deregulatory priorities.*"

The AIC considers that the proposals set out in the white paper, when taken as a whole, do not achieve a proportionate outcome. In particular, they add compliance obligations to many companies which have not been the cause of past problems and are unlikely to be a significant risk in the future because, in most respects, they are already sufficiently regulated.

Many of the reforms proposed, along with existing regulation, are applicable to PIEs. This definition is a blunt instrument as it treats all companies on a UK regulated market in the same way without recognising that these companies exist across a broad spectrum in terms of their size, complexity and the risks they pose to the market if they were to fail.

It also excludes many other large and complex companies, such as some private companies, from the most rigorous regulations just because they have chosen not to list.

Additionally, there does not seem to have been a strategic consideration of how the proposals will be implemented. For example, some rules are proposed for all companies, regardless of their country of incorporation, others are only for UK companies. Some are based on market capitalisation, some are regulatory requirements, some are best practice. The mix is so diverse that it is difficult to see how these proposals are being addressed in a coordinated manner.

To achieve a proportionate and targeted implementation of audit reform rules, the AIC **recommends** that the definition of PIEs is split into two categories: complex and non-complex.

This approach would allow standards to be developed that are proportionate to the type of entity and risks that are applicable. It would recognise that a one-size-fits-all approach is not appropriate, balancing the costs and benefits of applying those rules appropriately.

It would also allow the government to expand the definition of PIEs in proportionate way, protecting non-complex companies from incurring unnecessary regulatory burdens.

The AIC would be pleased to work with regulators to determine the definition of a complex PIE. We envisage that companies would have to meet a number of criteria to be deemed complex. These criteria should be set out in regulations. For example, the AIC **recommends** that, if companies meet any three of the following criteria, they would be complex:

- Have more than 500 employees
- Have a significant international presence
- Have a complex group structure

- Have a substantial number of service offerings or products
- Provide significant products or services in relation to public sector contracts
- Are not predominantly an investment vehicle
- Have complex supply chains.

If this approach is taken, the AIC **recommends** that non-complex PIEs are scoped out of many of the proposals the government has advanced. Whilst these proposals may be appropriate for complex PIEs, the AIC has significant concerns about costs versus benefit for non-complex PIEs, investors and the wider public interest.

This approach would also help ensure the UK public market maintains high standards whilst also delivering a more proportionate regulatory environment. There are many benefits of being on a public market. Listing provides a company with the ability to access capital. It increases its profile, which can increase demand for the company's shares, and improves its liquidity. It also helps broaden the company's shareholder base.

However, the number of listed companies has declined in recent years. One of the reasons that public markets are becoming less attractive is because of the regulatory and compliance costs companies incur. Listed companies often face significant and unnecessary costs of regulation.

In line with the UK Listing Review, which seeks to recommend reforms to the UK's market rules to boost growth and ensure the UK remains an attractive place to do business, the government should seek to create an effective and proportionate regulatory regime for all entities. Reforming the PIE definition to focus on complex and non-complex would help achieve this and ensure the UK can continue to compete with other international public markets in a competitive and global economy.

Overlapping measures

The AIC is also concerned that the government's proposals increase the scope of the regulator and place many new, overlapping, obligations on companies and directors. Many of these proposals seek to address the same or similar issues. This approach is not proportionate.

To protect against overlapping, and potentially unnecessary, measures there is a case for incremental change rather than a 'big bang' approach.

The AIC **recommends** the proposals are implemented in stages, allowing time to assess the effect each change has on the market prior to imposing further regulation. The response to the white paper should therefore identify measures to be introduced in the first wave, then others which might be implemented later, if required.

The AIC also **recommends** that consideration be given to how any new measures are implemented. There should be a clear framework in place setting out which measures are statutory, regulatory or UK Code reforms, and consideration should be given as to the impact the new measures will have on companies and whether the costs are proportionate to any benefit they might provide to shareholders.

The AIC **recommends** that, where possible, new measures be introduced via the UK Code. The UK is a world leader in corporate governance. Best practice has evolved, not via legislation but by a voluntary code of conduct and the impact of external scrutiny. These forces have successfully altered the behaviour, attitude and culture of companies. The focus should be on encouraging companies to have good corporate governance practices in place, rather than additional legislation and enforcement. This approach is proportionate as it allows companies the flexibility to tailor their arrangements to fit their individual circumstances whilst ensuring they explain any departures from the guidelines.

A missed opportunity – reform of the annual report and accounts

The focus of the white paper is the process of preparing the report and accounts and the oversight of that disclosure. There is a strong argument that this is putting the cart before the horse.

The AIC has long been concerned about the length and complexity of annual reports. Looking at how these documents are prepared without looking again at the subject of this process itself is a missed opportunity. The AIC **recommends** that a wider review of corporate reporting is undertaken in advance, or at least in tandem, of introducing the current proposals. It should consider splitting corporate reporting into separate components to make it a more effective tool for shareholders and stakeholders. The government's audit reform proposals, as they stand, will further increase the length of annual reports. They will also increase the liability of directors and make auditors and ARGA responsible for reviewing the entirety of annual reports. This is likely to result in increased compliance costs and possibly increased legal costs.

Continuing to increase the scope of the annual report is not inherently helpful. They have become convoluted documents which are too complex, opaque and lengthy for many audiences. The risk is that they remain largely unread. There needs to be a balance between meeting the needs of shareholders, meeting the needs of stakeholders, and making the reporting regime fit for purpose.

The AIC **recommends** that a fundamental review of the structure and content of annual reports and accounts is undertaken. Ensuring the scope and structure of this document is correctly set is vital to ensuring high-quality, focused and reliable information is provided to investors. Without such a review, many changes made as part of this consultation will not achieve their desired impact.

The AIC has set out in **Appendix 2** its proposals for splitting the annual report and accounts and creating a more effective reporting regime.

Key concerns

Reflecting the observations made above, the AIC's key areas of concern are:

- **The statutory objectives, scope and powers of ARGA** are not sufficiently clear, targeted and appropriate. Ensuring that the correct statutory framework is in place will provide the basis for ARGA to become an effective regulator in its field and allow its performance to be judged appropriately against its duties. If ARGA's statutory objectives are not properly established, if its remit is too wide, or it is not focused on the concepts of proportionality and targeting identified and materials risk, it is unlikely to be successful in the long-term.

- **Mandatory managed shared audits**. The AIC **recommends** all non-complex companies, such as investment companies, be excluded from this requirement. These proposals will result in unnecessary and disproportionate regulatory costs and burdens being imposed on non-complex companies. They will also result in unintended consequences, such as limiting the choice of audit firm for some companies, including investment companies; and
- **Increased, costly disclosures which do not add significant benefit to users of accounts**, such as the proposals for statements on internal controls and the audit and assurance policy. The AIC **recommends** non-complex PIEs be excluded from these measures. These proposals will also result in unnecessary and disproportionate regulatory costs and burdens being imposed on non-complex companies. The AIC is concerned that, over time, there will be increased pressure on companies to have independent assurance on other elements of company reporting.

Chapter 1 - The government's approach to reform

Q1 Should large private companies be included within the definition of a Public Interest Entity (PIE)? Please give your reasons.

As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. The AIC **recommends** these definitions are set out in regulations. If this approach was taken, should the government decide to include private companies, they need not all be subject to the same rules. The rules could be applied in a proportionate matter, in line with the nature of the company, balancing the costs and benefits of applying those rules appropriately.

Q2 What large private companies would you include in the PIE definition: Option 1, Option 2 or another? Please give your reasons.

Please see our response to question 1.

Q3 Should AIM companies with market capitalisation exceeding €200m be included in the definition of a PIE? Please give your reasons.

As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories.

This would also provide a mechanism to assess AIM companies as appropriate. The most complex companies would be subject to higher standards, without the need to impose blanket obligations across the whole quoted company market. Arguably, many large private companies have more 'public interest' characteristics than some with shares admitted to trading on AIM, or other listed companies, and will have more of an impact on the economy if they fail. This has been seen by corporate failures such as BHS.

If the government does not adopt the AIC's proposal to categorise PIEs as non-complex or complex, the AIC **recommends** that AIM companies are not brought within the definition of a PIE.

The purpose of AIM is that it is a market for entrepreneurial businesses. In time, many companies will move from AIM to the Premium segment of the Main Market of the London Stock Exchange. AIM provides these companies with a regulatory approach that is specifically tailored to the needs of growing companies. If these companies are made PIEs in an undifferentiated way, a range of existing and proposed requirements would be imposed on all of them. This would not be a proportionate response, particularly for less complex companies. It would significantly increase the regulatory cost burdens on these companies. It may also discourage companies from admission to trading on the AIM market, and drive them towards other, less onerous exchanges.

If the government does not adopt the AIC's proposal to categorise PIEs as non-complex or complex and AIM companies are brought into the definition of a PIE, the AIC **recommends** that the same thresholds that are proposed for large private companies also be applied to AIM companies.

Q4 Should government give newly listed companies a temporary exemption from some of the new reporting and attestation requirements being considered for Public Interest Entities?

The AIC does not have any comments on this question.

Q5 Should the government seek to include Lloyd's Syndicates in the definition of a PIE? Please give your reasons.

As outlined above in the section titled *Achieving proportionality*, whichever entities are defined as PIEs, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. This would allow different rules to be applied in a proportionate matter, in line with the nature of the entity and balancing the costs and benefits of applying those rules appropriately.

Q6 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?

As outlined above in the section titled *Achieving proportionality*, whichever entities are defined as PIEs, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. This would allow different rules to be applied in a proportionate matter, in line with the nature of the entity and balancing the costs and benefits of applying those rules appropriately.

Q7 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?

Please see our response to question 6.

Q8 Should any other types of entity be classed as PIEs? Why should those entities be included?

As outlined above in the section titled *Achieving proportionality*, whichever entities are defined as PIEs, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. This would allow different rules to be applied in a proportionate matter and balancing the costs and benefits of applying those rules appropriately.

Q9 How would an increase in the number of PIEs impact on the number of auditors operating in the PIE audit market?

The AIC does not have any comments on this question.

Q10 Do you agree that the government should provide time for companies to prepare for the introduction of a new definition of PIE?

The AIC agrees that any changes to the definition of PIE will have potentially significant implications for companies being brought into the definition as they may not only have to implement the new rules as a result of the audit reform, but will also have to implement other existing rules that apply to PIEs. These companies should have an appropriate length of time to implement the changes that will be required.

Q11 Do you agree that the government should seek to offer a phased introduction for a new definition of PIE?

The AIC agrees that a phased introduction could help companies who will be caught by the new definition to prepare for the transition.

Other comments

The AIC **recommends** that any measures brought forward as a result of the government's proposals should be done in stages to allow business to adapt and implement any reforms over time. Businesses are already under significant extra pressures due to Brexit and Covid. The impact of these two events will have an impact for some time to come. This should be considered when the implementation dates are set for the reforms to come into force.

The AIC supports the proposal to review the implementation of these reforms by way of a post implementation review. This will allow time for the changes to be bedded in before any further changes are made.

The AIC agrees with the government's proposals that any company qualifying and ceasing to qualify as a PIE, or indeed a complex or non-complex PIE, has some certainty as to when it is brought into or falls outside of the definition. The AIC supports the proposal for a company to be required to meet the threshold for three consecutive financial years before it qualifies as a PIE. Similar provisions could also be imposed in cases where companies move from non-complex to complex PIEs. Likewise, similar provisions should be in place when a company ceases to qualify as a PIE, or indeed a complex or non-complex PIE. These provisions should be set out in regulations.

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

Q12 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?

The AIC does not consider there is a need to strengthen the internal control framework for UK companies. Current provisions set out in law, market rules and the UK Code are sufficient to provide that companies report on the effectiveness of the company's internal controls in relation to financial reporting (see **Appendix 3** which sets out the existing provisions on internal controls and risk management). The AIC **recommends** that no further requirements are added to the internal control framework.

Most companies have good internal controls, and this should be recognised. The government should not impose new regulations on all companies, simply because there have been a handful of companies where there have been failures in internal controls.

Auditors do not have to rely on a company's internal controls when performing an audit. Furthermore, we are not aware of evidence that audit committees which are fulfilling their current duties do not act on the deficiencies that auditors bring to their attention. (If audit committees are not fulfilling their current duties it is debatable that adding obligations will enhance standards within those entities.)

Where companies, shareholders or wider stakeholders demand more assurance on internal controls and risk management, this can be provided by a reporting accountant, or other appropriate consultant, based on a defined and agreed scope. Different levels of liability could also be agreed with the reporting accountant or consultant. For example, investment companies may receive assurance reports on the internal controls of their service providers performed in line with the Technical Release Assurance on internal controls of service organisations (AAF01/20) published by the Audit and Assurance Faculty of the Institute of Chartered Accountants of England and Wales (ICAEW).

The AIC **recommends** that, if any further consideration is given to strengthening the internal control framework, this should be achieved through changes to the UK Code. This will recognise that companies may have different approaches to internal controls based on the size, nature and complexity of their business.

The AIC is concerned that any new regulations in this area will be especially harmful and disproportionate for smaller and less complex companies, including investment companies, and will not provide a commensurate benefit for shareholders.

For example, investment companies generally outsource all their day-to-day operations to third parties, some of which will provide assurance reports on their internal controls. As a result, there are limited internal controls in the company itself (but this is not inherently problematic). Some audits of investment companies are undertaken using a substantive rather than controls-based testing approach. Whilst the auditor will want to spend time understanding the systems and controls in place at the investment manager, no reliance will be placed on this during the course of the audit. Any extra work required of the auditor will increase its time and costs but will not change in any fundamental way how the audit is performed and would not provide shareholders with any significant additional comfort.

As set out in our response to question 14, if the internal controls framework is strengthened, the AIC **recommends** that this is achieved in a proportionate manner and that non-complex companies, such as investment companies, be excluded from any new requirements.

Q13 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?

As set out in our response to question 12, the AIC does not support strengthening the reporting framework around internal controls. However, if there is to be some strengthening of this framework, the AIC **recommends** the government takes a proportionate approach and option B is applied for companies within scope (which should be limited to complex companies).

Option B will require auditors to report in more detail about the work they already undertake to understand the company's internal control systems and how that has influenced, if at all, the approach they have taken to the audit. This will provide shareholders with transparency about the audit approach to internal controls. The AIC **recommends** that ARGA provides guidance to auditors on matters to cover in this new element of the audit report.

This approach will also recognise that the review of internal controls is only one element of an audit. Understanding the internal controls of a company helps auditors plan and conduct their work. It particularly helps them to assess whether they can rely on the internal controls and therefore may assist them in deciding whether to take a controls-based or substantive approach to their audit work. However, there is no requirement for auditors to take a controls-based approach, in any event, many auditors will take a substantive approach to audits of less complex companies.

Whilst it is usual for audits of complex companies to take a controls-based approach, this may not be the case for non-complex companies, for example investment companies. The AIC **recommends** that non-complex companies are excluded from any new rules on internal controls. These companies are likely to pose fewer risks. Imposing significant time and cost burdens on them is not commensurate with the benefits that may be received.

The AIC does not support the government's preferred option to require a directors' statement about the effectiveness of internal controls. It should leave the decision on whether the statement should be assured by an external auditor to the directors, audit committee and shareholders. Otherwise there is a danger that, over time, this will result in increased pressure, particularly by proxy voting agencies, to demand that auditors express an opinion on the systems and controls. This would effectively result in option C being adopted.

Option C is similar to the Sarbanes-Oxley Act (SOX) in the United States. These rules inappropriately prioritise process over outcomes. The UK has a superior system which recognises that companies may have different approaches to internal controls based on the size, nature and complexity of their businesses.

The Independent review of the FRC states that introducing SOX-style provisions could "*impose significant costs, at least initially, particularly on smaller listed companies. The US experience shows that smaller companies are affected disproportionately and listing could become less attractive.*"

The requirements of SOX have been widely criticised for being overly burdensome and costly to comply with, particularly for smaller companies. It has created unnecessary processes and procedures which are tick box in nature, requiring extensive paper/electronic trails to evidence that processes and procedures are appropriately followed.

There is no evidence that these procedures provide material, additional shareholder protection nor protect the wider public interest. These measures focus on administrative processes and increase the burdens of companies without improving the quality of the systems in place. There is a real risk that issues are lost in a blizzard of routine administrative and sign off procedures.

The AIC does not support option C, nor does it support option A.

Option A would require directors to make a statement about the effectiveness of the internal control and risk management systems. This is likely to result in increased compliance procedures being put in place increasing burdens on companies, without providing any significant benefit to shareholders.

If the government implements option A, the AIC **recommends** the changes are made via the UK Code.

The AIC also **recommends** that any new rules or best practice guidance in this area be restricted only to internal controls relevant to risks that may affect financial reporting.

Q14 If the framework were to be strengthened, which types of company should be within scope of the new requirements?

As set out in our response to question 12, the AIC does not support strengthening the reporting framework around internal controls. However, if there is to be some strengthening of this framework, the AIC **recommends** the government takes a proportionate approach.

The need for proportionality was highlighted by the respondents to the initial consultation who commented on internal controls. The government has stated that "*These responses mainly emphasised the need for a proportionate approach which has regard to the size and resources of those being regulated.*" These respondents "*also pointed to the high compliance costs in the US and warned about reforms which could make the UK a less attractive place to invest or to list companies.*" The government must be mindful of these views when progressing on this agenda.

As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** that PIEs are split into two categories, complex and non-complex. This would allow different rules to be applied in a proportionate matter, balancing the costs and benefits of applying those rules appropriately, in line with the nature of the company.

Any new rules in this area should only apply to complex companies. The AIC **recommends** that non-complex companies are excluded from any new rules on internal controls. These companies pose fewer risks. Imposing significant time and cost burdens on them does not provide compensating benefits. If non-complex PIEs do have new obligations imposed, then the AIC **recommends** that these should be limited to option B.

The AIC **recommends** that any changes be implemented in stages. This recognises that most companies exercise good internal controls.

Q15 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?

There is already a legal framework governing dividend payments in the UK. This is supported by guidance on realised and distributable profits, Tech 02/17BL, published by the ICAEW and the Institute of Chartered Accountants of Scotland (ICAS).

The AIC is not aware of any issues that have arisen with the law or guidance in the investment company sector. The AIC agrees with the government that, whilst the current UK rules and this guidance have complexities, they are well established and generally well understood and complied with. The AIC does not see the need for major reform. Instead, any changes should be proportionate to strengthen the current system.

To support a more robust regulator, the AIC **recommends** that the current guidance on realised and distributable profits, Tech 02/17BL, should be adopted by ARGA. This should remain as guidance. Should any changes be required to this guidance in the future, ARGA should undertake a public consultation in advance of making any amendments.

The AIC **recommends** that no further changes are made as the proposal for companies to disclose distributable reserves should be sufficient to provide shareholders and stakeholders with the information they need. If any changes are considered, the regulator should consider the implications of any divergence between UK and international accounting standards in this area.

Q16 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 AIC recognises that, for complex group structures, perhaps with international operations, there will be difficulties in calculating a distributable profit figure. Likewise, some companies will experience difficulties in calculating this as they may not have sufficiently detailed historic records.

Any proposed new disclosure requirements should recognise the difficulties some companies may face. The cost of implementing a new disclosure requirement should also be proportionate. If these proposals are adopted, the AIC **recommends** that companies should be permitted to report a “not less than” figure for its distributable reserves, with any proposed dividend payment not being allowed to exceed this figure.

If the regulator is asked to provide guidance on how companies may make this disclosure, this should take into account Tech 02/17BL. It should also provide companies with a degree of discretion about how to present estimated figures. Such guidance should be consulted on publicly prior to being issued.

Q17 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?

The AIC does not support the proposal for directors to make a specific statement about the legality of dividends and their effect on the future solvency of the company.

Directors already have legal duties to act in the best interests of a company. They also sign the statement of directors' responsibilities confirming, to the best of their knowledge, that the financial statements are prepared in accordance with applicable accounting standards and give a true and fair view of the assets, liabilities, financial position and profit/loss of a company. These requirements are sufficient to provide shareholders and stakeholders with assurance about any new distributable profit reporting disclosures.

Additionally, directors are prevented by law from making illegal dividends. Requiring a director to make a statement about the legality of dividends is superfluous. It would result in an additional and unnecessary disclosure in the annual report.

The paper recognises that "*A statement along the lines proposed could be perceived as unnecessary given that it would cover legal obligations with which directors must already be compliant. However, … It might also make it easier to pursue existing legal redress routes for a breach of directors' duties*". If there are issues with the current mechanism to pursue directors for making illegal dividends the government should consider a change in the law rather than require directors to make a statement on the legality of dividends. The AIC is not aware of any issues in our sector that would justify such a statement being made and **recommends** that no such statement be required.

If the government advances with this proposal, the AIC **recommends** that such a statement is not required by directors of non-complex PIEs.

Q18 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?

Yes, we agree that the combination of the recently introduced Companies Act section 172(1) reporting requirements, along with encouragement from ARGA will be enough to ensure that companies are sufficiently transparent about their distribution and capital allocation policies. As such, the AIC **recommends** that no further new reporting requirements are required.

As stated in the section above titled *Overlapping measures,* the AIC is concerned that the government is proposing implementing several obligations on companies and directors which seek to address the same or similar issues. If the government goes ahead with its proposal to require companies to disclose a "not less than" figure for its distributable reserves, it should not also introduce further measures in this area at the same time before first assessing whether those changes are sufficient. Any changes should be made in a proportionate manner.

If the government considers that such policies are required, the AIC **recommends** that the requirements for the policy are not prescriptive and allow companies the flexibility to draft their policies to reflect their individual circumstances. The AIC also **recommends** that any such disclosures are not required for non-complex PIEs.

Please also see our responses to questions 16 and 17.

Chapter 3 - New corporate reporting

Q19 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?

The AIC **recommends** that companies should have the flexibility to determine which specific matters are addressed in the resilience statement. Whilst there may be resilience issues common to many businesses, these may not apply to all businesses. Having to include a statement on a matter that is of less relevance may result in that issue being given more priority than another, more relevant, issue. This will not provide shareholders with clear and transparent information about the specific risks a company faces. It will be contrary to the proposed duties of ARGA to promote high quality corporate reporting and to promote brevity, clarity and usefulness in corporate reporting.

For example, some investment companies do not pay a dividend, or only pay a dividend to meet certain legal criteria to maintain investment trust status. Instead, these companies will invest for capital growth. This will be stated in the company's investment policy. Therefore, any mandatory requirement on such a company to report on the resilience of the company's dividend will not be meaningful. It will become a boilerplate disclosure which will not help shareholders understand the most relevant resilience issues material to the company.

The AIC **recommends** that there should be no obligation for companies to report in the resilience statement on matters which are not material to them. Instead, the AIC **recommends** that ARGA provides guidance on matters which it considers that companies should have regard to when making their resilience statements.

Q20 Should the Resilience Statement be a vehicle for TCFD reporting in whole or part?

The AIC does not consider that the resilience statement should be a vehicle for the Task Force for Climate-related Disclosures (TCFD) reporting.

As set out in above in the section titled *A missed opportunity – reform of the annual report and accounts*, the AIC has long been concerned about the length and complexity of annual reports. These documents should provide shareholders and other users with the information they require in a clear and concise form. The AIC has previously **recommended** that annual reports and accounts are split into separate components to make them more effective tools for shareholders and stakeholders (see **Appendix 2** for more detail).

Splitting the annual report in such a way would allow disclosures, such as TCFD, to be made in other documents if required. This would ensure that necessary disclosures are made, but that shareholders can find the most important information, relevant to the company in the Strategic Report.

If these proposals are not adopted, the AIC **recommends** a proportionate approach be adopted for non-complex PIEs. These should not be required to report on TCFD matters (unless required to under other mechanisms, such as the UK's Listing Rules).

Many investment companies would be categorised as non-complex. Currently, investment companies are exempt from the Listing Rule requirement to make TCFD disclosures. The decision to exclude investment companies from the TCFD disclosures reflects the fact that they do not have a significant operational impact in their own right. It would not be proportionate to require these companies to make TCFD disclosures if it would not provide a significant benefit to shareholders.

Q21 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?

The AIC **recommends** that the resilience statement be implemented in a proportionate way. As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** that PIEs are split into two categories, complex and non-complex. This would allow different rules to be applied in a proportionate matter, balancing the costs and benefits of applying those rules appropriately, in line with the nature of the company.

The AIC **recommends** that non-complex PIEs are not required to use reverse stress testing scenarios and that they be allowed to choose the time period covered in the medium to long term. That is, the relevant time period should not be fixed at 5 years.

This will ensure that the resilience statement is implemented in a proportionate way and that the greatest regulatory and cost burdens are borne by the most complex companies which will pose the greatest risk to the wider market if they were to fail.

Q22 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?

The approach non-complex PIEs companies take to audit and assurance is already clear in their annual reports. Many non-complex PIEs will not seek any independent assurance beyond that required by statutory audit, nor will they pay for any material non-audit services. In relation to investment companies specifically, these are also unlikely to have any internal audit functions. Therefore, the AIC **recommends** that non-complex PIEs are not required to have an audit and assurance policy.

Where PIEs are required to have such a policy, the AIC **recommends** that this is introduced via the UK Code, this will allow companies the flexibility to tailor the content of this policy to their individual circumstances and to take the most appropriate approach for their businesses. For example, the majority of investment companies have no executive directors or employees, therefore they will not have any internal audit function. There should be no requirement to comment on matters that are not relevant to the company.

The AIC also **recommends** that, where directors decide to obtain assurance, for example on their cyber controls, in one year, there should be no presumption that this will be repeated in future years.

The AIC is also concerned that whilst *"the government is not mandating an extension of the statutory audit, it recognises that an Audit and Assurance Policy can be expected to lead to more companies considering whether independent assurance is desirable on elements of company reporting that require specialist knowledge and skills which financial auditors may not be able to provide."* There is a danger that, over time, there will be an expectation that companies should seek more audit and assurance reports. The AIC objects to this direction of travel, particularly for non-complex PIEs. If any further assurance is required, this is solely a decision for the board.

The AIC **recommends** that, outside of the statutory audit, there should be no expectation placed on companies to have any independent assurance on other elements of company reporting. The size, nature and complexity of the company, including the sector it operates in, may mean that there is no need for a company to ever decide it would like further assurance on other areas of company reporting.

If companies decide they would like further assurance on other areas of company reporting, this should be a decision for the board and they should be able to appoint an appropriate consultant to provide such assurance based on a defined and agreed scope, taking into consideration appropriate materiality levels and liability clauses.

Q23 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?

As set out in our response to question 22, the AIC **recommends** that non-complex PIEs are not required to have an audit and assurance policy.

Where companies are required to have an audit and assurance policy, the AIC **recommends** this policy is included in the company's report and accounts each year but is only amended when there is a material change to the policy. This would be a proportionate approach to introducing such a policy.

The AIC does not agree that there should be a shareholder vote on the audit and assurance policy. Instead, this should be discussed by the audit committee and voted on by the board. If shareholders are not satisfied with the policy, they can discuss it with directors and raise questions about this at the company's AGM. Ultimately, shareholders have the ability to vote against a particular director, or against the adoption of the annual report and accounts.

If there is sufficient shareholder concern, a specific resolution on the policy could be requisitioned. This would be a powerful mechanism which boards would act upon. There is no need for a specific requirement for a vote on this policy. Shareholders do not often engage with companies about the audit and there is already a vote on the appointment and re-appointment of the auditor.

If the government advances with its proposal to have a shareholder vote on the audit and assurance policy, the AIC **recommends** any shareholder vote should be advisory, rather than binding.

Q24 Do you agree with the proposed scope of coverage and method for implementing the Audit and Assurance Policy?

Please see our responses to questions 22 and 23. The AIC **recommends** that non-complex PIEs are not required to have an audit and assurance policy.

The AIC **recommends** that, if an audit and assurance policy is required, the most appropriate method to implement this is via a change to the UK Code rather than through legislation. This will allow companies to take a more flexible approach to implementing the policy, and it will also enable ARGA, following public consultation, to provide guidance, possibly by way of an update to its Guidance on Board Effectiveness, to assist companies in implementing the policy.

The AIC **recommends** that PIEs within scope have a period of two years to prepare for the new requirement, rather than one year recommended by the government. This additional time will be particularly necessary if the government requires the policy to be subject to an advisory shareholder vote.

Q25 In order to improve reporting on supplier payments, should larger companies be required to summarise their record on supplier payments over the previous 12 months as part of their annual Strategic Report (applying at a group level in the case of parent companies)? If so, what should the reporting summary include at a minimum? Do you have alternative suggestions on how to improve supplier payments reporting?

We should note that as the substantial majority of investment companies do not have executive directors or employees and do not provide goods or services and therefore have no turnover, they are consequently not required to report on supplier payments. This is appropriate given their structure.

As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. If this approach was taken, this would allow different rules to be applied in a proportionate matter, balancing the costs and benefits of applying those rules appropriately, in line with the nature of the company.

The AIC **recommends** that non-complex PIEs be excluded from the rules on supplier payments. This would mean that the majority of investment companies would continue to be excluded from these rules.

Q26 To which companies should improvements in supplier payments reporting apply: companies which are PIEs and already report under the Payment Practices Reporting Duty, or PIEs with more than 500 employees?

Please see our response to question 25.

Q27 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?

The AIC agrees with the government's proposal not to introduce a new statutory requirement for directors to publish an annual public interest statement.

The AIC has responded to the FRC's October 2020 discussion paper on 'The Future of Corporate Reporting' which sets out our view on non-financial reporting in more detail. We agree that, in the longer term, having a more standardised approach to such reporting will provide investors with more comparable information, both in terms of consistency year-on-year and comparability across companies.

In time, it may be that this element of reporting has the same importance as financial information, but we do not consider that to be the case at the moment.

As non-financial standards develop, it is important that companies are able to tailor their reporting to address the most appropriate issues facing their company. It should not be a one-size-fits-all approach as there are so many aspects that could be covered in a 'non-financial report'. The AIC **recommends** that ARGA undertakes further consultation work in this area if it intends to develop any standards on non-financial reporting or require companies to publish an annual public interest statement.

If any proposals are taken forward in relation to non-financial reporting, the AIC **recommends** that such disclosures are not included in annual reports as they are currently. As set out above in the section titled *A missed opportunity – reform of the annual report and accounts*, the AIC has long been concerned about the length and complexity of annual reports. These documents should provide shareholders and other users with the information they require in a clear and concise form. The AIC has previously **recommended** that annual reports and accounts are split into separate components to make them more effective tools for shareholders and stakeholders (see **Appendix 2** for more detail). Any proposals for non-financial reporting should be included in a company's bespoke report.

Other comments

The AIC supports the government's proposal not to require the statutory audit to cover the audit of Alternative Performance Measures (APMs), Key Performance Indicators (KPIs), and company statements covering how directors have complied with their duty under Section 172 of the Companies Act to have regard to certain stakeholder interests and other matters. These proposals would not be proportionate and would impose additional cost and regulatory burdens on companies without any significant benefits.

Chapter 4 - Supervision of corporate reporting

Q28 Do you have any comments on the government's proposals for strengthening the regulator's corporate reporting review function set out in this chapter?

Powers to direct changes to reports and accounts

The AIC supports the proposals to allow the regulator to direct changes to be made to reports and accounts without the need for a court order. However, the AIC **recommends** that this power is used as a last resort after having extensively engaged with companies to ask them to rectify any non-compliance with accounting and other reporting requirements.

The AIC agrees that an appropriate mechanism should be put in place to ensure companies have the ability to challenge the regulator's decision.

Powers to publish findings of corporate reporting reviews

The government intends to allow the regulator to publish a summary of findings about a company's corporate reporting review. The AIC does not support this. Matters raised in a corporate reporting review should be kept private between the company and the regulator allowing the company to adjust its reporting if necessary. Disclosing these findings may unfairly throw a spotlight on companies making errors in good faith, particularly if this is in areas where there is room for interpretation. If the government continues with this proposal, summary corporate reporting reviews should only be published in egregious cases.

The AIC does not support any proposal to allow the regulator the power to publish full correspondence entered into during the course of a corporate reporting review. This will prevent full and frank conversations between the company and the regulator. It will not help improve the quality and transparency of corporate reporting.

In any event, the regulator should ensure that no commercially sensitive information is published as part of publication regarding a company's corporate reporting review.

Extension of corporate reporting review powers to the entire annual report

The government has already asked the FRC to extend its corporate reporting review to cover the entire annual report ahead of legislation to extend both the existing powers to request information from companies and the new power to direct changes to cover the entire content of the annual report.

The AIC is unclear what benefits this will provide to shareholders. We consider this approach will unnecessarily increase costs to companies. This approach is likely to result in longer annual reports and accounts, without providing significant benefit to shareholders. Directors and their advisers would have less incentive to exclude extraneous or irrelevant information. This is contrary to the principle of ARGA of "*promoting brevity, clarity and usefulness in corporate reporting*".

There are already sufficient and appropriate mechanisms in place through company law, accounting standards and market rules to hold companies and their directors to account.

Companies and their auditors will read the entire annual report and accounts to ensure they are consistent with the financial statements. Additionally, shareholders, analysts, governance agencies, institutional investors and other market participants take an active role in reviewing the entire annual reports. The AIC considers that this provides sufficient oversight.

If the government proceeds with its proposals, the AIC **recommends** the increased scope is only applied for complex PIEs. The current scope of the corporate reporting review should remain in place for non-complex PIEs.

Power to offer a pre-clearance service

The AIC **recommends** that prior to ARGA providing a pre-clearance service for novel and contentious matters connected with interpreting accounting standards it should undertake a public consultation to ascertain how this would operate, the scope of such a service and whether companies considered there was a need for such a service.

Extending corporate reporting reviews to a wider range of investor information

The AIC supports the government's recommendation that the FRC/ARGA does not extend its corporate reporting review work to a wider range of investor information. As the government has identified, this may lead to regulatory overlap with the FCA and confusion for companies and investors.

The government has already asked the FRC, working with the FCA, to undertake a pilot study of preliminary results and investor presentations to establish the extent of any inconsistencies between this information and the subsequent annual report and accounts. This is sufficient. It would not be proportionate to also consider extending corporate reporting reviews to a wider range of investor information.

The AIC understands that the FRC, FCA and the government will review outcomes from this study once it is complete. The AIC **recommends** that, prior to any assessment as to whether this should become a permanent feature of the regulator's work, a public consultation is undertaken to establish the scope, purpose and process of such reviews.

Promoting brevity and comprehensibility in accounts and annual reports

The AIC supports the principle of "*promoting brevity, clarity and usefulness in corporate reporting*". Applying this principle should help improve the quality of corporate reporting. Please also see our response to question 75.

The government proposes that the concept of "usefulness" extends to work by the regulator to improve the digital accessibility of company reports and their availability in appropriate machine-readable formats.

The AIC **recommends** that the regulator does not introduce tagging requirements that go further than the European Single Electronic Format (ESEF) requirements as adopted in the UK. These will require companies preparing IFRS consolidated financial statements to tag their primary financial statements included in their annual report and accounts for financial years beginning on or after 1 January 2022.

The AIC **recommends** this is not extended to other companies that do not prepare IFRS consolidated financial statements. This would add unnecessary time and cost burdens to these companies. The AIC also **recommends** that there is no move towards companies being required to tag financial information on a line-by-line basis in their annual report and accounts.

Requiring companies to go further than EU legislation would create additional cost and regulatory burdens for UK companies. This would be an unnecessary administrative burden to companies incorporated in the UK.

Instead, the AIC **recommends** that all corporate reports are published in searchable PDF. This would meet investor needs to easily identify the sections of a report that are of the most interest to them.

A more disciplined approach to guidance and discussion documents

The AIC supports the recommendation that the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. Such documents should only be issued where they add clear value.

Chapter 5 - Company directors

Q29 Are there any other arrangements the government should consider to ensure that overlapping powers are managed effectively?

The AIC does not have any comments on this question.

Q30 Are there any additional duties that you think should be in scope of the regulator's enforcement powers?

The AIC does not support the government's proposal to legislate to provide ARGA with powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors. This approach is a significant extension of the regulator's powers, in an environment where other mechanisms already provide sufficient regulatory control. With this in mind, the AIC **recommends** that the focus should be on encouraging companies to have good corporate governance practices in place, not on additional enforcement.

There are already accepted practices established in company law for acting against directors. Section 174 of the Companies Act 2006 sets out the test to be applied regarding directors exercising reasonable care, skill and diligence. There are two parts to the test. The first element sets out a minimum objective standard expected of any director. The second, subjective test, requires a director to carry out his/her duty with the general knowledge, skill and diligence that she/he possess. A director who has more experience, knowledge and skill will have a higher threshold in discharging this duty. This provides sufficient powers to sanction directors.

Shareholders have powers to appoint and remove directors from company boards. The FCA, in its capacity as the UKLA, also has powers over directors in relation to their compliance with the Listing Rules, DTRs and in relation to Market Abuse Rules.

Additionally, the AIC does not support the government's proposal for all directors of companies which are PIEs to be in scope of the ARGA's proposed new powers.

Each director of a company brings different skills to the board. This supports the effective functioning of a board and it encourages board members to have constructive debates and challenge the opinions of others. If ARGA is given the power to act against all directors where there are concerns about financial reporting, it may result in unintended consequences, such as restricting diversity.

The AIC does not agree with the government's analysis that the "*risk of deterring candidates from non-financial backgrounds from applying for board positions is small*". Increasing enforcement powers by what is, essentially, an accounting regulator may increase the propensity of boards to recruit individuals with accounting skills and reduce the propensity of other candidates to apply for roles. This would be detrimental to ensuring boards are appropriately balanced with a diverse range of skills and perspectives.

These risks are increased as it is not clear what the evidential basis will be for ARGA to exercise its additional powers. There is also a concern as to how its enforcement action would be calibrated. Informal assurances that action would only be taken in the most serious circumstances are insufficient.

It is also unclear what the scope of AGA's powers would be. The measures proposed in the white paper already significantly extend its oversight beyond the financial statements. The intention is to extend its reach into other areas of preparing the report and accounts. It is not clear how the limits of AGAs enforcement role will be limited. There is a risk that the regulator is reaching into areas of corporate behaviour which are very different from the traditional role of regulating the preparation of the report and accounts.

Given this, it is also unclear that ARGA has the necessary skills and expertise to undertake such a role. Clearly there would be an option for ARGA to recruit to fill these gaps, but this creates a significant risk of regulatory overreach. The AIC's concerns about this matter are increased as the statutory basis for ARGA is poorly defined and delineated.

The AIC **recommends** that the new regulator should not be given additional powers to sanction all directors, regardless of their membership of a professional body. The current mechanisms are sufficient.

If the government intends to take these proposals forward, the AIC **recommends** that, before it does so, ARGA should set out specifically the scope of these enforcement powers and how they will be exercised proportionately with proper regard to adequate mechanisms, including a clear right of appeal.

Additionally, if the government advances with its proposals, the AIC **recommends** that the duties in scope of the new enforcement powers are strictly limited to breaches by directors of the existing statutory duties relating to corporate reporting and company audits. These should not extend to any other aspect of directors' duties.

The AIC does not consider there to be any additional duties that should be in scope of the regulator's enforcement powers, if they are to be adopted at all.

Q31 Are there any existing or proposed directors' duties relating to corporate reporting and audit that you think should be specifically included or excluded from further elaboration for the purposes of the directors' enforcement regime?

The AIC does not support the government's proposal for the regulator to have enforcement powers over breaches of directors' duties. See our response to question 30.

The AIC also does not agree that the regulator should have the power to impose more detailed requirements as to how certain statutory duties relating to corporate reporting and audit are to be met by directors.

These duties are either self-evident, such as the duty to approve and sign the annual accounts and the duty to approve the directors' report, or they are high level and overarching principles, such as the duty to approve accounts only if they give a true and fair view and the duty to keep adequate accounting records.

Those that are high level principles provide flexibility and are more likely to result in the appropriate behaviour. Were detailed requirements to be put in place these would be more likely to result in a tick box approach to complying with duties. The risk is that the outcome being sought would become lost and, as a result, there could be more failures in achieving the desired standards of behaviour.

Q32 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?

The AIC does not support the proposal to require directors of PIEs to meet behavioural standards set by ARGA. Company law already requires directors to exercise independent judgment, reasonable care, skill and diligence, and avoid conflicts of interest. Directors are also required to make certain statements in the annual report confirming that, to the best of their knowledge, the financial statements give a true and fair view of the financial position and the profit/loss in the period. There is no need to create additional, overlapping, requirements.

The AIC does not consider that setting behavioural standards for directors is within the scope of a corporate reporting and audit regulator. No evidence has been provided that such standards would have prevented corporate failures that have occurred in the past.

The AIC considers that existing requirements are sufficient to hold directors to account in relation to their statutory duties relating to corporate reporting and audits and **recommends** that no new standards be applied.

Q33 Should the government's proposed enforcement powers be made available to the regulator in respect of breaches of directors' duties?

The AIC does not support the government's proposal for the regulator to have enforcement powers over breaches of directors' duties. The government proposes that the new enforcement powers given to ARGA will work alongside existing enforcement regimes and states that "*ARGA's use of such powers will need to be coordinated with other regulators to avoid an overly complex regime for businesses*". This is a disproportionate response. It creates unnecessary, overlapping, requirements and will result in confusion about the responsibility and powers of different regulators and the law.

The AIC considers there are already appropriate and established practices in company law for acting against directors, along with powers held by the FCA to enforce against breaches of the Listing Rules, Transparency Rules or Market Abuse Regulation.

Q34 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 AIC supports the proposal that ARGA conducts a consultation on changes to the UK Code to review the need for clawback provisions to be included in directors' remuneration arrangements and to review the conditions within which clawback provisions can be triggered.

However, the AIC **recommends** that this review is limited to consider such provisions for executive directors which have performance related pay or complex remuneration structures in place. These are typically used to provide directors with large bonuses/remuneration and, depending on their structure, can reward the wrong behaviour.

The substantial majority of investment companies do not have executive directors or employees. Usually, the non-executive directors are paid a flat fee. Most investment companies have boards whose total pay (i.e. the aggregate of all board members) is under £250,000. The quantum of pay is low and the structures are straightforward. The AIC Code reflects this and as such it does not refer to executive directors with more complex remuneration structures.

Other comments

The AIC supports the government's view that "*the introduction of an authorisation type scheme for company directors would represent a major extension of regulation and a disproportionate burden that potentially deters listing and investment in the UK, particularly by internationally mobile businesses.*" The AIC agrees with the government's conclusion not to introduce such a regime.

Chapter 6 - Audit purpose and scope

Q35 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?

When planning an audit, many auditors will undertake a general and/or regulatory news search about the company and its directors. This will help inform the audit plan and approach. Whilst there is a benefit in auditors giving some consideration to wider information, this should not be overly burdensome or a disproportionate focus of the audit. General news searches may not provide accurate information about the company or its directors, therefore auditors will treat this with some amount of scepticism.

Ultimately, whilst such a review of other publicly available information may help inform the auditor, the audit is conducted based on information that is provided by the company and is disclosed in the annual report and accounts. The primacy of this information should not change. This will help to preserve the independence of the auditor and ensure the auditor continues to use their professional judgement when evaluating information.

The AIC **recommends** that the auditor is not given a statutory responsibility to consider wider information. This is not a proportionate response and would result in a significant increase in audit costs without a significant benefit to shareholders. Auditors cannot be expected to, and it is not desirable for them, to consider every piece of wider information about a company. This is not a good use of time or resources.

Instead, the AIC **recommends** ARGA provides guidance about auditors considering wider information. Any guidance about considering wider information should be broadly framed allowing the auditor to use their judgement about what to look at depending on the nature of the information and its potential relevance to its audit work.

Any guidance published by ARGA should recognise that a review of wider information should be proportionate and, as stated above, a review of other publicly available information should only help to inform the auditor's approach to the audit.

If this does not encourage the auditor to perform an adequate review then ARGA could publicly consult on proposed revisions to auditing standards.

Any consideration given by the auditor to the conduct of a director should only help to inform the auditor's wider judgement about the audit. The AIC **recommends** that there is no expectation that the auditor should formally assess or report on the conduct of a director. This is the responsibility of the board.

Directors have legal duties to exercise reasonable skill, care and diligence along with having statutory duties in relation to the preparation of the company's accounts and reports. The UK Code also provides that "*There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors. The chair should consider having a regular externally facilitated board evaluation. In FTSE 350 companies this should happen at least every three years.*"

Q36 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 Brydon Review proposed the following new audit purpose:

> *"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."*

The AIC supports defining the purpose of an audit. This should help to reduce the so called 'expectations gap'. However, the AIC **recommends** this definition is revised to focus on the financial statements, otherwise there is a significant risk that the expectations gap will persist and may indeed worsen. Proposed deletions are shown in text struck through and insertions are shown in underlined text:

> *"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~~ in the financial statements."*

Having a wider remit, which is not sufficiently well defined, will contribute to the 'expectation gap' problem. Investors will expect the regulator to be looking at all information published by or about a company.

Unless there is a clearly defined scope and purpose set for the regulator, there is a risk that ARGA will be subjected to unrealistic expectations. It may be considered to have failed in its duties for not having oversight of information which it should not reasonably be expected to have responsibility for. This could undermine confidence and the reputation of the regulator.

Q37 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?

As set out in our response to question 36, ARGA should have a very clear and defined duty focused on statutory audit, financial reporting and corporate governance. Please see our responses to questions 74 and 75 for more detail. The AIC **recommends** that the remit of ARGA is not extended beyond this. ARGA does not have the capabilities to cover every possible "wider auditing services" that a company could consider. Furthermore, it is not clear how such standards would be set to cover such a wider scope of potential work that could be undertaken under this banner.

The AIC also **recommends** that, outside of the statutory audit, there should be no expectation on companies to have any independent assurance on other elements of company reporting. The size, nature and complexity of the company, including the sector it operates in, may mean that there is no need for a company to receive further assurance on other areas of company reporting.

If companies decide they would like further assurance on other areas of company reporting, they should be able to appoint an appropriate consultant to provide such assurance based on a defined and agreed scope, taking into consideration appropriate materiality levels and liability clauses.

If the directors decide to have some form of extra assurance work performed in one year, for example a review of their cyber controls, there should be no presumption that this will be repeated in future years.

Please also see our response to questions 22 and 23 regarding our comments on the audit and assurance policy.

Q38 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?

The AIC does not support the remit of ARGA being extended to corporate auditing. Please see our response to question 37.

Q39 What role should ARGA have in regulating these wider auditing services? Should its role extend beyond setting, supervising and enforcing standards?

The AIC does not support the remit of ARGA being extended to corporate auditing. Please see our response to question 37.

Q40 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?

The AIC does not support the remit of ARGA being extended to corporate auditing. Please see our response to question 37.

However, if the government proceeds with its proposals for corporate auditing, and in any event, in relation to statutory audits, the AIC agrees that the majority of proposed audit principles suggested by the Brydon Review should be adopted.

However, the AIC does not agree with the principle that states "*Auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders*".

Shareholders should remain the primary audience for financial information and their needs should be paramount. The auditor reports to the shareholders of a company as the primary users of the financial statements and ultimate owners of the company. This does not negate the importance of other stakeholders in the company, but shareholders are, and should continue to be, the primary audience. Shareholders ultimately pay for the audit to be conducted.

Also, if auditors were made potentially liable, or otherwise accountable, to all stakeholders, the costs to the shareholder would increase, but the benefits would only accrue to the other stakeholders. This is not fair or proportionate. The AIC **recommends** that the proposed audit principles should be revised to recognise this and that the requirement to have regard to the users of the report beyond the shareholders be deleted.

The AIC also does not fully agree with the principle that states "*Auditors ask the directors to report any material information that may legitimately be disclosed to assist the understanding of users of an audit report, and, if necessary, disclose it themselves*". Whilst the auditor should ask the directors to report such information, if the directors are unwilling the auditor should not disclose that information. There may be a number of reasons why the directors are unwilling to report such information, for example it may be commercially sensitive.

Ultimately, if an auditor disagrees with a company on a certain matter or considers the annual report and accounts to be misstated or has been unable to form an opinion, then a qualified, adverse or disclaimer of opinion may be provided.

The AIC also **recommends** that the principle that "*Auditors' reports give transparency to any differences of view with management and how they were resolved*" be limited to any "*material differences*". This will focus the attention on only those matters which will be of primary concern to the user.

Q41 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?

The AIC does not support the remit of ARGA being extended to corporate auditing. Please see our response to questions 36 and 37.

Q42 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.

The AIC does not support the proposal to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud. Nor does the AIC support the proposal to require auditors to report on whether this statement is factually accurate or auditors reporting on the steps they took to detect any material fraud and assess the effectiveness of relevant controls.

These proposals are another example of where the government is seeking to implement a number of different measures all in one go, to tackle the same or similar issues. Please see the section above titled *Overlapping measures*.

The government is already seeking to increase the internal control framework in the UK (please see our responses to questions 12 to 14). Additionally, the FRC has recently published a revised auditing standard setting out the responsibilities of auditors relating to fraud (ISA 240). The FRC states that "*The revisions to the standard are designed to provide increased clarity as to the auditor's obligations, addressing the concern raised by Sir Donald Brydon in his review of the quality and effectiveness of audit. The revisions include enhancements to the requirements for the identification and assessment of risk of material misstatement due to fraud and the procedures to respond to those risks*." Implementing all these proposals at the same time is not a proportionate response. The AIC is concerned that this will result in a significant increase in the cost of the audit without any clear benefit to shareholders.

ISA 240 states that, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The responsibility of the auditor is to obtain "*reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error*".The AIC **recommends** these responsibilities remain unchanged.

Were auditors to be given greater responsibility to report on a director's statement or to detect material fraud, the costs of the audit could rise exponentially and in many cases there will be no clear benefit to shareholders.

There will always be a risk of fraud arising in a small number of companies and this is particularly hard to detect where there is collusion. To help address this, if there is demand from boards, shareholders or stakeholders, companies could engage a reporting accountant or other appropriate consultant on an ad hoc basis to review certain parts of their businesses where there are increased concerns in relation to fraud. This could include reporting on a company's systems or other internal controls in place to detect or prevent fraud.

If the government adopts its proposed package of reforms on preventing and detecting fraud, the AIC **recommends** that this is implemented in a proportionate manner. The AIC **recommends** that directors of complex PIEs, which pose the higher risk to the public interest if they were to be the victim of fraudulent activity, report on the steps they have taken to prevent and detect material fraud. Please see the section above titled *Achieving proportionality*.

Q43 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.

Please see our response to question 35. Auditors already give some consideration to wider information when conducting an audit. The AIC **recommends** ARGA provide guidance about considering wider information.

Q44 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?

Please see our response to question 40.

The AIC supports the continuation of the "true and fair override". Although this is rarely used, it is a helpful and important tool which can be used if the strict application of accounting standards does not provide the right approach.

Q45 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?

The AIC does not agree there is a need for specific assurance on APMs or KPIs. Some companies, such as investment companies, have a limited number of APMs and KPIs and many of these are simple to calculate. Some may also be included within the current statutory audit process, or shareholders may consider they receive sufficient assurance over these figures from the current review of other information included in an annual report which is undertaken by auditors.

However, if some form of further assurance is demanded by shareholders, the AIC **recommends** that the specific nature of this assurance be determined by directors. It would not be proportionate to mandate that companies must adopt a one-size-fits-all approach to gaining assurance on APMs and KPIs.

If the government wanted to proceed with this requirement, the AIC **recommends** that this is implemented in a proportionate manner, and such regulatory burdens are only imposed on complex PIEs which pose the higher risk to the public interest. Please see the section above titled *Achieving proportionality*.

Q46 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?

The AIC does not have any comments on this question.

Q47 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?

The AIC does not have any comments on this question.

Q48 Do you agree that a new, distinct professional body for corporate auditors would help drive better audit? Please explain the reasons for your view.

The AIC does not have any comments on this question.

Q49 What would be the best way of establishing a new professional body for corporate auditors that helps deliver the government's objectives for audit? What transitional arrangements would be needed for the new professional body to be successful?

The AIC does not have any comments on this question.

Q50 Should corporate auditors be required to be members of, and to obtain qualifications from, professional bodies that are focused only on auditing?

The AIC does not have any comments on this question.

Q51 Do you agree that a new audit professional body should cover all corporate auditors, not just PIE auditors?

The AIC does not support the remit of ARGA being extended to corporate auditing. Please see our response to questions 36 and 37.

Other comments

The government decided not to advance proposals to require auditors to "read and consider" material outside the annual report, such as regulatory announcements and investor presentations, and report if they consider this information to be materially misstated. The AIC agrees with this conclusion and considers that it would not provide any significant benefit to investors but would increase the costs of the audit.

Chapter 7 - Audit Committee oversight and engagement with shareholders

Q52 Do you agree that ARGA should be given the power to set additional requirements which will apply in relation to FTSE 350 audit committees?

As outlined above in the section titled *Achieving proportionality*, the AIC **recommends** the government takes a proportionate approach to the definition of PIEs, splitting PIEs into complex and non-complex categories. If this approach was taken, the government need not subject all types of entity to the same rules. This would allow different rules to be applied in a proportionate matter, balancing the costs and benefits of applying those rules appropriately.

The AIC **recommends** that no additional requirements are imposed on audit committees for non-complex PIEs, and in particular, those which are listed.

There is already significant regulation and guidance in place regarding the duties of directors on audit committees. These place a significant onus on the committee members to act independently and to have certain competencies. For example:

- Directors have legal duties to act in the best interest of shareholders;

- The FCA's Disclosure Guidance and Transparency Rules contain rules for audit committees of listed companies;
- The UK Code contains a number of recommendations which apply to the board and the audit committee (these are replicated in the AIC Code);
- The FRC has published guidance papers for audit committees, including: Guidance on Audit Committees (April 2016) and Audit Quality – Practice aid for audit committees (December 2019) which highlights factors that audit committees may consider when assessing audit quality.

These provide an appropriate and sufficient regulatory framework in relation to audit committees.

If the government does not adopt the AIC's proposal to categorise PIEs as non-complex or complex, the AIC **recommends** that any additional requirements only apply to audit committees of FTSE 100 companies.

Irrespective of whether there is a 'market cap' test, the AIC does not agree that there needs to be any additional requirements imposed in the investment company sector. Applying any additional rules on audit committees for investment companies would not be proportionate given the unique structure and characteristics of our sector. The AIC is not aware of any concerns raised by investors about the quality of the audit for investment companies.

The structure of investment companies is very different from trading companies. As outlined in the section above titled *Introduction to investment companies*, the majority of investment companies have independent boards comprised of non-executive directors. The day-to-day operations of investment companies are outsourced to external third-party service providers, such as the fund manager and the administrator. Typically, investment companies are operationally very simple with limited, or no, physical presence, no executive directors or employees. This means that their audits are relatively simple and the typical audit fee for an investment company is much lower than that of a trading company.

Additionally, investment companies that are subject to the FCA's Chapter 15 Listing Rules are also required to have a board of directors which "*must be able to act independently*" of the investment manager. This ensures the directors are independent of those performing the day-to-day operations of the company.

Audit committees of investment companies will have significantly less day-to-day involvement with the auditor. The "cultural fit" bias, identified in the Statutory audit market study, published by the Competition and Markets Authority (CMA), poses less of a risk in the tender process.

In the event that non-complex PIEs are not excluded from these provisions, the AIC **recommends** that investment companies are excluded. Investment companies that should be excluded are:

- Companies listed on the London Stock Exchange under Chapter 15 "Closed-Ended Investment Funds: Premium Listing";
- Companies listed on the Specialist Funds Segment of the London Stock Exchange; and
- Investing companies quoted on AIM.

The AIC supports the views expressed by the CMA that any future regulations to scrutinise audit committees should build on existing rules and guidance already in place. Therefore, the AIC **recommends** that any new measures are introduced via the UK Code. As outlined above in the section titled *Overlapping measures*, this would allow companies the flexibility to tailor their arrangements to fit their individual circumstances whilst ensuring they explain any departures from the guidelines. Any new UK Code provisions should mirror the recommendations already included in the regulations and guidance papers identified above. This will help to reduce the regulatory, cost and compliance burden for companies and meet the recommendations of the CMA that the standards draw on existing voluntary codes.

Q53 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?

The AIC **recommends** that any duty the government imposes on ARGA to monitor compliance with the new audit committee 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, is used proportionately by ARGA. Please see our response to question 52 which sets out that any new powers should only be applied to complex PIEs and, in any event, should exclude investment companies.

The AIC agrees with the government and **recommends** that appropriate safeguards be put in place to deal with confidential information which the regulator obtains using these powers. None of this information should be made public.

The AIC also **recommends** that any information requested from audit committees is information that committees already have available or are already providing, for example, to the board. There should be no expectation that companies prepare information solely for use by the regulator. No unnecessary time or cost burdens should be placed on companies.

The AIC agrees with the government's proposal and **recommends** the regulator takes a risk-based approach to monitoring ongoing compliance. This should take into account the company's size, nature and complexity.

In cases where the regulator identifies concerns, the AIC **recommends** that it writes to the audit committee to highlight any specific areas of concern. Any discussions should take place privately. This is more likely to shift the activity or behaviour successfully and may prove to be a more effective method to engage more fully on issues and hold audit committees to account.

The powers stated above are sufficient to ensure effective compliance with any new requirements. However, if the government goes ahead with its proposal to allow the regulator to have the power to place an observer on the audit committee where it has concerns, and those concerns have not been resolved through engagement, then the AIC **recommends** that the observer's presence on the committee is also kept private for the same reasons as set out above.

The AIC does not support the proposal for the regulator to take any remedial steps publicly. If any public notices or statements to shareholders are made, this should only be undertaken after all other engagement mechanisms have been exhausted.

However, the AIC recognises that the regulator may wish to use anonymised examples of good and poor performance in any guidance it publishes which will help audit committees identify best practice.

Q54 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)?

The AIC does not support the proposal to give the regulator the power to appoint auditors even in specific, limited circumstance. This goes against the fundamental premise of having a competitive market. It may also result in unexpected consequences.

Introducing a third party into the process of appointing the auditor will risk other issues arising as they may not have the requisite detailed knowledge or understanding of the business.

There are any number of reasons why a company has parted with its auditor outside the normal rotation cycle, for example it may have moved into a different sector and does not consider the auditor to have sufficient experience in that sector. This should not automatically result in the regulator being involved in appointing a new auditor.

The FRC already has powers to apply to the court to remove an auditor from office where there are proper grounds to do so. The AIC **recommends** this power be transferred to ARGA. This, along with other proposals made by the government, will help to improve the quality of audits.

The AIC **recommends** that in all, except the most exceptional circumstances, the audit committee continues to be responsible for selecting the auditor and making a recommendation to the board regarding the appointment of the auditor.

If the government proceeds with this proposal, the AIC **recommends** that this is implemented in a proportionate manner, such that the regulator only takes such powers in relation to complex PIEs which pose the higher risk to the public interest if they were to fail. Please see the section above titled *Achieving proportionality*.

Q55 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?

The AIC does not support the proposal. It goes against the fundamental premise of having a competitive market.

However, if the government proceeds with its proposals, particularly in relation to managed shared audits, it will need to closely monitor the impact of these changes in the audit market. The AIC is concerned that the managed shared audit requirement will produce unintended market distortions, potentially making it difficult for some companies to find an auditor. The AIC **recommends** the government and ARGA do everything they can to make sure such distortions do not occur, and act quickly if any indication of a distortion is identified. Please see our response to question 61 for more details.

Q56 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?

The AIC does not support ARGA having the power to appoint an auditor. Please see our response to questions 54 and 55.

Q57 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)?

Please see our response to question 55.

Q58 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?

No, the AIC does not agree with this proposal.

Shareholders already have sufficient mechanisms to engage with directors to discuss their views about audit matters. For example, the AGM already provides shareholders with a forum to raise questions about the audit. Outside of the AGM, shareholders are able to raise concerns with the board or the audit committee via the company secretary.

Directors have legal duties set out in company law, including the responsibility to exercise reasonable care, skill and diligence. If a shareholder were to approach a director about an audit matter, the director would be bound to consider the matter and act appropriately. If a director fails in this duty, shareholders have the ability to vote them out of office.

The FRC's Guidance on Audit Committees includes a section on the audit committee communicating with shareholders. It states the audit committee should "*be prepared to meet investors*". It also states, "*The chairman of the audit committee should be present at the AGM to answer questions on the separate section of the annual report describing the audit committee's activities and matters within the scope of the audit committee's responsibilities*".

Current arrangements for shareholder communication are already extensive. The AIC is not aware of any situations where shareholders have been unable to raise questions about the audit with the board or audit committee if they wish to do so.

Many shareholders do not actively engage with the company about key issues relating to the operation of the company. Therefore, it is difficult to believe they will engage in matters relating to planning an audit. This is likely to be an esoteric topic and there is no reason to believe that shareholders will be better placed than the board or the auditor to determine how an audit is undertaken.

In many cases, shareholders will not have a detailed knowledge about the operations of the company, nor will they possess accounting knowledge. The AIC considers that the auditor and the audit committee are best placed to plan and approve the audit scope and materiality.

These proposals will place significant cost burdens on companies, requiring them to undertake extra work, such as setting out procedures as to how shareholders can engage, commenting on how shareholder views have been taken into account and explaining why they have/have not been incorporated into the audit. The AIC does not consider this will provide any proportionate benefit for shareholders.

If the government proceeds with this proposal, the AIC **recommends** that this is implemented in a proportionate manner, and such proposals are only implemented for complex PIEs which pose the higher risk to the market if they were to fail. Please see the section above titled *Achieving proportionality*. It would be disproportionate to apply these to all Premium Listed companies through changes to the UK Code.

Additionally, the AIC **recommends** that:

- Shareholder votes (if they occur) are only advisory and it remains the responsibility of the auditor and audit committee to determine the scope of the audit;
- The auditor is not required to consider proposals which fall outside of the scope of a company audit;
- The company should not be required to publish or provide any new information to shareholders. There is likely to be sufficient disclosure about the risks affecting the company and the key audit matters contained in the prior annual report and accounts;
- The matters on which companies are obliged to engage with shareholders on, in relation to audit processes, are strictly limited in scope.

The AIC does not support the proposal that auditors be obliged to consider suggestions put forward by shareholders, nor does it support the proposal that the audit committee should communicate which shareholder suggestions put forward for consideration have been accepted or rejected. Were companies required to facilitate interaction between shareholders and auditors outside of the AGM, this would create a significant administration burden without any significant benefit.

The aim of any shareholder engagement should be to benefit the governance or operations of the company. If any suggestions are taken forward, they should be done so on their merit and the company should not be burdened with the cost and compliance burden of having to respond to individual suggestions put forward by shareholders. The AIC considers this is not practical or desirable and it will not provide a significant benefit to shareholders.

The AIC **recommends** that any proposal relating to giving shareholders a formal opportunity to engage with risk and audit planning are considered more fully by ARGA and consulted on prior to any changes being implemented. Any detailed proposals should undergo a full cost/benefit analysis to ensure any changes made will bring benefits commensurate with the costs involved.

Q59 Do you agree with the proposed approach for ensuring greater audit committee chair and auditor participation at the AGM? How could this be improved?

The AIC agrees with the government's approach that it is not necessary to add a standing item to AGM agendas for questions to be put to the auditor and the audit committee chair.

The government proposes changes to the guidance to audit committees to encourage questions from shareholders about the company audit and changes to the Stewardship Code to promote greater engagement from investors on matters relating to audit quality. If these are advanced, then the AIC **recommends** ARGA consults on any proposed changes.

Q60 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 AIC considers that existing Companies Act provisions are adequate. Were the auditor required to state further reasons as to the departure of an auditor, unintended consequences may arise, particularly if shareholders misunderstood or misconstrued the reasons for the departure. This could cause significant harm to the company.

There may be any number of reasons why a company has parted with its auditor outside the normal rotation cycle. Making this statement alone could damage a company's reputation and/or share price if shareholders consider this to be negative.

Other comments

The AIC agrees with the government's conclusion that it would not be proportionate to amend company law to require audit fees to be shown on the face of the profit and loss account.

For companies other than small and medium size companies, the annual report and accounts must disclose the amount paid to the auditor for auditing services and the amount for non-audit services. This should be split between the different types of services provided (for example, tax, internal audit and other services). Therefore, shareholders of these companies will already have access to such information.

Chapter 8 - Competition, choice and resilience in the audit market

Q61 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 AIC is particularly concerned about the government's proposals to implement a mandatory managed shared audit requirement. This concern arises from the following factors:

1) **Unnecessary and disproportionate regulatory costs and burdens being imposed on non-complex PIEs, including investment companies:**

   Whilst the mandatory managed shared audit requirement is similar to the CMA's proposals in this area, the CMA also proposed an exemption for investment trusts and individual entities that do not prepare consolidated accounts, yet the government is not proposing to automatically exempt these companies.

   The government states that it "*agrees that it may not be proportionate or practical for these companies to implement a shared audit. However, as there is reason to consider* *that many Challengers have the capacity to carry out these less complex engagements as sole auditor, the Government would expect their audit committees to carry out an audit tender that encouraged the appointment of a Challenger firm. Therefore, an automatic exemption is not proposed for these entities. The Government instead intends to work with the regulator to develop a modified approach for these entities to follow, which will be set out in regulations.*"

2) Difficulty of identifying a material proportion of the audit to allocate to a second audit firm

The audits of investment companies in particular would be difficult to divide sensibly between two auditors. The extra costs this would entail would not be proportionate and this may result in a reduction of audit quality.

The key constituent to an investment company audit is the existence and valuation of its investment portfolio. The value of the portfolio has a direct relationship to the income received in the year. It also forms the basis for calculating many of the company's expenses, such as its management fee. Without the knowledge gained from the audit work on the investment portfolio, it would be difficult for an auditor to provide any significant scrutiny and challenge on the accuracy and completeness of the company's income or expenses.

The regulatory environment for investment companies also places certain obligations on investment companies over a size certain threshold, such as the requirement to have an independent valuation and the requirement to have a depositary to hold assets that are held in custody.

Please see **Appendix 4** which sets out our reasons for this recommendation in detail.

If an automatic exemption is not adopted, the AIC is keen to work with the government and the regulator to develop "*a modified approach*" that is proportionate and does not require investment companies to incur significant and unnecessary extra costs.

3) Unintended consequences limiting choice of audit firm

Introducing a mandatory managed shared audit requirement is likely to restrict auditor choice for some companies. Currently much of the investment company sector is audited by the Big Four audit firms and one other audit company.

These companies have invested in the skills and knowledge needed to audit the investment company sector. This requires them to understand the specific rules that apply to our sector, such as Chapter 15 of the Listing Rules and the AIC Code, and understand the implications of these rules for their audit processes.

Not all audit firms will want to invest the time and money in the required resources to audit specialist sectors, such as the investment company sector. Therefore, although an investment company might be in theory able to appoint any challenger auditor (to avoid the need for shared audit) the range of firms able and or willing to provide an audit is likely to be far more limited than listed trading companies which do not have specific rules that apply to them.

The appetite for challenger firms to enter this part of the market may be limited because the audit fees for investment companies have traditionally tended to be significantly lower than other trading companies. For example, as previously stated, the largest investment company by total assets is Scottish Mortgage Investment Trust PLC, which is in the FTSE 100. Its annual report and accounts for the year ended 31 March 2020 shows fees paid to the auditor for audit services of £45k.

Choice for investment companies may be further restricted if one of the challenger auditors is conflicted out of performing audit work for a particular investment company.

At the same time, these companies will be denied access to the four largest incumbents in the market. This is not an acceptable position.

The choice of audit firm may be further restricted if audit firms do not want to tender for investment company audits because it will not provide them with a sufficient fee. This fee would be further reduced where it has to be split between two audit firms as extra processes and procedures will be required to enable the two firms to work together.

This may make it almost impossible for companies in specialist sectors, such as investment companies, to secure competing tenders for their audit work. This could have significant implications for the cost of audit. In the most extreme circumstances, companies might not be able to secure auditors at all.

4) Imposing rules on the users of the service rather than the audit market itself

It is not justifiable to impose remedies on the users of services because of concentration in the supplier market. It can be argued that one of the reasons that there is now more limited choice in the audit market is that the competition authorities allowed established audit firms to merge. To now, in effect, punish companies with legal duties to appoint auditors for these failings is perverse. If remedies are required then they should be imposed on the auditors, not companies and their shareholders.

For these reasons, the AIC does not agree with this approach. The AIC **recommends** that non-complex PIEs should be automatically excluded from the requirement to have a shared audit. The costs of requiring non-complex PIEs, including investment companies, to have such audits would not be in line with the commitment to proportionate regulation made by the government and regulators. Please see the section above titled *Achieving proportionality*.

In any event, the AIC **recommends** investment companies should be excluded from the requirement to have a shared audit.

The AIC **recommends** that audit committees of non-complex PIEs have full choice to select the most suitable service provider for their company, without limitation.

If the government proceeds with its proposals to have a managed shared audit for complex PIEs, the AIC **recommends** that any new approach be introduced over time when audit contracts are re-tendered rather than requiring companies to immediately adopt new measures which could result in significant disruption in the audit market and a reduction in audit quality.

Q62 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?

The AIC does not have any comments on this question.

Q63 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?

The AIC does not support the introduction of a managed market share cap. The AIC **recommends** that the choice available to audit committees to select the most suitable service providers for the company must remain as extensive as possible.

The AIC considers that this proposal will have similar unintended consequences for limiting choice of audit firm as set out in our response to question 61 where audit firms will not want to 'use up' their allowed market share cap auditing smaller or less high-profile companies. This may make it almost impossible for companies in specialist sectors, such as investment companies, to secure competing tenders for their audit work. This could have significant implications for the cost of audit. In the most extreme circumstances, companies might not be able to secure auditors at all.

Q64 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?

The AIC does not have any specific comments on this question.

However, given that the government's proposals in this area will apply initially to audit firms who carry out statutory audits of 15% or more of the FTSE 350 by audit fees, the AIC is concerned that the measures may produce unintended market distortions, potentially disincentivising challenger firms from scaling up operations in the FTSE 350 market.

The AIC is concerned that this proposal would have similar unintended consequences for limiting the choice of audit firm as set out in our response to question 61. The AIC **recommends** that the government and regulator act to ensure such distortions do not come to fruition.

Q65 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?

The AIC does not have any comments on this question.

Q66 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?

The AIC does not have any comments on this question.

Q67 The government believes these proposals will meet its objectives. In the event that they prove insufficient to improve audit quality, and full separation of professional services firms is required, do you have any comments on how to make this work most effectively?

The AIC does not have any comments on this question.

Q68 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?

The AIC does not have any comments on this question.

Other comments

The AIC **recommends** that the definition of a challenger firm should be reconsidered.

The proposal to define a challenger firm as a "*firm that provides statutory audits to Public Interest Entities (PIEs) and whose audit revenues did not represent more than 15% of the FTSE 350 statutory audit market by fees in either of the prior two years*" could lead to firms moving in and out of this status. It is not clear how a company would assess which firm is a challenger or not. The process to appoint a new audit firm can be lengthy. Companies may find themselves in a situation where they are midway through a tender process and then suddenly the status of an audit firm changes which could result in unnecessary time and costs being incurred. The impact of this may be particularly severe for companies in specialist sectors, where there may already be a limited number of audit firms with the skills and experience of auditing these companies.

There may also be issues if a firm becomes a non-challenger after appointment. It is assumed that there would not be a requirement to operate a shared audit if this situation arises. If so, this should be specified. If this is not the case, then it makes the shared audit proposal even less appropriate.

Chapter 9 - Supervision of audit quality

Q69 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?

The AIC does not have any comments on this question.

Q70 What types of sensitive information within AQR reports on individual audits should be exempt from disclosure?

The AIC does not support the government's intention to legislate to allow AQR reports on individual audits to be published by the regulator without the need for consent from the audit firm and the audited entity. The AIC **recommends** no such legislation is put in place.

The AQR is a report about the audit based on the work undertaken by the audit firm. The audited entity will have no control over the records maintained by the audit firm. However, the publication of an AQR could result in unintended consequences for the audited entity and affect market views on the company. For example, these documents could be used by external parties such as potential investors or loan providers to make decisions that will affect the company. This could have negative consequences for the audited entity.

The government's proposals seek to improve quality in the audit market, yet this measure could result in the companies and shareholders being penalised.

If the government proceeds with this proposal, the AIC **recommends** that this is implemented in a proportionate manner, and such proposals are only implemented for complex PIEs which pose the higher risk to the public interest. Please see the section above titled *Achieving proportionality*.

Furthermore, if this legislation is introduced, the AIC **recommends** the regulator is required to obtain the audited entity's consent prior to publication. The AIC also **recommends** only a summary report is published. The AIC also **recommends** that the audited entity is provided with a copy of the report prior to publication and is allowed to redact such information that it considers to be commercially sensitive or confidential.

Q71 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?

Please see our response to question 70.

Q72 Do you agree with the government's approach to component audit work done outside the UK? How could it be improved?

The AIC does not have any comments on this question.

Q73 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?

The AIC shares the government's desire to ensure that audited entities continue to be willing to seek legal advice where necessary. Therefore, the AIC supports the government's proposal that "*any measures to address the problem would need to be targeted only at documents belonging to the audited entity that had already been shared with the auditor. In addition, if the regulator were able to see privileged information, it would need to be strictly limited in circulation and purpose, with appropriate safeguards.*"

Chapter 10 - A strengthened regulator

Q74 Do you agree with the proposed general objective for ARGA?

No. The AIC does not consider that the government's proposed objective "*to protect and promote the interests of investors, other users of corporate reporting and the wider public interest*" is sufficiently clear, targeted or appropriate. This objective is too wide and poorly delineated. It potentially extends its reach far beyond what is suitable for a regulator with the primary purpose of ensuring the integrity of the report and accounts and overseeing the audit sector.

Instead of the general objective proposed by the government, the AIC **recommends** the objective set out by the Independent review of the FRC is adopted. This states that ARGA's objective should be:

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

The AIC considers this also meets the government's objective to ensure that it remains relevant when ARGA is carrying out its wider policy-making functions. For example, the AIC considers that setting standards and issuing guidance would also be met by this objective as this would come under the broad headings of "*statutory audit, corporate reporting and corporate governance*". It also recognises the ARGA will have functions relating to accountants and actuaries as these are included as "*professional advisers*". The AIC **recommends** this objective is adopted.

Without a clearly defined objective there is a risk that ARGA's role will extend into areas which are not appropriate. There is a risk that its role will overlap with other regulators, notably the FCA. Failing to define ARGA's statutory duties effectively creates risks for the regulator. It may create expectations that it has obligations relating to matters which it considers are not it its remit. The lack of a clear regulatory perimeter could undermine confidence in ARGA.

The objective proposed in the Independent review of the FRC establishes clearer and more appropriate duties for ARGA. It will help define ARGA's role as being distinct to other regulators, such as the FCA, and provides a more suitable and specific purpose for ARGA.

The government also proposes that ARGA will have a quality and competition objective. The AIC **recommends** the proposed quality objective be adopted.

The AIC **recommends** that ARGA should not have a competition objective. The objective proposed is "*To promote effective competition in the market for statutory audit work*". No clear justification for it to have a specific competition objective has been advanced. It is unclear why responsibility for competition in the audit market should not lie with the CMA. Were ARGA to be considering the introduction of price regulation, as has been introduced in utilities markets, then the creation of a dedicated regulator might be appropriate. The FCA has competition objectives, but it also deals with complicated interlinked markets dominated by retail consumers, who have very different needs from corporate entities. Concentration in the audit market has not been a product of weak consumers. Arguably, it has been created by poor merger control mechanisms.

The decision to create a statutory regulator, ARGA (which the AIC supports), does not provide the basis for giving it a competition objective. This attempt to broaden the regulator's objective is not justified. ARGA should be focused on promoting quality as outlined in its quality objective.

Q75 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?

The AIC agrees with the majority of regulatory principles for ARGA to have regard to. In particular, the AIC supports the principle of "*promoting brevity, clarity and usefulness in corporate reporting*". Please also see our response to question 28 which includes a section on this.

As set out in above in the section titled *A missed opportunity – reform of the annual report and accounts*, the AIC has long been concerned about the length and complexity of annual reports. These documents should provide shareholders and other users with the information they require in a clear and concise form. The AIC has previously **recommended** that annual reports and accounts are split into separate components to make them more effective tools for shareholders and stakeholders (see **Appendix 2** for more detail).

The AIC does not agree that the regulator should be "*promoting innovation in statutory audit work, corporate reporting and corporate governance*". It is not a regulator's job to promote innovation. This is the role of the market. The role of the regulator is to protect high standards. This is already reflected in the proposed quality objective, which the AIC **recommends** is adopted.

The Independent review of the FRC also recommended two other duties for ARGA which the AIC supports and **recommends** are adopted. It suggested that ARGA should act in a way which:

- Is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulator action; and
- Prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code.

As explored in the section above titled *Achieving proportionality*, the AIC **recommends** that the Legislative and Regulatory Reform Act 2006 should be amended to include ARGA.

As a statutory regulator, ARGA will be required to comply with the Regulators' Code. This provides that "*Regulators should base their regulator activities on risk.*" The AIC **recommends** this is reflected in ARGA's objectives to ensure they are clear and transparent.

Other comments

The AIC supports the government's proposal that the regulator will be given the power to make rules requiring that market participants pay a levy to meet the regulator's costs of carrying out its regulatory functions. However, the AIC **recommends** that this legislation provides that the levy ARGA can set must be proportionate to the work it undertakes and the size of the company that will be required to pay the levy.

The AIC **recommends** that ARGA be given powers to endorse other industry codes of best practice, such as the AIC Code, which adapts the Principles and Provisions set out in the UK Code to make them relevant for the investment company sector. The AIC Code is currently endorsed by the FRC. It is widely used by investment companies and valued in the market. The AIC **recommends** that ARGA continues to endorse the AIC Code.

Chapter 11 - Additional changes in the regulator's responsibilities

Q76 Should the scope of the regulator's oversight arrangements be initially confined to the chartered bodies and should they be required to comply with the arrangements?

The AIC does not have any comments on this question.

Q77 What safeguards, if any, might be needed to ensure the power to compel compliance is used appropriately by the regulator?

The AIC does not have any comments on this question.

Q78 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?

The AIC does not have any comments on this question.

Q79 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 AIC does not have any comments on this question.

Q80 – Q93

The AIC has no comments on these questions as they relate to the oversight and regulation of the actuarial profession.

Q94 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?

The AIC does not support the extension of the matters that PIE auditors are already required to disclose to the regulator when they have viability or other serious concerns about a PIE during the course of an audit. The government has not provided specific examples where such provisions would have prevented the failure of a PIE.

Q95 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?

The AIC does not have any comments on this question.

Q96 How much time should be given to respond to a request for a rapid explanation?

The AIC does not support ARGA having the power to request a rapid explanation. Please see our response to question 94.

However, if the government does decide to adopt this proposal, the AIC **recommends** that any timeframe should be proportionate to the matter in hand and should allow directors and officers of the company sufficient time to fully respond to the regulator's concerns.

Q97 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?

The AIC does not support ARGA having the power to request an expert review. Please see our response to question 94.

However, if this proposal is adopted, the AIC **recommends** that a summary of the expert reviewer's report is only published as a last resort after all other tools available to the regulator to encourage the company to amend its accounts have been exhausted.

The AIC also **recommends** that care is taken to ensure commercially sensitive and confidential information is appropriately redacted.

Q98 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?

The AIC does not support ARGA having the power to request an expert review. Please see our response to question 94.

Other comments

The government proposes providing ARGA with new powers to address serious concerns in PIEs but considers these should be limited to the areas where the regulator has existing enforcement powers. This, it states, would include those areas where new obligations are being imposed or proposed on companies as a result of the audit reform proposals.

As set out in our response to question 94, the AIC does not agree that any further powers be given to ARGA without a further consultation that clearly sets out the need for such powers, the scope of the powers and the cost/benefit of introducing such powers. This proposal should be fully justified.

The AIC **recommends** there is a case for staged change because of the substantial number of proposals and their potential to overlap, as set out in the section above titled *Overlapping measures*. The AIC **recommends** that, in the first instance, other proposals should be taken forward as part of the package on audit reform, such as those supported by the AIC above. These should be given time to embed before any further changes are considered. Companies should also be given an appropriate length of time to make any necessary changes to their operations where required.

Only if there is not sufficient headway being made in audit quality should the government consult further on whether it should give ARGA new powers to address serious concerns in PIEs. If such proposals are taken forward, the AIC **recommends** such powers are limited to corporate reporting and audit.

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Appendix 1 – A summary of the AIC's key themes and recommendations

Key themes which form the basis of the AIC's response

- The **definition of Public Interest Entities** (PIEs) should be split into two categories: complex and non-complex allowing the reforms to be developed in a proportionate way, balancing the costs and benefits of regulatory action;
- Proposals should be implemented in stages with **overlapping obligations removed**;
- A fundamental review of the **structure and content of annual reports and accounts** should be undertaken; and
- The **statutory duties** for the Accounting, Reporting, Governance Authority (ARGA) should be appropriately defined.

Key recommendations

- No further requirements should be added to the **internal control framework**. However, if there is to be reform, measures should be limited to complex PIEs where auditors should report more detail about the work they already undertake;
- No further **distributable profit disclosures** are required. However, if there is to be reform, companies should be able to report a "not less than" figure for distributable reserves, with any proposed dividend payment not being allowed to exceed this figure. Directors should not be required to make a specific statement about the legality of dividends and their effect on the future solvency of the company;
- Non-complex PIEs should be allowed to choose the time period covered by the **resilience statement** and determine what matters are be addressed in these statements. They should not be required to use reverse stress testing scenarios;
- Non-complex PIEs should be excluded from the requirement to have an **audit and assurance policy**. There should not be a shareholder vote on the audit and assurance policy and proposals to give shareholders a formal opportunity to engage with risk and audit planning should not be adopted;
- ARGA should not have powers to **investigate and sanction** breaches of corporate reporting and audit-related responsibilities by PIE directors. Also, no **behavioural standards** should be introduced for directors;
- Auditors should not be given a statutory responsibility to consider **wider financial or other information** during the course of an audit, nor should they formally assess or report on the conduct of directors;
- No new **corporate auditing** framework should be introduced. Outside of the statutory audit, companies should not be expected to have any independent assurance on other elements of company reporting;
- No additional requirements should be imposed on **audit committees** in relation to the appointment and oversight of auditors, nor should additional requirements relating to **fraud** be introduced;

- All non-complex PIEs should be excluded from the requirement to have a **managed shared audit**.

Appendix 2 – Creating an effective reporting regime

Annual reports currently provide shareholders with historic financial information about the company. They also seek to provide investors with an understanding of how a company is governed, its strategy and how it operates in the best interests of its shareholders.

Shareholders should remain the primary audience for financial information and their needs should be paramount.

Investors are increasingly demanding more information about companies. Not only about their financial position, but also about every aspect of their operations. Companies should seek to provide their shareholders with the information they want. However, continuing to increase the scope of the annual report to address other aspects of a company's operations is not sustainable or appropriate. There needs to be a balance between meeting the needs of shareholders, meeting the needs of stakeholders, and making annual reports fit for purpose.

Annual reporting requirements should not become overly prescriptive or burdensome to companies. Companies should not be required to report on a uniform basis about matters that may not be material to their operations, or of value to their shareholders.

The AIC has long been concerned about the length and complexity of annual reports. The AIC **recommends** that a wider review of corporate reporting is undertake which considers splitting corporate reporting into separate components to make it more effective tool for shareholders and stakeholders (see below).

All of these reports could be required to be on the company's website so they can be easily located by users.

Components of corporate reporting

- 'Strategic Report' – This would be the principal disclosure for most shareholders. It would include the current Strategic Report or Management Report. It would provide a high-level overview of what the company does and how it has performed in the period. It could also include more forward-looking information. The Strategic Report should include a clear signpost for shareholders detailing where additional information, such as the Historic Report (see below), can be found online.
- 'Historic Report' – This would be a backward-looking document. It would contain information that is required by company law and accounting standards. It would include, for example, the directors' report, corporate governance statement, directors' remuneration report, statement of directors' responsibilities, and the full financial statements.
- 'Bespoke Report' – This report would be optional. If companies chose to publish a Bespoke Report, it would include information that is not required but gives shareholders a better insight into certain aspects of a company's operations. It would be for each company to assess whether such a report would be useful to its shareholders and what it should contain. This could include other information that shareholders of the company have indicated they particularly value. For example, it could include a specific report on cyber security, ESG matters, risk or internal controls. Where information on these areas is required by legislation that would be included in the Strategic or Historic Report, but further information could be given in the Bespoke Report.

This report would not necessarily need to be published at the same time as the company's Strategic and Historic Reports, reducing the burden on companies. It would also not necessarily be required to be produced each year. The content could be different from one report to another to meet the specific demands of shareholders allowing companies to tailor the information to the company itself, its size or its sector.

- 'Legal and Regulatory Disclosures Document' – This document would be mandatory. It would include information that is required by law and/or regulation but is not material to the understanding of the nature and performance of the company.

  For example, investment companies may include a statement on greenhouse gas emissions in this document. Investment companies do not have employees or premises. Accordingly, many investment companies currently state in their annual reports that the company has no greenhouse gas emissions.

Appendix 3 - Existing provisions on internal control and risk management

This section should be read in conjunction with our response to question 12.

The Companies Act requires "*reasonable accuracy*" in annual reports and accounts. It provides that:

- Every company must "*keep adequate accounting records*" that are sufficient to "*show and explain the company's transactions*" and "*disclose with reasonable accuracy, at any time, the financial position of the company at that time*";
- Directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss;
- The auditor of a company must have regard to the directors' duty as set out in the bullet point above.

Additionally, the UK Code states that:

- The board should present a fair, balanced and understandable assessment of the company's position and prospects (Principle N);
- The directors should explain in the annual report their responsibility for preparing the annual report and accounts and state that they consider the annual report and accounts, taken as a whole, to be fair, balanced and understandable (Provision 27);
- The board should establish procedures to manage risk and oversee the internal control framework (Principle O);
- The audit committee, or similar, is responsible for reviewing the company's internal financial controls and internal control and risk management systems (Provision 25); and
- The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operation and compliance controls (Provision 29).

The FCA's Disclosure Guidance and Transparency Rules (DTR) requires the corporate governance statement to "*contain a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process*" (DTR 7.2.5).

Investment companies are Alternative Investment Funds (AIFs) within scope of the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD places certain obligations on investment companies and their managers over certain size thresholds (this includes the majority of investment companies). These include:

- Having a valuation of the investments performed by the Alternative Investment Fund Manager (AIFM), at least once a year. The valuer is also required to have appropriate procedures so that a proper and independent valuation of the investment can be performed.

- Appointing a depositary whose function it is to safeguard the assets of the company. The depositary must also ensure that the investment company's cash flows are monitored and payments, such as dividend income, are correctly received. For assets that are held in custody (e.g. equities and bonds) the depositary has strict liability for those assets and they must be segregated and kept in a separate account, so they can be identified as belonging to the investment company.

  For assets that are not held in custody (e.g. derivatives, real estate and private equity instruments) the depositary must verify the ownership of the assets and maintain records of those assets. The depositary is appointed by the investment company, and it reports to the company.

- Requiring the AIFM to have permanent risk management and compliance functions with adequate risk management controls, procedures and systems and review these annually. Where proportionate the AIFM must also have an internal audit function. The AIFM is required to have adequate systems in place to identify, manage, measure and monitor all the risks applicable to the investment fund strategy. These rules formalise the risk management process.

The requirements of the AIFMD provide the board and shareholders of an investment company with additional comfort regarding the valuation and ownership of its investments, along with the risks involved in its investment portfolio.

Appendix 4 – Reasons that investment companies should be excluded from managed shared audit requirements

This section should be read in conjunction with our response to question 61.

Structure of investment companies

Investment companies have independent boards, most often comprised of non-executive directors only. They have no executive directors or employees. The investment company has contracts in place with each of its service providers and these are reviewed on a regular basis by the board.

Investment companies do not have complex group structures, international divisions or complex accounts.

Regulatory environment

Investment companies are Alternative Investment Funds (AIFs) within scope of the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD places certain obligations on investment companies and their managers over certain size thresholds (this includes the majority of investment companies). These include:

1. Having a valuation of the investments performed by the Alternative Investment Fund Manager (AIFM), which may be the investment manager, or an external valuer at least once a year. The valuer is also required to have appropriate procedures so that a proper and independent valuation of the investment can be performed. The valuation function can only be performed by the AIFM if it is functionally independent from the portfolio management function and no conflicts of interest exist.
2. Appointing a depositary whose function it is to safeguard the assets of the company. The depositary must also ensure that the investment company's cash flows are monitored and payments, such as dividend income, are correctly received. For assets that are held in custody (e.g. equities and bonds) the depositary has strict liability for those assets and they must be segregated and kept in a separate account, so they can be identified as belonging to the investment company.

   For assets that are not held in custody (e.g. derivatives, real estate and private equity instruments) the depositary must verify the ownership of the assets and maintain records of those assets. The depositary is appointed by the investment company, and it reports to the company.
3. Requiring the AIFM to have permanent risk management and compliance functions with adequate risk management controls, procedures and systems and review these annually. Where proportionate the AIFM must also have an internal audit function. The AIFM is required to have adequate systems in place to identify, manage, measure and monitor all the risks applicable to the investment fund strategy. These rules formalise the risk management process.

The requirements of the AIFMD provide the board and shareholders of an investment company with additional comfort regarding the valuation and ownership of its investments, along with the risks involved in its investment portfolio. This sits alongside the work the auditor performs. Having a mandatory joint audit would not provide the board or shareholders with any additional protection.

Division of investment company audits

As stated in our response to question 61, the key constituent to an investment company audit is the existence and valuation of its investment portfolio. The value of the portfolio has a direct relationship to the income received in the year. It also forms the basis for calculating many of the company's expenses, such as its management fee. Without the knowledge gained from the audit work on the investment portfolio, it would be difficult for an auditor to provide any significant scrutiny and challenge on the accuracy and completeness of the company's income or expenses.

Investments held by an investment company are managed by an investment manager and those that can be held in custody, such as equities and bonds, are held by a custodian.

For investment companies with unquoted investments, the most challenging part of the audit is the ownership and valuation of the investments. Whilst this remains an important area of focus for investment companies with quoted investments, it is likely to be less of a key risk. The completeness of the revenue and the calculation of the investment management fee are also likely to be key considerations for the auditor.

Typically, investment companies do not have subsidiaries. In cases where they do, these subsidiaries are likely to be very simple. For example, they may simply issue zero dividend preference shares. This means it will be difficult for a challenger firm to audit a 'meaningful proportion' based on legal subsidiaries.

Investment company audit fees

Investment company audit fees tend to be significantly lower than more complex trading businesses, either in the FTSE 350 or large privately owned companies.

For example, the largest investment company by total assets is Scottish Mortgage Investment Trust PLC, which is in the FTSE 100. Its annual report and accounts for the year ended 31 March 2020 shows fees paid to the auditor for audit services of £45k.

Proposed mandatory managed shared audit exemption

The AIC supports the recommendation in the CMA's market study report that there should be some exemptions from the requirement to have a mandatory managed shared audit. The AIC **recommends** that non-complex PIEs are excluded from this requirement (see the section above titled *Achieving proportionality* for discussion of non-complex PIEs).

If this is not adopted, the AIC **recommends** that investment companies that are AIFs within scope of the AIFMD are specifically excluded from the requirement to have a mandatory managed shared audit. This will exclude closed-ended collective investment companies that operate as funds, regardless of their tax status and domicile.

This would be a proportionate response, particularly given that the AIC is not aware of any concerns raised by investors about the quality of the audit for investment companies.