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July 8, 2021

The Rt. Hon. Kwasi Kwarteng MP
Department for Business, Energy & Industrial Strategy

Re: Restoring trust in audit and corporate governance

Dear Secretary of State Kwarteng,

IFAC (International Federation of Accountants) welcomes the opportunity to comment on the Department of Business, Energy & Industrial Strategy ("the Department" or "the Government") Consultation on the Government's proposal for Restoring trust in audit and corporate governance ("the Consultation"). As the global voice of the accountancy profession, IFAC represents over 180 Professional Accountancy Organizations in 135 jurisdictions—including the Association of Chartered Certified Accountants (ACCA), Chartered Accountants of Ireland (CAI), Chartered Institute of Management Accountants (CIMA), Chartered Institute of Public Finance and Accountancy (CIPFA), Institute of Chartered Accountants of England & Wales (ICAEW), and Institute of Chartered Accountants of Scotland (ICAS)—thereby representing over three million professional accountants worldwide.

The Government has put forth a very comprehensive assessment of issues that are relevant to restoring trust in *both* audit *and* corporate governance. We firmly support such an approach that addresses the credibility of directors' accountability and reporting as well as the statutory audit. As recommendations to this Consultation are considered, we propose the following three principles as criteria for assessing future reforms.

1. ***A well-functioning ecosystem*: The success of a corporate entity, the quality of its reporting, and the quality of its audit all depend on a functioning and effective ecosystem of participants.** There is a key role to be played by company boards/directors, audit committees, management, the finance and accounting functions, internal audit, regulators, and shareholders. Auditors—no matter how independent, skilled or resourced—are unlikely to overcome significant shortcomings in other areas of the ecosystem, which can lead to poor quality corporate reporting (including its assurance) or even corporate failure. Consequently, we strongly support a holistic approach—also focusing on directors and other participants in the ecosystem who are not members of a professional accountancy body but are crucial to the success and resilience of a company.

2. *Focus on High quality Audits*: High-quality audit and assurance engagements are essential to trust and confidence of investors, analysts, regulators, and others in the reporting of an entity's performance and ability to create long term value for shareholders. IFAC supports the Department's thorough assessment of how best to ensure this trust and confidence in corporate reporting by UK companies, including with respect to the emergence of broader corporate reporting, such as sustainability-related disclosures. As the Department considers future reforms, we strongly encourage an unwavering focus on

achieving high-quality audits. We believe this must be the primary objective of future legislative or regulatory action in the UK and elsewhere.

3. *International Perspective*: As the global voice of the profession responsible for audit and assurance engagements, our Consultation responses bring an international lens to the issues raised and focus on core principles for enhancing the quality of audit in the UK and globally. Recognizing the UK's position of regulatory leadership in the global financial reporting ecosystem, we urge the Department to consider the importance of harmonized international standards that govern audit and the accountancy profession's code of ethical conduct.

Following consultations and reviews in the UK in 2019 (as well as in other jurisdictions, including Australia, Netherlands, and South Africa),[1] IFAC published its views on Achieving High Quality Audits (February 2020). In doing so, we set out a vision for a well-functioning "ecosystem"—built upon five key components—that, in combination, can meet the expectations of stakeholders.

1. The Right Process
2. The Right People
3. The Right Governance
4. The Right Regulation
5. The Right Measurement

We believe that the topics addressed in the Consultation align well with these five factors. In the Appendix, we use this framework to analyze those proposals and topics that are of particular relevance to the global accountancy profession in achieving high-quality audits, which depend on and are intertwined with good corporate governance. Historically, there has been inadequate focus on the roles, shortcomings, and needed reforms to board directors and management teams in the aftermath of a company failure. Yet, they bear ultimate responsibility for the success of a business. We look forward to the dialogue and reforms that this consultation can facilitate in the pursuit of enhancing trust in audit and corporate governance.

Sincerely,

Kevin Dancey, CEO IFAC

[1] This "Point of View" policy document has been translated into five languages and serves as the benchmark for IFAC's analysis of audit reform globally.

APPENDIX: IFAC Audit Framework Analysis of BEIS Proposals

1. The Right Process

IFAC supports the evolution of assurance services that best meet the needs of investors and a wider stakeholder group—including specific assurance engagements to assess internal controls and risk management systems, fraud detection or forensic review, forward looking / going concern assessment, digital reporting, "non-GAAP" metrics, and reports or disclosures that enhance corporate reporting (including information reported under the International Integrated Reporting Framework).[2]

However, we agree with the Brydon Review's conclusion that audit innovation may increase public accounting firm exposure to litigation and thereby stifle the development of single-purpose reviews. IFAC supports the premise of Consultation question 4—that legal liability issues could adversely impact the Governments' dual interest in fostering innovation and market competition. We therefore support approaches to liability regimes that employ features such as proportionate liability and liability caps.

In particular, forward looking and qualitative information about governance, strategy, and risk management of material sustainability (or "ESG") factors that contribute to enterprise value may warrant specific consideration (or safe harbor) in order to support the adoption and implementation of new reporting requirements contemplated as part of an emerging global system for investor-focused sustainability reporting requirements.[3]

We urge the Department to support a broader scope of assurance to include sustainability-related (or "ESG") disclosures. As investors increasingly incorporate sustainability matters into their asset allocation decisions, high-quality assurance of this information is an important global investor protection issue. As a component of IFAC's efforts to promote a global system for high-quality sustainability-related reporting requirements, we partnered with AICPA & CIMA to benchmark the current state of assurance with respect to sustainability disclosures.

Our report, The State of Play in Sustainability Assurance, indicates that assurance practice is still evolving as various efforts are underway to harmonize and rationalize standards and requirements for sustainability-related reporting. Based on information reported by 100 of the largest UK-domiciled companies, we observed:

- 55% of the companies disclosing sustainability information included *some* assurance.
- 97% of the assurance being provided resulted in a "limited" assurance report.
- Some assurance included engagements not conducted in accordance with IAASB standards.
- 53% of assurance reports were provided by audit firms (or an audit firm affiliate), while 47% were performed by other types of service providers.

As IFAC noted in its response to the Brydon Review,[4] "over time, expanded reporting may help avoid large, high-profile, unexpected corporate failures. The nature and extent of corporate disclosure content assured by the audit profession must, therefore, be re-assessed by the accounting profession, regulators, auditors, and other impacted stakeholders." We agree with the Governments proposal that auditors (and/or assurance practitioners) should consider wider information (disclosed on a mandatory or voluntary basis, depending on jurisdiction-specific reporting requirements) in an effort to see audit

[2] See IFAC Point of View on Achieving High-Quality Audits. Also, ICAEW's "three pillars" framework contemplates additional, or bespoke, assurance engagements beyond the required statutory audit: https://www.icaew.com/technical/thought-leadership/audit-and-assurance-thought-leadership/user-driven-assurance-fresh-thinking

[3] This includes the IFRS Foundation's current initiative to establish a new International Sustainability Standards Board, as well as jurisdiction-specific initiatives/requirements for sustainability-related reporting.

[4] IFAC response to Brydon Review

(including assurance of "Extended External Reporting"[5]) become more trusted, more informative and hence more valuable to the UK.

Such broader scope "corporate auditing," covering both the auditing of financial statements and also the assurance of wider information, will be most effective if based on i) suitable criteria (i.e., a reporting framework such as that being proposed by the IFRS Foundation's initiative to establish an International Sustainability Standards Board), ii) appropriate underlying subject matter, and iii) sufficient and appropriate evidence.

2. The Right People

IFAC supports steps to strengthen the independence of audit professionals and audit practices/businesses, while not severing linkages to critical subject matter expertise and interdisciplinary cross-training within public accountancy firms.

High-quality audits depend on individuals, acting in the public interest, with the experience, integrity, independence, professional judgement, skills and subject matter expertise needed to perform a high-quality audit. The increasing complexity of businesses and accelerating reliance on technology are driving the need for firms that perform audits to hire more specialized professionals. The multidisciplinary business model—which allows for specialists with diverse skills (e.g., risk advisory, information technology, tax, ESG, etc.) to operate within one firm—best attracts, develops, and retains these professionals. Initiatives to limit or eliminate multidisciplinary firms (e.g., "audit-only" firms) would reduce the ability to hire and retain this talent pool,[6] impede the development and dissemination of subject matter expertise within public accountancy firms, and result in a significant negative impact on overall audit quality.[7]

Therefore, noting that the largest audit firms are already working with the FRC to implement an effective operational split incorporating key elements of the Government's proposals, we recommend pursuing no future action to effect full separation. Regulation that would result in audit-only firms will lead to a decrease in audit quality.

In our view, questions of audit quality, for engagements conducted by professional accountants working in a multidisciplinary firm, should focus first and foremost on safeguarding against any real or perceived threat to compliance with the code of ethics that governs professional accountants. In this way, multidisciplinary firms can ensure the independence of their specialists and be positioned to provide immediate audit support anywhere within a firm's network of operation. This is best accomplished through strict adherence to the principles and standards of the International Code of Ethics for Professional Accountants (including International Independence Standards) ("the Code"), as adapted for application in the UK, including the Non-Assurance Services (NAS) and fee-related provisions of the Code. The International Ethics Standards Board for Accountants (IESBA) has recently revised these provisions to significantly strengthen the guardrails around auditor independence in these two important areas.[8] Further, in 2020, the IESBA released revisions to the Code to promote the role and mindset expected of professional accountants. These provisions require

[5] "Extended External Reporting" refers to terminology used by the IAASB in its *Non-Authoritative Guidance on Applying ISAE 3000 (Revised) to Extended External Reporting (EER) Assurance Engagements*, which addresses the application of ISAE 3000 (Revised) in sustainability-related and integrated reporting engagements (among other extended external reporting).

[6] Note increase in non-accounting hires (to 31% in 2018) of new bachelor's and masters' of accounting graduates in US CPA firms. See chart 3.5, page 22 of 2019 Trends in the supply of accounting graduates and the demand for public accounting recruits from the AICPA.

[7] Achieving High-Quality Audits

[8] Global Ethics Board Takes Major Step Forward in Strengthening Auditor Independence: Comprehensive Package of New Measures to Safeguard Auditor Independence in Relation to Non-Assurance Services and Fees Paid by Audit Clients

professional accountants, among other things, to demonstrate the role, mindset and behavioral characteristics expected of them, in serving the public interest.[9]

IFAC supports the role and responsibility of Professional Accountancy Organizations ("PAOs") to ensure that all professional accountants have access to relevant, high-quality certification and continuing education programs, specifically including certification and programs for the provision of audit and assurance services to a broad range of potential clients—even the most complex global companies.

As audit evolves, so must education, certification, and development requirements of professional accountants. IFAC encourages its member bodies (PAOs) to continue to coordinate and facilitate a dialogue between educators and employers (both firms and businesses) so that the skills and competencies of professional accountants best match the skills required for audit and assurance services of the future.[10] This dialogue should also include regulators and other parties and policy makers charged with ensuring audits are of high quality and fulfill their public interest mission.

The audit profession is based on fundamental ethical principles and relies on experienced and trained practitioners who apply professional judgement and professional skepticism. Therefore, standard setters—for ethics, audit and assurance—also play an important role. IESBA has responded, in part to recent audit events, by addressing the issues highlighted above. Further, the International Auditing and Assurance Standards Board (IAASB) has published three new and revised standards designed to strengthen and modernize an audit firm's approach to quality management.[11]

Further, IFAC supports the International Panel on Accountancy Education (IPAE) and its call to action urging PAOs, organizations, and individuals to take steps to re-imagine the future accountant. The IPAE is a key component of IFAC's accountancy education stakeholder engagement framework.[12]

Professional accountants need PAOs that deliver not only entry-level certification, but life-long education and re-accreditation as appropriate. We believe that existing PAOs stand ready to work with Government and other interested parties to strengthen training, certification, and on-going accreditation/education to sustain the high-quality audits that all stakeholders support. Fragmentation of the existing PAOs in the UK, and elsewhere, should be subjected to careful analysis of economic viability and unintended consequences. Therefore, we caution against proposals that a new, distinct professional body for corporate auditors would help drive better audits.

3. Right Governance

Audit quality depends on the right company culture—starting with the tone at the top—and right oversight of management, the finance/accounting function, and audit functions (both external and internal).[13]

The G20/OECD Principles of Corporate Governance, ICGN Global Governance Principles, and other international baselines for good corporate governance can serve as useful guidance for national policymakers.[14] IFAC supports Business at OECD's advocacy in this area as representative of the

9 Final Pronouncement: Revisions to the Code to Promote the Role and Mindset Expected of Professional Accountants
10 Achieving High-Quality Audits
11 Introducing the Quality and Management Standards
12 IFAC Point of View: Embracing a People-Centered Profession
13 Achieving High-Quality Audits
14 G20 G20/OECD Principles of Corporate Governance help policy makers evaluate and improve the legal, regulatory, and institutional framework for corporate governance. ICGN Global Governance Principles serve as ICGN's primary standard for well-governed companies and have been developed in consultation with ICGN Members, which includes asset managers responsible for investments in excess of $US26 trillion.

global business community and reiterate their emphasis on the importance of organizational culture, board responsibility, auditor independence, and the risks of over-regulation.

Those charged with governance are best placed to oversee the audit on behalf of shareholders. Board directors and audit committees are best positioned to be in regular, on-going communication with company management with respect to internal financial information, internal controls, public financial disclosures, and their assurance.[15] Together with management, they must ensure transparency and effective communication with shareholders about the audit, including scope, quality of audit firm, important audit findings, matters of going concern, capital maintenance, etc.[16]

We support reasonable, practical, and proportionate steps that would enable i) shareholder views to be effectively communicated to audit committees, ii) shareholder suggestions to receive genuine consideration by the audit committee and statutory auditor, iii) shareholders to have an appropriate opportunity for engagement regarding the audit at annual general meetings, and iv) shareholders to receive information regarding a change in a company's external auditor.

Audit committees—as critical components of company boards—must be independent of management and actively engaged in setting the audit plan and empowered to set engagement terms, including fees commensurate with delivering a high-quality audit. To effectively undertake this responsibility, the qualifications of the audit committee members are critical—possessing appropriate skills, including knowledge of company operations, strong finance and accounting expertise, and other skills that ensure diverse audit committee composition.[17] As a whole, audit committees must be vigilant, agile, disciplined, and engaged.[18] We agree that appropriate regulatory oversight—proportionate and evidence-based—can help ensure that directors and audit committees conduct their duties in a high-quality manner on behalf of shareholders and other company stakeholders. At the same time, boards and audit committees, especially those of the largest and most complex companies, need highly experienced directors. Any new regulatory oversight must be structured in a balanced manner so as not to discourage those most qualified to serve.

In addition, professional accountants—working *within* a reporting entity, from entry level to Chief Financial Officer—also play a key role in all steps of the reporting process and should support a successful, high-quality audit process—applying their ethical foundation (i.e., the Code) and technical skills to the preparation of reported information and facilitating communication between boards, auditors and stakeholders. Independent, internal auditors who monitor, review, and provide assurance also play a critical role.[19]

4. The Right Regulation

IFAC believes that audit quality has been enhanced by the development and adoption of global standards set by independent, transparent, and publicly accountable boards with the relevant expertise—such as the IAASB and IESBA.

Fragmentation in standard setting, including ISQM 1, would have a negative impact on audit quality, globally.[20] Jurisdiction-specific requirements can serve to enhance, but should not carve out or substantively alter, global standards for reporting, assurance, or the ethical conduct of the accountancy

[15] Value of the Audit: A Brief History and the Path Forward
[16] IFAC Response to Brydon Review
[17] Achieving High-Quality Audits
[18] See IFAC Point of View: Maintaining Trust & Confidence During a Crisis
[19] Achieving High-Quality Audits
[20] ISQM1 – *Quality Management for Firms that Perform Audits or Reviews of Financial Statements , or Other Assurance or Related Services Engagements* requires public accountancy firms who perform audit or assurance engagements to design a system of quality management to manage the quality—on a firm-wide basis—of engagements performed by the firm.

profession. As Government considers appropriate reforms, including giving a new regulator the power to establish a standardized code of ethics, we strongly urge consideration be given to the fundamental importance of harmonized international standards, which are an essential underpinning of today's globalized capital markets and business environment. Current protocol in the UK provides that compliance with a mandatory Ethical Standard (currently established by the FRC, but responsibility for which could be transferred to a new regulator) also results in compliance with the International Code of Ethics for Professional Accountants (including International Independence Standards). The role of the Code—serving as a global baseline for ethical standards—should be maintained.[21]

IFAC recognizes that Professional Accounting Organizations play an important role in working with governments to ensure that regulation is effective, efficient and in the public interest. Ongoing dialogue and a cooperative approach are essential to ensuring an appropriate balance between self-regulation by the profession (including with respect to areas of enforcement), self-regulation with public oversight and accountability, and external regulation.[22]

IFAC believes that the impacts of policy tools such as requiring more than one audit firm on a single audit/assurance engagement are highly dependent on jurisdiction-specific legal, cultural, historical, and structural factors that must be carefully considered, including an evidence-based analysis of likely consequences.

In examining earlier policy proposals for joint audit in the UK, IFAC determined that the evidence in support of improved audit quality and enhanced competition were inconclusive—both in terms of academic analysis as well as observed market practice in both France and Denmark (i.e., the two EU countries with decades-long experience with mandatory joint audit). Meanwhile, the data suggests a meaningful premium in the fees associated with joint audits, especially for medium and smaller size companies.[23] Any proposal to require "managed shared audit" (as defined by Government) should be equally subject to careful analysis. Therefore, we urge Government to reconsider its proposed legal-subsidiary based system for managed shared audit.

Regulatory reform should take into account relevant market incentives that provide guardrails on professional behavior, contribute to expectations for high-quality audits, and effectively incentivize high-quality and ethical work on the part of professional accountants and the firms they work within. For example, the Center for Audit Quality highlights existing market incentives, including:[24]

- Reputation risk: Damage to an audit firm's or an individual auditor's reputation can materially impair the viability of a public accounting firm or the career of an individual auditor.
- Litigation risk: Exposure to financial penalties—both at the firm and individual—can be significant.
- Regulation risk: New regulatory restrictions or regulatory interventions can result in economic, civil, or criminal penalties/impairments.

A holistic approach to regulation—focused on achieving high-quality audits—should recognize existing market incentives that foster high-quality, ethical, professional behavior.

[21] See IFAC website: United Kingdom | IFAC
[22] See Regulation of the Accountancy Profession
[23] See addendum to Achieving High-Quality Audits—Joint Audit: The Bottom Line – The Evidence is Unclear Joint audit is defined as two (or more) audit firms appointed to share responsibility for a single audit engagement and to produce a single audit report. Joint audits typically involve joint planning, fieldwork allocated between the firms, and a cross-review by each firm of the other's work. The firms jointly report to the audit committee and are both party to the audit report.
[24] Value of the Audit: A Brief History and the Path Forward

5. The Right Measurement

IFAC and the accountancy profession are committed to continuous improvement, recognize the negative consequences of any audit failure, and take their public interest role seriously.

- We encourage the profession (PAOs and firms) to provide more and better information about audit quality that informs policy discussions, enhances transparency, and promotes higher audit quality.[25]
- As previously noted, the IAASB has published three new and revised standards designed to strengthen and modernize an audit firm's approach to quality management.[26]
- Also, IESBA has revised the Code to promote the role and mindset expected of professional accountants, including having an inquiring mind.[27]

Audit quality is complex and difficult to define, and can best be assessed through a multi-factor *Framework of Audit Quality*.[28] This said, IFAC supports audit quality disclosures like the Audit Quality Indicators developed by the Center for Audit Quality in the US and elsewhere, peer reviews, and other initiatives—aimed at communicating a better understanding of audit quality, especially through the incorporation of quantitative, relevant, comparable metrics.[29] Similarly, we support Government proposals that provide more transparency to stakeholders on audit quality performance.

IFAC notes that over 40,000 audits of public listed companies are conducted each year without issue.[30] From this perspective, the number of significant audit failures is extremely low. The level of attention given to the auditor's potential role in a small number of recent corporate failures overstates the perception of problems with audit. We note that the number of regulatory findings observed in the high-risk audit files reviewed by regulators continue to decrease globally in all areas of audit and represent a very small fraction of the thousands of Public Interest Entity audits conducted in IFIAR jurisdictions.[31]

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[25] Achieving High-Quality Audits

[26] Introducing the Quality and Management Standards

[27] See: Revisions to the Code to Promote the Role and Mindset Expected of Professional Accountants and Exploring the IESBA Code, Installment 11: The Role and Mindset Expected of Accountants—A Focus on Bias

[28] A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality: https://www.iaasb.org/publications-resources/framework-audit-quality-key-elements-create-environment-audit-quality
Also, ACCA proposes additional factors that determine audit quality. See: pi-tenets-quality-audit.pdf

[29] CAQ Audit Quality Disclosure Framework: https://www.thecaq.org/wp-content/uploads/2019/03/caq_audit_quality_disclosure_framework_2019-01.pdf

[30] Data obtained by IFAC from Audit Analytics for 2019 estimating the number of Public Interest Entities that exist in jurisdictions that submit audit review data to IFIAR.

[31] Data from IFIAR indicates that the percentage of listed PIE audits inspected with at least one finding has decreased from 47% to 37% from 2014 to 2019. At the same time, the number of IFIAR members reporting from their jurisdictions has increased from 30 to 37 members. See IFIAR 2018 Survey of Audit Inspection Findings, page 4, May 16, 2019: https://www.ifiar.org/?wpdmdl=9602