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The Rt Hon Kwasi Kwarteng MP
Secretary of State for Business, Energy & Industrial Strategy
1 Victoria Street
London
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8 July 2021

Dear Mr Kwarteng,

Response to 'Restoring trust in audit and corporate governance – Consultation on the Government's proposals'

Thank you for giving us the opportunity to comment on the BEIS consultation: Restoring trust in audit and corporate governance. This response represents the views of the UK's Investor Relations Society ('the IR Society').

The Investor Relations Society's mission is to promote best practice in investor relations; to support the professional development of its members; to represent their views to regulatory bodies, the investment community and Government; and to act as a forum for issuers and the investment community. The Investor Relations Society represents members working for public companies and consultancies to assist them in the development of effective two-way communication with the markets and to create a level playing field for all investors. It has approximately 800 members drawn both from the UK and overseas, including the majority of the FTSE 100 and much of the FTSE 250.

We have considered and set out below specific responses to a number of the questions in the consultation. In doing so, we have selected those issues that are most relevant to the Society's members.

A summary of our key points is set out below, both at the overall level and by the main topics of consultation:

<u>Overall</u>
The recommendations contained in the consultation paper are the product of deep review of audit and governance matters by expert committees and offer many important steps towards offering greater confidence to, and building further trust with, investors.

- The scope of corporate reporting and the insight provided, has already evolved substantially in recent years and is set to go further in areas such as climate reporting, so we support efforts to make audit and the annual report more informative.
- We recognise the damage that corporate failures can do across communities and society, as well as the effect this can have on investor confidence. So proportionate measures that improve control and oversight over business, including challenge at suitable moments, are welcomed. Director responsibility is an important part of this process.
- Nevertheless, we would observe that in our experience, companies are typically run well, supervised by boards that are prudent and serious in their governance and are committed to meaningful dialogue with investors. The examples of corporate failure in both the listed and private sectors are relatively exceptional, though a matter rightly of great concern.
- Accordingly, we believe reforms that apply to a wide group of companies need to be proportional in their application, weighing up the perceived benefits against the time involved and cost required to implement the provisions and ensure compliance.
- A number of the proposals will likely provide useful insight to investors and other stakeholders, as well as assurance, but we would also ask that consideration is given to the time and resource that will be required in implementing the measures for companies to whom the final provisions apply.
- Related to this, we believe that many companies could experience pressure on capacity given the need to implement the large number of proposals contained in the document, particularly at the current moment as companies emerge from the pandemic and face a number of other regulatory and investor demands. This may also become an issue in the wider system, as auditors, corporates, regulators and investors seek to employ additional expertise.
- We are concerned to avoid too much additional burden on companies at a time when their competitiveness in the global market-place is crucial and also in the context of other initiatives that seek to make the UK an attractive place for companies both to locate and list.
- Given the above, we would suggest a phased timetable for implementation wherever possible, giving companies time to establish processes and build staffing levels in order to meaningfully meet requirements, without detriment to their businesses and competitiveness.
- We also believe it is important to consider the various proposals asking whether each would always provide better and more effective engagement with investors. To pick out one example, in the case of audit, will most investors in practice have the capacity and desire fully to engage?

<u>The Government's approach to reform</u>

- We believe large private companies should be included within the definition of a Public Interest Entity (PIE) to establish equivalence with their listed peers and, in terms of the specific universe of companies to be included, we favour the Government's Option 2 as set out on page 33 of the consultation document.
- With regard to AIM companies with market capitalisations above €200m, the ethos of this market is to foster higher growth entrepreneurial companies with lighter touch governance than is applied to premium listed companies. Their investors in our view

generally accept this trade-off and we would suggest that this group are not brought into mandatory scope.
- We believe it is desirable that the Government should provide sufficient time for companies to prepare, where they are included in the new definition of a PIE, given the demand it is likely to represent to develop systems and processes to comply.

<u>Directors' accountability for internal controls, dividends and capital maintenance</u>
- We believe there is a case for strengthening the internal control framework for UK companies to provide greater comfort to stakeholders.
- In this regard we support the Government's initial preferred option (Table 2 as set out on pages 48 and 49 of the consultation document).
- Accordingly, our preference is that directors should be required to attest an adequate internal control structure and procedures for financial reporting. We agree that decisions about whether the internal control effectiveness statement should be subject to external audit and assurance should largely be a matter for audit committees, though we are not convinced this is typically a matter for shareholders.
- We understand the theoretical interest in having a figure for distributable reserves, and that this might have provided useful challenge in certain cases. However, we are not of the view that investors focus very closely on this factor in their questions about dividend. Distributable reserves are a backward-looking measure and there are many other factors that boards consider when setting or proposing dividends, including future prospects, cash flow and the signal they are giving to investors. Boards give very careful consideration in setting their dividend payments.
- We believe that an explicit statement about the legality of dividends and their effect on the future solvency of a company would be effective and potentially sufficient. We would suggest that these requirements be applied to all PIEs to provide a degree of harmonisation.

<u>New corporate reporting</u>
- We are supportive of the introduction of a resilience statement recognising, and agreeing with, the drive to focus on the longer-term prospects and sustainability of a business. However, companies have varying levels of visibility into prospects for their businesses and for some, consideration of time horizons beyond five years poses challenges in terms of realistic risk forecasting.
- With regard to incorporating climate reporting, in our opinion, the Resilience Statement should not be a vehicle for TCFD reporting although it might usefully include a summary of TCFD analysis and conclusions as part of the drive to integrate sustainability factors more widely in the annual report and accounts.
- We approve of the proposal to delay the introduction of the Resilience Statement in respect of non-premium listed PIEs for two years as it would give companies time to establish the processes required at a time when there are many other demands on them. We believe that recently listed companies should be in scope but entitled to a two-year delay period for implementation in line with that proposed for non-premium listed PIEs.

Company directors

- The IR Society supports the concept of directors' accountability and responsibility in accordance with the principles of the UK Corporate Governance Code but believes these should be balanced against the increasing burden of tighter provisions.
- With specific reference to malus and clawback, we would welcome further clarity and guidance on who provides judgement on questions of materiality and misconduct or reputational damage; what factors need to exist or thresholds passed in respect of each condition before clawback provisions are triggered; and what levels of clawback apply.

Audit committee oversight and engagement with shareholders

- We would like to see further explanation and clarity regarding the proposals and implementation method for giving shareholders a formal opportunity to engage with risk and audit planning. In our view, this proposal raises a number of questions which need to be resolved prior to successful implementation, not least the extent and depth of the additional anticipated engagement which may have resource implications for companies. As stated above, we also have reservations about the extent of the appetite of many investors to engage.

A strengthened regulator

- We agree with the proposed general objective for ARGA and would welcome a well-resourced regulator with suitably expanded powers. We agree it will be important to define carefully the respective responsibilities of ARGA and other regulatory bodies, notably the FCA.

In the section that follows, we have provided specific answers to a number of the consultation questions that have been posed.

We hope you find these comments useful and please do not hesitate to contact me if you have any further questions.

Yours sincerely,

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Chair of the Investor Relations Society's Policy Committee
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Consultation Questions

Section 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.

- We believe large private companies, typically employing high numbers of staff, should be included within the definition of a PIE since it is reasonable to expect large private companies to have a good level of governance, parallel to listed peers.

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

- We suggest Option 2. We favour a narrower test whereby the threshold is only extended to large companies with both over 500 employees and a turnover of more than £500m. Companies falling within this definition are likely to be operating at a scale that enables them to more easily absorb the additional burden of the associated reporting requirements and are the most meaningful systemically. We understand that there may be capacity issues in terms of availability of qualified staff, so are mindful of not increasing regulatory reach too far.

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

- With regard to AIM companies with market capitalisations above €200m, the ethos of this market is to foster higher growth entrepreneurial companies with lighter touch governance than is applied to premium listed companies. Their investors in our view generally accept this trade-off and would not want a substantial burden of regulation, looking to the Nomad regime for protection. Although some of these companies may voluntarily adopt higher standards than regulatory minima, we would suggest that this group are not brought into mandatory scope.

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

- We agree. Providing sufficient time for companies to prepare for the introduction of a new definition of PIE is appropriate, as for many companies there is likely to be a resource challenge in complying with the requirements in developing systems and processes to comply. Companies should not be expected to do everything at once. Allowance should be made for companies to take a thoughtful and considered approach.

Section 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?

- Yes, taken in aggregate, we believe there is a case for strengthening the internal control framework for UK companies, though it is important to recognise that many larger listed companies with international reach will generally follow US SOX requirements, which we presume would give them a sufficient level of compliance with UK provisions along with associated exemptions. We are conscious that other companies, some substantial, that do not comply with US SOX requirements

will often consider that they have strong existing internal controls. As such we are mindful of the need to balance the additional burden of further need to strengthen against the benefits that are likely to accrue.

- In terms of the principal benefits and disbenefits:
  - We believe that a stronger internal control framework, combined with attestation by directors, will offer accountability from a company's board, while promoting higher standards across the organisation.
  - A stronger internal control framework should offer assurance to all stakeholders, including the investment community. In this way, a company can confirm compliance with its policies and procedures, show evidence of its commitment to preserve its assets and control its exposure to risk.
  - However, reviewing and reporting on internal controls will incur further expense and require management focus. We therefore believe that in considering the specific enhancements they wish to make to existing measures, companies are likely to take some account of the anticipated cost against the additional assurance that will be received.

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?

- In general terms, yes, we would support the Government's initial preferred option for the reasons set out below.
- Our preference is that directors should be required to confirm an adequate internal control structure and procedures for financial reporting, but that decisions about whether the internal control effectiveness statement should be subject to external audit and assurance should be a matter for audit committees, not mandatory. We are not convinced this is necessarily a matter where shareholder capacity to be involved is as deep as some suggest.
- We believe that the Government's initial preferred option has the potential to produce better out-turns from flexible, principles-based assurance without the need for a more prescriptive, regulation-based approach.
- We agree that companies should only be required to have their internal controls assured by an external auditor in limited circumstances, for example in the case of a fundamental breakdown of internal controls or evidence of fraud.
- We have concerns regarding enforcements, including what would be the hurdles that need to be met to allow for sanctions on directors; and would sanctions apply to specific individual directors, for example the Chair of the Audit Committee, or across all directors given collective responsibility?

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

- We agree with the suggestion that the requirements should apply initially to premium listed companies, with a possible temporary exception for certain newly listed companies, and be extended to other PIEs after two years. We would recommend a phased implementation.

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?

- We have some concern that there is no one specific way to determine realised profit and losses. This reflects the fact that variations in practices exist between companies within a sector and between sectors across the market.
- If ARGA is to assume responsibility for defining realised profits and losses, we would suggest that it provides guidance (option 1) rather than prescriptive rules (option 2). This in turn would be preferable to relying on the standard accounting principles set out by professional bodies including the ICAEW and ICAS.

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?

- We have some concern whether the proposed new distributable profit reporting requirement provides as much precise and useful information for investors and other users of accounts as might be first thought. This is because the calculation of distributable profit for a company can be influenced by group structure, and how and where cash is accumulated around the group.
- Equally we are not aware of investors regularly asking for information on distributable reserves. Investors generally appreciate that a company's level of distributable reserves can fluctuate over time depending on what investments the company undertakes during any specific period and focus on other factors when considering the dividend payout.
- Typical questions that issuers receive from investors regarding the level of payout include:
    - What are the metrics the board will look at with regard to setting the dividend?
    - How does consideration of the credit rating influence thinking about the dividend payment?
    - Is there anything in a company's debt agreements which restricts its dividend paying capability to?

  As such, investors are concerned with several factors beyond the level of distributable profit.
- In our experience, boards give very careful consideration to setting their dividend payments taking into account a number of factors including earnings, balance sheet strength, cash flow and future prospects, as well as any other considerations, including legal and regulatory frameworks.
- The dividend is also a forward indicator for many investors and thus partly a signalling tool for use by corporates. As such, there may be times when a company will wish to send a particular message to investors, for example its confidence in future cash generation, or caution due to market environment. We have some concern that the distributable reserve could become too much of a focus for the complex decision that is being taken.
- Overall, in our opinion, we question whether the effort of determining a comprehensive group distributable reserves number may be disproportionate to the benefit.

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?

- An explicit statement about the legality of dividends and their effect on the future solvency of a company might be an effective way of both reinforcing directors' existing focus on the dividend (see above) and create greater confidence from the investor perspective. While it could be argued that this also falls into consideration under Section 172 of the Companies Act with regard to how wider stakeholders are taken into account in the payment of dividends and as such is un-necessary,

an explicit directors' statement would offer some level of additional assurance about the legality of dividends and their effect on the future solvency of a company.

- Although we represent listed companies, the group where dividend decisions are likely to be of the greatest interest and relevance, we believe these requirements should be extended to all PIEs to provide wider confidence in the conduct of larger private companies, specifically that they do not pay excessive dividends. It would also provide a degree of harmonisation between the private and quoted domain.

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?

- In our experience many, perhaps most, companies for some time have focussed on clearly communicating their capital allocation and distribution approach to investors. Those that do this get credit for the clarity it provides and it helps their relationship with shareholders. They are also aware that their compliance with the stated policy is monitored closely by investors as guardians of capital and any deviation will need to be carefully explained to maintain investor confidence. That said, flexibility to step outside of previous guidance exists and is welcome.
- We don't believe a new reporting requirement, potentially more prescriptive, is necessary as existing arrangements work in practice.

Section 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 type of resilience issues identified in the report – liquidity, solvency and business continuity; supply chain; digital security; investment needs; dividend sustainability and distribution policy; climate risk – appear appropriate and of interest to both investors and wider stakeholders. However, we would favour companies retaining flexibility in this regard including the specific detail they report.
- Such matters should be addressed in the short- and medium-term sections so investors can understand both the immediate risks facing a company, as well as enabling them to gain an appreciation of any emerging structural risks as set out in the medium-term assessment. We would expect significant overlap between the short- and medium-term sections of the Statement. In addition, as medium-term is now to be defined as five years, we would point out for some companies visibility over this timeframe may be limited, whereas for others in more predictable sectors, this may be less of an issue.
- Like the Government, we agree with the Brydon Review that viability reporting over the medium term should do more to evidence scenario planning by companies. However, we believe companies should retain flexibility over how many reverse stress test scenarios they include in their Resilience Statement.
- We note that for many companies there is diminishing ability to forecast accurately for periods beyond five years in the future given the higher degree of uncertainty and the lower visibility over future risks to the business.

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

- We believe the Resilience Statement should not be a vehicle for TCFD, but it may be appropriate to include a summary of TCFD analysis and conclusions.
- In our opinion, it would be better for a company to show full TCFD reporting disclosures separately and, or, include them as part of a sustainability report. If combined, there is a concern that the Resilience Statement becomes unwieldy and that it may draw undue prominence to climate within the statement at the expense of other risks.

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?

- Yes, we agree with the proposed company coverage for the Resilience Statement.
- We also agree with the proposal to delay the introduction of the Statement in respect of non-premium listed PIEs for two years as this should provide sufficient time for such entities to prepare.
- We believe that recently listed companies should be in scope. Aside from those that may already be captured as large private companies anyway under the new PIE definition, recently listed companies should have good disclosure of risk in place prior to listing and may, in any case, want to adopt best practice as reassurance for investors after flotation. However, we believe newly listed companies could have the same two-year delay period in implementation proposed in respect of non-premium listed PIEs.

Section 5: Company directors

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 proposed minimum list of malus and clawback conditions seems appropriate. However, it would be helpful to receive guidance on: who provides judgment on questions of materiality and misconduct or reputational damage; what factors need to exist or thresholds be passed in respect of each condition before clawback provisions are triggered; and what levels of clawback apply?
- It is important that the best candidates to be members of boards are not deterred from making themselves available by the breadth of conditions under which clawback conditions can be triggered, overly punitive approaches, or by the burden of legislation.

Section 7: Audit committee oversight and engagement with shareholders

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?

- In our view, there needs to be clarity regarding what this is likely to involve and the nature of the potential outcomes. Is the purpose of the engagement to obtain feedback and is there then an expectation that audit companies would seek to implement changes in response to shareholder feedback? Would audit companies be expected to explain why they haven’t taken on board feedback provided by shareholders?

- We would have potential concerns over the likely extent and depth of the engagement, particularly for smaller companies.
- Greater engagement could require shareholders now having to meet with the Chair of the Audit Committee in addition to their possible engagements with the company on other matters including remuneration and sustainability. We would question to what extent many shareholders are prepared for this level of activity.
- In turn, we note this could involve a potentially significant further level of engagement for companies.

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?

- We believe there should be consideration of whether the AGM is the most appropriate forum or whether other occasions or communication channels might be more appropriate. For some companies the auditor is considered a central part of the team at the AGM, for others less so.
- One alternative, or supplementary approach, could be for corporates to hold an event around audit for top shareholders periodically, with the auditor participating in order to explain their work?
- Second, we recommend that there should be greater clarity regarding what matters lie outside the scope of the audit, noting that it may vary across sectors. In principle, the auditor's report to shareholders should be comprehensive.

Section 10: A strengthened regulator

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

- Yes, we agree with the proposed general objective for ARGA and would welcome a well-resourced regulator with suitably expanded powers. We believe it will be important to define carefully the respective responsibilities of ARGA and other regulatory bodies, notably the FCA.
- Section 10.1.8 of the consultation states that "The Government intends to legislate to give ARGA the following objective which will apply when it is carrying out its policy-making functions: 'to protect and promote the interests of investors, other users of corporate reporting and the wider public interest'". We would welcome clarity on who are considered the 'other users of corporate reporting' in this context.