

8 July 2021

Audit Reform and Regulation Team  
Department for Business, Energy and Industrial Strategy  
1st Floor, Victoria 1  
1 Victoria Street  
London  
SW1H 0ET

Email: [audit.consultation@beis.gov.uk](mailto:audit.consultation@beis.gov.uk)

Dear Audit Reform and Regulation Team

## **RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE**

1. I am writing to set out Deloitte LLP's response to the Government's Consultation Paper that was issued in March. This letter describes our overall views on the consultation and is supplemented by a summary of our position on the main points in the Consultation Paper (Appendix 1) and our detailed responses to each question (Appendix 2).
2. We have been consistent in our support for corporate governance and audit reform that is in the public interest, that improves trust in business, that builds confidence in the UK as a leading capital market and that strengthens its position in the global economy.
3. We recognise the critical role that audit plays in the country's business environment and support changes that enhance audit quality and improve choice in the audit sector.
4. The White Paper provides a once in a generation opportunity to reform the corporate reporting system in the UK. As will be seen from the appendix, we support most of the White Paper's proposals.
5. It is important that there is an overarching vision and framework for the corporate reporting system in the UK. Without such a vision, there is a danger that fewer stakeholders will engage in the debate or recognise the benefits of reform and may consequently provide less support than they otherwise might. Stakeholders may subsequently be disengaged from the process of reform and, post-implementation, choose to do the minimum to comply, rather than embrace the potential opportunity that the Government intended.
6. With that in mind, what follows in this letter is an articulation of what we think the vision should be, and key elements that it should incorporate.
7. Our vision is for a system that provides high quality corporate reports that are forward-looking as well as backward looking, that are rigorously and independently assured and that provide timely, comprehensive and insightful information across financial and non-financial measures relevant to the needs of investors and others. This will generate greater trust and provide transparency to all stakeholders, helping them make informed decisions about who they invest in, lend to, work for, and co-operate and transact with.
8. Achieving this objective requires clarity on the roles and responsibilities of each type of participant in the system, including:

- i. *Investors and wider stakeholder communities* that actively engage on the governance and business model of the entity.
- ii. *Executive directors* who demonstrate a clear understanding of their roles, responsibilities and obligations, their organisation's purpose, business model, strategy and operations, and the risks and uncertainties it faces as well as the controls to mitigate them, and who identify and report risks as they emerge; and *non-executive directors* who challenge and comment on these issues, and call out concerns when they arise.
- iii. *Auditors and other assurance providers* that clearly articulate their approach to audit and assurance in their reporting to stakeholders; how they assess risk and perform procedures to address this risk; and the findings and observations from their testing, including the detection of material fraud. When emerging issues or warning signals arise, they raise matters in a timely manner with the appropriate parties (including consideration of whether reporting to regulators is required).
- iv. *A joined-up, high quality legal and regulatory regime* that oversees the entire UK corporate system, including:
  - clearly identifying and maintaining the standards expected of directors, auditors and investors;
  - identifying issues in the system, evaluating their impact and addressing them; and
  - driving improvement across the system through the encouragement of the right behaviours and culture, the application of incentives, and proportionate enforcement and liability mechanisms to all participants.

This is akin to the regulatory system that currently exists in UK financial services – an equivalent regime is lacking in the rest of the corporate sector.

9. The vision should be supported by:
  - 9.1. Encouraging each participant in the system to go beyond the minimum requirements that are set in standards, and incentivising voluntary reforms that complement legislation and regulation as a mechanism to drive change in the public interest. Our own commitment to voluntary action, including setting up an independent Audit Governance Board and implementing operational separation, demonstrates how much can be achieved through voluntary measures in a short space of time.
  - 9.2. Ensuring all roles within the system – at corporates and their boards, auditors and other assurance providers, investors, and regulators – are attractive to high quality candidates.
10. Properly implemented, the vision should lead to a corporate environment with the following characteristics:
  - 10.1. Improved trust and transparency: clarity that the overall system operates to a high level of quality through the use of appropriate checks and balances that support the public interest. The vision is not one of “no corporate failure” - there will always be some corporate failure and a market that does not encourage entrepreneurial risk-taking will never be attractive to investors or leading businesses. However, the underlying risks should be transparent to all relevant stakeholders to support informed decision-making.

- 10.2. Better positioning for the future: the scope of information prepared by the company, assurance provider and regulator changes as needs evolve, and is suitably detailed and specific to the company involved but also comparable and easy to understand by the reader.
  - 10.3. Better engagement by all stakeholders, a more attractive and more trusted business environment and more competitive capital markets.
11. Key elements that should be incorporated in the framework include:
- 11.1. Defining an overall high-quality, improvement-focused regulatory regime with joined-up oversight of corporate Britain. This would:
    - i. Provide early warning of potential issues, in a similar way to the Prudential Regulatory Authority (PRA) in financial services.
    - ii. Define and assess quality on a more meaningful basis and put in place appropriate enforcement and disciplinary checks and balances. At the moment, for example, the FRC's Audit Quality Review process places too much emphasis on the quality of documentation and does little to distinguish between a high-quality audit of a poorly run and controlled company and a poor-quality audit of a well-run and controlled company. As a result, good auditors are disincentivised from providing assurance over the companies where risks are likely to be highest.
    - iii. Ensure that, in the event of failure, accountability is apportioned across the system appropriately and proportionately (and, where applicable, with regulators coordinating on which one should take the lead). This contrasts with the current situation, whereby accountability for corporate failures rests *de facto* with the auditor, with the unintended consequence that some companies find it increasingly difficult to appoint an auditor with the requisite level of skills.
  - 11.2. Strengthening the internal control framework at UK companies, with independent, external assurance over the directors' statement of internal controls and enforced through rigorous regulatory oversight.
  - 11.3. Reinforcing the responsibilities of directors in the prevention and detection of fraud, and auditors in the detection and reporting of fraud. This needs to be strongly linked to the internal control framework, with clear guidance on materiality in the context of fraud.
  - 11.4. Clarifying the Government's approach on wider assurance services, including how they should be regulated, and how investors and other stakeholders should be engaged on them, supported by the Audit and Assurance Policy (AAP).
  - 11.5. Addressing the regulatory and civil liability regimes. Currently these inequitably allocate accountability between parties, deter the participation of challenger firms, set lower thresholds for sanctions for auditors than other professions, make the audit market less resilient and less attractive, and risk penalising innovation and change, even when it is done in the public interest (for example, to directors on the information they disclose, or to auditors who wish to provide assurance in the public interest that is outside the strict confines of the statutory audit).
  - 11.6. Putting in place effective mechanisms to provide greater choice and resilience in the audit market. We recognise the regulatory and governmental impetus to achieve this but believe the managed shared audits proposal will present practical difficulties for challenger firms and companies, act as a deterrent for UK listings and is unlikely to achieve its objectives. Whilst we recognise that no solution is perfect and each has potential unintended consequences, we think

a managed market share cap mechanism is more likely to achieve the Government's aims, possibly in conjunction with closer cooperation between Big Four firms and challengers. We suggest that any future recommendation should initially be tested through a pilot programme.

12. As the Government considers the responses to its White Paper, we urge it to consider how developing a vision of the type described here will help in the design of an implementation framework to guide how the proposals could be taken forward. The implementation framework would include thinking on:
  - 12.1. Proportionality: which issues and which companies need to be the focus of these reforms to get the biggest public interest benefit, without damaging companies' prospects or reducing capital market attractiveness? The Public Interest Entity (PIE) definition should cover entities that are of public interest and reforms should be applied to different market segments on a proportionate basis in a way that does not unduly burden entities or stifle innovation and the competitiveness of UK markets.
  - 12.2. Timing: given the volume of change implied by the White Paper, how can reforms be introduced in a way that is manageable and without undue delay? We understand that some are suggesting that reforms should be separated into different groups (for example, auditor and non-auditor reforms) and implemented on different timescales. Our view is that system-wide reform is critical, so we do not support this.
  - 12.3. Voluntary measures: how can players go beyond the minimum standards to deliver change more quickly, or be more responsive to stakeholder needs? How can the Government create an environment to encourage this?
  - 12.4. An improvement culture: how should the system continue to evolve and how can existing market participants and new entrants, think tanks, professional institutes and business schools work together on this effectively?

We are grateful for the engagement we have had with BEIS ministers and officials as we have developed our response and we would like to maintain this dialogue as the reforms are considered further. If you have any questions about our response, please do not hesitate to get in touch.

Yours faithfully



**Stephen Griggs**  
UK Managing Partner  
Deloitte LLP



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