July 8, 2021

The Honorable Kwasi Kwarteng MP
Secretary of State
Department for Business, Energy and Industrial Strategy
1 Victoria St
London SW1H 0ET
United Kingdom

Re: Restoring Trust in Audit and Corporate Governance

Dear Minister Kwarteng:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to comment on the *Restoring trust in audit and corporate governance: Consultation on the government's proposals* (Consultation). A strong system of financial reporting is vital to investor confidence and the effective functioning of our global capital markets. In the United States, the enactment of the Sarbanes-Oxley Act of 2002 (SOX) strengthened how all of the key stakeholders in the US financial reporting ecosystem – companies, regulators, corporate directors, and the audit profession – must work together constructively and continuously to produce high quality financial reporting. The US public company auditing profession embraces continuous improvement and an unwavering commitment to audit quality. Based on the US public company audit profession's commitment to audit quality, our experience with SOX and the importance of a strong UK audit and capital markets system – recognizing the differences between our jurisdictions – that we offer our views on specific aspects of the Consultation.

The US Experience

The enactment of SOX, which passed both chambers of the US Congress nearly unanimously, [1] has stood the test of time. For example, according to a recent Audit Analytics article, US public companies issued a total of 85

[1] On July 25, 2002, the Senate voted on final passage of H.R. 3763, 99-0. The House voted on final passage on the same day, 423-3. https://www.congress.gov/bill/107th-congress/house-bill/3763/actions.

restatements in 2019 to fix significant financial misstatements.[2] This was the lowest number in 15 years. The SOX provisions focus on four key areas:

1. Independent oversight of public company audits by the Public Company Accounting Oversight Board.
2. Requirements for audit committees to be responsible for hiring, firing, and overseeing the external auditor, including fees and independence.
3. Enhanced transparency and executive accountability, including the requirement for the CEO and CFO to certify financial reports quarterly and internal controls over financial reporting (ICFR) annually. Further, the independent external auditor attestation on ICFR (based on size of the issuer, as defined).
4. Enhanced auditor independence rules (as overseen and approved by the independent audit committee).

As noted above, these provisions recognized that audit quality was not solely the responsibility of auditors and there was not one stakeholder in the US financial reporting ecosystem that alone could produce high quality financial reporting and high-quality audits. Rather it takes the roles of company management, audit committees, auditors, and regulators working in concert to foster a system that supports both high-quality financial statements and audits. We are pleased to see that the Consultation sets out a package of measures that would enhance or establish requirements for all stakeholders in the financial reporting ecosystem, and we encourage the government and regulatory bodies to not lose sight of this key aspect of restoring trust in audit and corporate governance.

Below we discuss two key components of the US experience with SOX reforms for your consideration as you finalize the audit and corporate governance reforms in the UK.

Robust Internal Control Over Financial Reporting Protects Investors

Management's ability to fulfill its financial reporting responsibilities depends in part on the design and operating effectiveness of the controls it has put in place over accounting and financial reporting. Without such controls, it would be difficult for most companies to prepare timely and reliable financial reports for investors, lenders, and other users. While no control system can absolutely assure that financial reports will not contain material misstatements, an effective system of ICFR can substantially reduce the risk of such misstatements.[3]

Prior to the enactment of SOX, there was limited visibility to investors and the markets related to the effectiveness of a public company's internal controls. Section 404 of SOX, as implemented by the SEC, focuses on the assessment and related reporting of the effectiveness of a company's ICFR which is designed to prevent or detect material misstatements to a company's financial statements resulting from fraud or error. This includes management's responsibility to annually assess and report on the effectiveness of internal controls under Section 404(a) and the auditor's responsibility to perform an audit of the effectiveness of ICFR under Section 404(b).

The focus on ICFR has had a positive impact on both financial reporting and audit quality, as evidenced in part by the trend in quantity and severity of restatements in the US noted above. In particular, the

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[2] See Audit Analytics Report, *2019 Financial Restatements Report*, available for download at this link.
[3] See CAQ's, *Guide to Internal Control Over Financial Reporting*.

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auditor's annual assessment of the effectiveness of a US public company's ICFR has played an important role in this trend in serving as a guardrail for management, an independent check for audit committees and for bolstering investor confidence in the company's ICFR and overall financial reporting. The benefits of focusing on ICFR, including auditor attestation in connection with ICFR, may be even more pronounced for smaller companies which, according to some studies, could be more susceptible to ICFR problems.[4] Moreover, we note the importance of management's internal controls over other types of information – outside of the financial statements – which companies are increasingly disclosing, such as ESG information. As investors increasingly ask for, and rely on, this type of information, the framework for investor and market confidence in a company's ICFR may be transferable to other forms of reporting.

We note that the Consultation states, "a tentative preferred option which would require a directors' statement about the effectiveness of the internal controls, but (unlike the US's approach to internal controls which mandates external auditor attestation in most cases) leave the decision on whether the statement should be assured by an external auditor to the directors, audit committee and shareholders."[5] We acknowledge the initial implementation of the ICFR provisions of SOX in the US was not without costs or without the need to revisit the initial requirements and guidance – for both management as well as the external auditor.[6] However, these revisions occurred within a relatively short period of time, due in part to active oversight by regulatory bodies and engagement with preparers, auditors, and other stakeholders. For the past 14 years, the US capital markets have clearly benefited from both management and external auditor attestation over ICFR. In short, much has been learned since the ICFR provisions were implemented in the US, and we believe any requirement for attestation over ICFR in the UK could benefit from the lessons learned in the US.

Moreover, we are concerned that the tentative preferred option for ICFR attestation described in the Consultation could lead to confusion about whether a company has subjected their ICFR to attestation from an independent external auditor, given our global markets.

Robust Oversight of Auditors by Audit Committees

In the US, audit committees of listed public companies are required to consist solely of board members independent from management, meaning they could not be affiliated with the company or any subsidiaries nor directly or indirectly receive any compensation from the company other than in their capacity as members of the board. As a result of SOX, audit committees are directly responsible not only for the appointment, compensation and oversight of the work of external auditors, but also for oversight of financial reporting more broadly. These reforms underpin the vital role independent audit committees have come to serve in the financial reporting ecosystem to help protect investors.

Investors have come to understand the roles and responsibilities management, auditors and audit committees have under SOX, and this understanding promotes comparability, consistency and reliability of the information on which they base their capital allocation decisions.

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[4] 2011 SEC 404b Float Study, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float between $75 and $250 million.

[5] See page 19 of the Consultation.

[6] For example, Auditing Standard No. 5 (now AS 2201) replaced Auditing Standard No. 2 after several years of the SEC and PCAOB monitoring implementation. Additionally, in 2007 the SEC staff published, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* in response to requests for further guidance to assist company management in complying with the SEC's ICFR evaluation and disclosure requirements.

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Companies today are predominantly global in nature with operations around the world. The UK capital market system, including its audit market, are of importance to the US and overall global markets. The harmonization of regulations around the world, where possible factoring in jurisdictional considerations, is a benefit to all members of the financial reporting ecosystem and further support orderly and efficient markets for global investors.

We appreciate the opportunity to provide our views on the Consultation. We would be pleased to discuss our comments or answer any questions regarding the views expressed in this letter. Please address questions to Dennis McGowan (dmcgowan@thecaq.org) or Carolyn Hall (chall@thecaq.org).

Sincerely,

Dennis J. McGowan

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