

8th July 2021

Via email: audit.consultation@beis.gov.uk

Dear Minister,

RPMI Railpen (Railpen) response to the Department for Business, Energy and Industrial Strategy's Consultation on *Restoring trust in audit and corporate governance*

About Railpen

RPMI Railpen (Railpen) is the investment manager for the railways pension schemes, and is responsible for managing c. £32 billion of assets. Railpen is authorised and regulated by the Financial Conduct Authority (FCA). The Trustee's mission is to pay the pensions of its 350,000 members securely, affordably and sustainably. The Trustee, and its subsidiary Railpen, undertake responsibilities attributed to asset owners and asset managers, and we have answered the issues raised in the consultation in a way which reflects the breadth of our responsibilities.

Unlike many UK Defined Benefit (DB) schemes, the railways pension schemes include many open DB sections, which means that the Trustee expects to be paying the pension of an eighteen-year-old who is their first job today out to 2100 and beyond. Our investment time horizon is, accordingly, very long and we welcome the Department's work to strengthen the corporate governance framework – a vital component in ensuring sustainable financial markets which work for pension scheme investors and, ultimately, pension savers.

Introduction

Investors like Railpen need accurate corporate reporting, which we can rely upon to provide a true and fair view of a company's financial health, to support us in making investment decisions and acting as engaged stewards of our members' assets. We recognise that there are a number of flaws in the way the UK audit market is currently structured and regulated and which do not incentivise auditors and companies to consistently provide the high-quality audits and information which investors require.

Railpen was an early pioneer in UK corporate governance and a key strand of this work has been our engagement and voting activity to encourage a considered approach to the audit by portfolio companies. We regularly engage with company management and boards on issues such as oversight of the audit process and how Audit Committees work to ensure auditor independence and professional scepticism is 'baked into' the audit process. We were also one of the first UK asset owners to publish our expectations around auditor remuneration, auditor rotation and climate accounting in our global voting policy, and how we will vote where these expectations are not met.

Although we believe that investors have an important role to play in reminding companies, Audit Committees and auditors that shareholders are the primary clients and users of corporate reporting information and the audit process, we recognise that we cannot do this alone. We therefore welcome

the UK government's consideration of this complex and multi-layered issue and its intention to ensure co-ordinated activity by policymakers, regulators, auditors and investors to help create a market for corporate reporting and audit which is fit for purpose.

Our response primarily highlights our views regarding the proposed mechanisms for improving investor engagement with the audit process. We also offer some further thoughts on the broader functioning of the audit market and proposed structural remedies, as well as on directors' duties and corporate reporting.

Our response

We are supportive of the government's approach and of the majority of the detailed proposals in the consultation, though below we recommend some additional ways in which we think the proposals could be strengthened. We think that the creation of a strong, effectively-governed and well-resourced regulator in the Audit, Reporting and Governance Authority (ARGA), with the necessary powers to set standards, hold company directors and auditors to account and a clear understanding of the investor perspective, will be fundamental to the success of the measures proposed in the consultation.

We also recognise that this paper makes a number of far-reaching proposals affecting several different parts of the value chain. A considered and well-structured approach to implementation will be critical for ensuring individual stakeholders can meaningfully and appropriately respond. We are therefore supportive of a phased-in approach for some of the reforms within a two-year grace period. We also believe that opportunities for critical review should be built into the implementation roadmap: every regulatory action, no matter how well-intended, will have unintended consequences and a greater or lesser impact than predicted and it will be important to be able to reflect and adjust as necessary.

Public Interest Entities

We strongly support the proposal that large private companies be included within the definition of a Public Interest Entity (PIE). We are conscious that there is a growing level of corporate activity taking place in the private sector that could be deemed to be in the public. Given the material impact of poor corporate governance on stakeholders and shareholders, we are concerned about the long-term implications of this trend should the gap between governance standards for private and listed companies grow.

We do not have a strong view on which of either Option 1 or 2 would be the most appropriate approach for identifying companies. We do think that there is benefit in ensuring a multi-metric approach that would make it harder for companies to indulge in regulatory arbitrage.

We support the inclusion of AIM companies with a market capitalisation of EUR200m or above as we consider these companies to constitute a public interest. We recognise that that the market capitalisation figures for what AIM companies can be relatively volatile, but think this should not be deemed an insuperable barrier to inclusion. There may be merit in considering, for instance, market capitalisation on a rolling basis to avoid this issue.

Director Accountability

We believe there is a clear case for strengthening director accountability in a number of areas, including over internal controls and for mismanagement. We believe that the US Sarbanes-Oxley Act (SOX) has led

to an improvement in the quality of controls through its emphasis on the responsibility and accountability of senior executives and the Board for a robust approach to internal controls and risk management. We would therefore be most inclined to support Option C of the approaches outlined, which requires a directors' statement about the effectiveness of internal controls and the company's auditor to attest to and report management's assessment.

We think that malus and clawback provisions are an important tool to help structure executive remuneration in a way which aligns senior management's interests with those of shareholders. Although ostensibly Remuneration Committees already have the necessary powers to enforce and influence remuneration policies, we note that historically they have been reluctant to exercise downward discretion or the malus and clawback provisions. There is some evidence that this is gradually changing – perhaps in line with growing investor antipathy to what are deemed to be unwarranted and undeserved pay arrangements – but we think further steps should be taken to ensure appropriate progress.

We would therefore welcome use of more defined trigger points for these provisions and of the proposed accompanying changes to the UK Corporate Governance Code. We believe that thought could be given to encouraging the proxy adviser community to incorporate an assessment as to whether or not a company has made full use of these trigger points into their voting recommendations to clients.

Corporate Reporting

The Resilience Statement

We are very supportive of the government's proposals to expand reporting requirements for PIEs to set out how directors have assessed the company's prospects and address challenges to the business model over the short-, medium- and long-term. We believe that material and forward-looking information is vital for investors to make the appropriate investment decisions. We would encourage the regulator to consider how it can encourage companies to report on what have previously been considered "non-financial" risks such as cyber security or labour relations in a way which is not overly prescriptive.

We agree that, given its long-term and forward-looking focus, the Resilience Statement is the appropriate place for inclusion of Taskforce for Climate-related Financial Disclosure (TCFD) reporting and metrics. We look to the regulator and policy makers to ensure that such a requirement does not reduce companies' focus on material ESG risks to simply climate change, but that companies are also encouraged to consider and report on risks such as cyber security, demographic changes and workforce treatment/engagement in the new Resilience Statement.

The Audit and Assurance Policy

Please also see our comments on investor engagement with the audit process below.

We believe that investors would find the proposals around an Audit and Assurance Policy of use in helping assess how robust and considered a company's approach is to assurance of its company reporting, which in turn should encourage greater investor engagement with the audit process. We also believe that this proposal will help remind auditors that their true clients are the investors, as opposed to the company.

We agree in particular that a description of the policies the company has in relation to the tendering of external audit services would be helpful, as would a description of the extent to which employee and shareholder views have been taken into account in the formulation of the policy.

In addition to the proposed minimum required disclosures, we would recommend requiring reporting of the following information:

- How the company has ensured that its approach to tendering incentivises the professional scepticism and challenge needed from the external auditor;
- The timetable for re-tendering the audit and, where feasible, plans for consulting with investors and other stakeholders on the selection criteria; and
- If the company has said that it has not consulted employees and shareholders in formulating the policy, what its rationale is for not doing so (this should be supported by an approach from regulators which strongly encourages companies to consult these groups).

We would also support an annual advisory shareholder vote. The best Audit and Assurance policies will be subject to continuous and iterative review and conversations with shareholders and other stakeholders should, accordingly, be undertaken on a regular basis. As the audit and assurance market, and hence companies' activities on audit, is likely to develop rapidly in light of regulatory developments, it is also likely that there may be significant changes to an Audit and Assurance Policy in a given year and shareholders should therefore be given the opportunity to have their say on an annual basis. Our experience of conversations with companies around remuneration, for instance, in jurisdictions where an annual 'say on pay' vote is not mandatory, indicate that the timetable for company conversations with investors almost entirely mirrors the timetable for a given vote.

Audit purpose and scope

We recognise that steps have been taken to revise the International Standard on Auditing to require auditors to take a wider perspective, but feel that further steps are required to ensure that auditors consider relevant director conduct and wider financial or other information. We also think that there will be additional benefits for the audit industry in encouraging recruitment of those with a more diverse set of skills and professional backgrounds, which should both help achieve a shift in mindset and improve audit quality¹. We therefore support the government's proposals in this regard. We hope that investors will be fully involved in the discussion with the regulator regarding the creation and enforcement of standards.

We also support the suggestion that the definition of wider auditing services be subject to oversight by the regulator via the Audit and Assurance Policy. Given the proliferation of metrics produced by companies, we would be particularly keen for auditing and assurance to be extended to key metrics such as remuneration or other material environmental, governance and social metrics.

¹ For instance, Railpen believes that there is an urgent need for auditors to more explicitly consider material climate change impacts in their assessment of the financial accounts and assumptions used: they already have a regulatory framework which supports them to do so, but progress to date has been slow. It is arguable that attracting – and recognising the need to do so – individuals from a climate or environmental science background would help raise standards across the audit industry on climate accounting. As one of the first investors to explicitly highlight our expectations on climate accounting – and where we will vote if these expectations are not met – in our 2021 Global Voting Policy, and a signatory to the IIGCC's [Paris-aligned Accounts](#) initiative, we would be happy to discuss this specific issue further if helpful.

As part of this, we would welcome the extension of the quality inspection regime but ask that ARGA is more timely and transparent about the findings of its inspections. This allows companies to learn from each other and offers valuable insight to investors. It has been a flaw of the Audit Quality Review (AQR) regime that there has not been this transparency to date.

Shareholder engagement with the audit process

We agree with Sir Donald Brydon in his review that many investors do not engage with the audit process, or with audit issues generally, despite their role as the primary users of financial accounts. This lack of engagement is supported by evidence that, for instance, the level of dissent on audit-related resolutions at company AGMs remains very low – even where there has been evidence of poor practice on audit².

Most investors do not have the technical expertise or access to information required to identify fraud or mismanagement, and this is why boosting investor engagement with the audit is only one part of the jigsaw of measures required to ensure a high-quality audit. We agree with the government that the primary mechanism for shareholder engagement with the audit process must be the Audit Committee, and we support proposals to ensure greater two-way dialogue, including through the provision of enhanced disclosure from the Audit Committee to shareholders.

We believe that the opportunity for attendance and discussion at a company's Annual General Meeting (AGM) is an important tool for investors. We would be keen to see the government take up the recommendation made in the Brydon Review of a mandatory standing item to the AGM agenda for questions to be put to the senior audit partner and the Audit Committee Chair. While this will not be sufficient in itself to improve the dialogue, for many investors this will be a key opportunity to directly ask questions of the accountable individuals.

We recognise that the government has proposed an Audit Users Review Board. We believe consideration should also be given to encouraging greater collective action by investors on audit issues specifically. This will be particularly important given the highly technical nature of audit as it will enable the sharing of expertise and if, as suggested, ARGA imposes thresholds around the size of the shareholding required for Audit Committees to be formally required to consider and respond to shareholders' requests. Collective engagement opportunities would also be more efficient for the companies. The Investor Forum might be an appropriate avenue for doing so. We believe that requests from investors should only be considered where they have a holding in the company but should be allowed whether or not the investors have voting rights attached to their holding.

We agree with the government that the current provisions of the Companies Act covering the departure of an auditor from a PIE do not currently ensure adequate information is provided to shareholders. We support the Brydon Review's recommendations that where this happens, a company is required to hold a general meeting. This would be an important opportunity for direct engagement between key company decision-makers and shareholders and to give shareholders a better understanding of any potential areas of concern highlighted by the auditor's departure.

² 2019 AGM Voting Review (Pensions and Lifetime Savings Association (PLSA), 2019)

Oversight of the Audit Committee

The very best Audit Committees understand not only that it is the shareholders that are the true clients of any audit, but that a high-quality audit is in the company's interests as well. Although some companies have Audit Committees with this mindset, we believe that there remain committees whose focus appears to be reduction of the auditors' fees. We therefore support the proposal that ARGA should have the power to set additional requirements of Audit Committees, although we do not think that greater regulatory oversight in itself will be sufficient to achieve the cultural change and shift in mindset needed from board directors on many Audit Committees in the FTSE 350.

We would welcome consideration from ARGA to impose requirements for further reporting and disclosure on auditor remuneration. Investors are much more interested in a high-quality audit than in a reduction in auditor fees which may necessitate some cutting of corners in the audit process. We would welcome requirements on Audit Committees to disclose the rationale for any significant reduction in fees over the previous year – particularly where this is combined with a change in the audit firm used. In 2021, Railpen's voting policy updated included our intention to vote against auditor remuneration resolutions where the remuneration had decreased by a specified proportion without clear rationale – and our analysis for the 2021 AGM voting season would highlight that disclosure from many companies in this area is of variable quality.

We recognise that ARGA does need greater powers to act where it believes an Audit Committee is not functioning effectively. We think that careful consideration should be given to the impact of placing an ARGA observer on an audit committee in terms of the dynamic and conversation. We draw the government's attention to The Pensions Regulator (TPR)'s power to appoint an independent trustee to trustee boards where it feels escalation of support and intervention is needed; we wonder whether ARGA could pull together a similar pool of expert and independent individuals from the industry who could be drafted in to observe. This could build upon, for instance, those individuals who have joined the FRC's new Advisory Panel.

The particular role of asset owners and their advisers

Asset owners, such as pension schemes, occupy a particular role as clients at the end of the investment chain, adjacent to the end beneficiary. The ability of pension schemes to act as demanding clients of their managers and advisers is an important mechanism for pulling good practice on investment issues up through the chain.

The Railways Pension Scheme is privileged to have its own internal asset manager, Railpen, which includes internal portfolio managers and a Sustainable Ownership team. We recognise however that most pension schemes will usually delegate implementation of investment activities – including company and stock analysis – to external managers and receive advice from these managers or third-party investment consultants. Ultimately it is the schemes' beneficiaries who are impacted by any potential loss of value if an audit fails to pick up material issues at a company.

We believe that the pension scheme voice must be explicitly incorporated in the Audit Users Review Board and in conversations between ARGA and investors on audit issues. We would also welcome consideration by the FCA in designing its regulatory framework for investment consultants as to whether there is a mechanism for ensuring consultants encourage their clients to scrutinise and engage with investment managers' stewardship activity on audit issues specifically.

Shared audit arrangements and market cap proposals

For Railpen it is the quality of the audit, rather than the precise shape and structure of the audit market which matters. However, we do believe that the creation of a market where (i) there are more than four major audit firms, (ii) all firms recognise that investors are the true clients of the audit, and (iii) all firms are capable of providing high-quality audits of even complex or multi-national companies would be a positive development for ensuring the audit market's long-term resilience.

We are sceptical of the benefits of managed shared audit arrangements. We believe that shared audits still run the risk around a lack of co-ordination between the different audit firms and that certain aspects of the audit may be missed or glossed over as a result. We also believe there are issues with a joint audit approach, although at least a joint audit would mean more pairs of eyes.

We welcome the government's statement that a market cap arrangement is still an alternative, although we would encourage serious consideration sooner rather than later. We believe that such an arrangement would be more directly beneficial, not least as it is the attitude of the individuals involved in an audit which is a key determinant of audit quality and such a move could encourage ambitious audit partners or prospective partners to consider at which firms their career goals are most likely to be achieved. This could in turn lead to a greater flow of quality candidates to firms beyond the Big Four.

Audit firm culture and professionalism

In addition to the culture and mindset shift required from Audit Committees and investors, we believe there is also a need for cultural change amongst company auditors. Key components of this new culture must be professional scepticism and challenge, ensuring that the needs of shareholders and other stakeholders are placed at the heart of any audit and assurance process supported by a regulator which ensures that the education necessary to achieving this culture shift takes place.

We think that many of the steps outlined by the government in its consultation will help drive this cultural change. We also believe that the mandatory auditor rotation and re-tendering requirements have been a powerful tool for helping to reduce stagnation and promote independence of thought. We would be interested in understanding whether there might be scope in the wake of Brexit to tighten the timings on mandatory auditor rotation to, for instance, 10 or 15 years. We note that the 2018 UK Corporate Governance Code now says that whether a board director has served for more than nine years should be a key factor in determining the director's independence.

We particularly support the creation of a new professional body for corporate auditors whose remit extends beyond that of the existing accountancy professional bodies. This would be useful in providing opportunities for development and recognition which is specific to corporate audit which should help retain and attract more individuals into the field.

The Stewardship Code

We are strong supporters of the Stewardship Code and were one of the first pension scheme signatories. We believe that its shift to a new outcomes-based approach and more stretching standards will be an important tool in raising standards of engagement and voting in the UK. We would support work to find a suitable mechanism for raising the profile of audit as a key issue for consideration in the Code, but also suggest that audit issues be placed on the agenda at an early stage of the new Occupational Pension Schemes Council (OPSC) for discussion by pension schemes.

We note the government’s intention to consider at a later stage whether to introduce “stronger requirements for reporting on the Code or to alter the balance between a rules and voluntary Code-based approach if the desired outcomes have not been achieved.” We believe that caution should be taken around requiring all asset owners to sign up to and report against the new, stretching Code, given the resources needed to do so in a meaningful way will be beyond some schemes with limited governance resources.

We hope that the views expressed in this document have been helpful and would be pleased to liaise further with the minister or his department if that would be of use.

Yours sincerely,

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