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ShareAction»

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Sent via email to audit.consultation@beis.gov.uk

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

I am writing to respond to your consultation *Restoring trust in audit and corporate governance: Consultation on the government's proposals* on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors.[1] We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the view of clients, beneficiaries and pension scheme members.

Strong and independent audits ensure that company finances are transparent and accountable to stakeholder groups with a legitimate interest in a company's financial accounts. It provides the tools stakeholders need to make informed decisions regarding their relations with the firm. For example, audits can help employees and trade unions get a clearer picture of how an organisation is being managed and whether it is putting people jobs or pensions at risk. However, issues with weak regulation, limited sanctions and poor standards means that we have seen serious cases of audit failure in which wider stakeholder groups have suffered a result:

- Carillion: Auditor KPMG failed to warn of financial problems at Carillion and allowed the construction firm to conceal debt and issue big dividends. When Carillion collapsed in in 2016, thousands of people lost their jobs,[2] 30,000 suppliers suffered financial losses[3] and taxpayers lost an estimated £148 million.[4]
- Climate change: Companies are failing to tackle the climate crisis in their business plans and financial statements. ClientEarth found that 90 per cent of financial accounts and audit report for the 250 largest listed companies in the UK made no reference to climate risks or their financial impact.[5]
- Patisserie Valerie: Auditor Grant Thornton failed to warn of suspected fraud at Patisserie Valerie. Over 900 people lost their jobs when the café chain went into administration.[6]

[1] https://shareaction.org/
[2] Parliament UK (2018). Carillion: Summary. https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76903.htm
[3] TT (2018). Carillion collapse leaves 30,000 businesses losing out on £1bn. https://www.telegraph.co.uk/business/2018/01/15/carillion-plunges-liquidation-putting-jobs-pensions-government/
[4] BBC (2018). Carillion collapse to cost taxpayers £148m. https://www.bbc.co.uk/news/business-44383224
[5] CE (2021). ClientEarth reveals UK companies not adequately reporting on climate change. https://www.clientearth.org/latest/latest-updates/news/clientearth-reveals-uk-companies-not-adequately-reporting-on-climate-change/
[6] TG (2019). Patisserie Valerie falls into administration as bank talks fail. https://www.theguardian.com/business/2019/jan/22/patisserie-valerie-administration-cafe-chain

We welcome the Government's focus on audit and corporate governance reform. **Our response prioritises chapters 3, 4 and 10 of the consultation document**. We support many of the Government's proposals and in some areas urge it to go further. Our recommendations are summarised below:

- The UK should match the ambition of the EU around corporate sustainability reporting.
- A new resilience statement should be introduced and apply to all companies.
- The Government should clarify its approach to sustainability reporting and use its 2023 review to consider the effectiveness of these proposals.
- The FRC should introduce a new Public Interest Report and the Government should consider the most effective place to include all relevant sustainability information, including public interest reporting, in its 2023 review.
- The Government should update the list of specified stakeholders to whom a company should have regard.
- ARGA should be independent, have "real teeth" and put sustainability at the heart of its operations
- The Government should clarify what responsible business behaviour looks like in s.172 of the Companies Act.

Recommendation: The UK should match the ambition of the EU around corporate sustainability reporting

The 2019 Green Finance Strategy committed the Government to 'match the ambition' of the EU's Sustainable Finance Action Plan.[7] In the Chancellor's recent Mansion House speech, he stated the UK had not secured a financial services deal with the EU and would now use its 'new freedoms to follow a distinctive approach'. But pursuing a distinct regulatory regime must not mean pursuing a weaker regulatory regime and the Government should clarify that it still intends to at least match the EU's ambition in relevant areas contained within this consultation.

Proposals for the EU's Corporate Sustainability Reporting Directive have recently been published. The Directive is intended to help companies focus and report on meaningful information and channel finance to activities and projects needed to make the European economy more sustainable. These include:

- **The principle of "double materiality" is clarified and properly enshrined in the draft proposal.** EU policy makers have clarified that double materiality is key so that investors, other finance providers, supervisors, citizens, and other stakeholders can understand risks and opportunities stemming from sustainability matters that companies face, as well as the actual and potential adverse impacts of corporate business models and operations on people and planet. UK Policy makers should follow suit in this respect by ensuring the UK regime considers the impacts of a company on society and the environment. Companies operating in the EU will need to make these disclosures anyway and so should not object to doing the same in the UK. The UK has always been a leader on corporate governance and should therefore at least keep pace with the EU.

- **A comprehensive report that is both forward looking and retrospective, which includes short, medium and long-term horizons and is both qualitative and quantitative**. The subject areas in the report include resilience, opportunities, transition plans, stakeholder interests, impacts and strategy implementation. In addition there is a focus on targets and progress, the role of the board and management, due diligence process, principal adverse impacts and the processes by which reported

[7] Green Finance Strategy 2019, HM Government, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

information is identified. If the UK is serious about matching the ambition of the EU then policy makers should include these reporting areas at a minimum.

- **A requirement to report on plans to ensure the compatibility of company business models with a 1.5 °C world, in line with the Paris Agreement.** The low carbon transition will generate risks and opportunities that will have major implications for companies' business models and strategies. This requires a clear framework specifying what needs to be reported and should also be integrated into the UK regime. This would be complementary to the excellent start BEIS has already taken regarding climate-reporting by large companies.

Recommendation: A new Resilience Statement should be introduced and apply to all companies.

The new Resilience Statement proposal is welcome and should apply to all companies. At a minimum, the Resilience Statement should include the following:

- Threats to liquidity, solvency and business continuity in response to a major disruptive event (such as a pandemic) which disrupts normal trading conditions;
- Supply chain resilience and any other areas of significant business dependency (e.g. on particular markets, products or services);
- Digital security risks (both including external cyber security threats, and the risk of major data breaches arising from internal lapses);
- The business investment needs of the company to remain productive and viable; the sustainability of the company's dividend and wider distribution policy; and
- ESG risks including, but not limited to, climate change. A wider focus on systemic/material ESG risks should be required including biodiversity loss and poor population health.

The timeframes of such risks should be assessed and placed in the relevant section of the report. Including relevant climate information in resilience statements, and framing reporting around a company's resilience to climate risk, is sensible. While the inclusion of climate risk is welcome, the Government should also consider requiring that companies include other material sustainability risks to the company.

Changes to the Occupational Pension Schemes (Investment) Regulations in 2018 mean that trustees are now required to take into account financial material ESG factors. In addition, DWP is currently consulting on how to drive up trustees' consideration specifically around material social factors. BEIS should work with DWP to ensure that they are enabling investors to do this, rather than inhibiting them by only requiring information around climate change. The creation of a new space to focus on all material risks would be welcome, and should help shareholders to drive ESG up boards' agendas. If the changes are to be fit for the future, it would be a mistake to only focus on climate change.

Clarity on how the Government sees this report fitting together with the public interest report would be helpful, as would guidance on where information relating to the *impacts* of the company on climate change, the wider environment and society should sit. We are concerned that this information being separated could lead to a perception that there is no connection between corporate resilience and the public interest.

Recommendation: The FRC should introduce a new Public Interest Report and the Government should consider the most effective place to include all relevant sustainability information, including public interest reporting, in its 2023 review.

The Government should clarify how its proposals will interact with the FRC's plans for the future of corporate reporting. We note that the Government does not intend to introduce Public Interest Statements. We do, however, support the introduction of Public Interest Reports as has been proposed by the FRC.

Having companies themselves outline their perception of their obligations to the public interest would be a good way to start an evolving conversation of the role of business in society. However we believe having separate financial and Public Interest Reports could create a risk that directors see this as a semi-optional CSR-type extra, rather than something inherent to their purpose as a company. In our recent response to the FRC's future of corporate reporting consultation, we commented that considering stakeholder interests is at the heart of UK company law (section 172, Companies Act 2006) and we believe it sends the wrong message to split these into a separate reports. Such reports enable all stakeholders to understand the positive and negative impact of companies on society and to help to enhance or mitigate these as appropriate. We would encourage the Government to ensure all relevant sustainability information to be included together, in the same report. Such a report should also consider the most effective place to include public interest and other sustainability information in its 2023 review based on the impact the FRC's proposed changes have (if any) on the proper integration of climate-related and other financial risks by investors.

Reporting should be structured around the concept of double materiality. The financial performance of a company may be impacted by an issue, or the corporate itself may impact on social and environmental concerns. As the European Commission states, "[t]hese two risk perspectives already overlap in some cases and are increasingly likely to do so in the future." For example, corporate workforce practices have been shown to have a material impact on both companies and on society this year, during the COVID-19 pandemic. Asking companies to assess and evaluate their activities through this lens, using clear and comparable standards and in a single report, should avoid reinforcing the idea that their business activities take place within a bubble.

Recommendation: The Government should update the list of specified stakeholders to whom a company should have regard

Section 172 of the Companies Act lists stakeholders to whom a company should have regard. These include employees, suppliers and customers, the community and environment, and shareholders. The Government's review presents a clear opportunity to consider how comprehensive this list of stakeholders really is. A recent ShareAction report on the future of AGMs recommended that a company's stakeholders should include, at a minimum:[8]

Workers: The Companies Act's use of the phrase 'employees' no longer describes many of those who provide labour to companies. Research from the TUC evidences that one in nine UK workers are in insecure forms of work. 'Workers' of all types should be considered as stakeholders by companies, including those in traditional forms of employment, alongside 'self-employed' workers in the gig economy, those employed through third parties, those working as contractors, and as seasonal workers, and those in supply chains.

Trade unions: Given the intrinsically imbalanced nature of the relationship between workers and companies, many workers may not want to speak out individually, especially if they lack job security. Trade unions provide a democratic means for workers to speak collectively and with one voice and as such trade unions and similar bodies should be considered stakeholders.

Suppliers: Suppliers are key to the proper functioning of companies and should continue to be considered as stakeholders in law, both individually and via supplier trade associations.

Communities directly affected by corporate activity: While the Companies Act makes reference to 'the community', it doesn't refer to specific communities. Communities are stakeholders and include:

- Those affected in a local, geographical sense by corporate operations.

[8] Fit-for-purpose? The future of the AGM, ShareAction, https://shareaction.org/wp-content/uploads/2021/01/Future-of-the-AGM.pdf

- Those affected in a global sense by corporate operations and activity on the climate crisis. This includes but is not limited to communities bearing the frontline impact of the climate crisis, whether from flooding, drought, crop failure or other natural disasters.
- Communities who have historically been, and continued to be, oppressed because of a company's actions, including but not limited to the LGBTQIA+ community, racially oppressed people, the disabled community, and women and non-binary people.

Communities indirectly affected by corporate activity: The complexity of the systemic challenges that we face, and the interconnectedness of a globalised world, means that individuals and organisations can be affected by corporate activities at great geographical and temporal distance. Those who are indirectly severely affected by company activities are also stakeholders, for example future generations.

Customers and users: The Companies Act refers to customers, which are of course the lifeblood of the company. Consumer associations are one way that customers come together, and they should be considered stakeholders. In order to reflect the growth in business practices (such as in the technology sector) where advertisers are the customer, paying for the attention of users, product users should also be considered stakeholders, as a group that is significantly affected by what a company does.

Recommendation: ARGA should be independent, have "real teeth" and put sustainability at the heart of its operations

The new audit regulator - Audit, Regulator and Governance Authority (ARGA) - must be independent and have real teeth. This includes having robust governance arrangements that exemplify best practice in its recruitment processes, code of conduct and policies dealing with potential conflicts of interests in its appointment. It should be properly resourced to deal with complex investigations and have the power to issue effective sanctions that will act as a strong deterrent for companies' malpractices. ARGA should consider its own position as regulator of both companies and also investors through the Stewardship Code to ensure it remains and independent and impartial regulator. ARGA should continue the FRC's recent work scrutinising Stewardship Code statements of potential signatories, but it should also have powers to supervise/investigate stewardship activities of investors to ensure that practices match stated policies.

The Government should ensure that sustainability is put at the heart of its operations. The Treasury recently recommended that the FCA have 'regard to the Government's commitment to achieve a net-zero economy by 2050 under the Climate Change Act 2008 when considering how to advance its objectives'.[9] BEIS should take a similar approach to ensure environmental and societal concerns are embedded within ARGA's operational objectives from day one.

Recommendation: The Government should clarify what responsible business behaviour looks like in s.172 of the Companies Act.

As a member of the Better Business Act Coalition, we support clarification of what responsible corporate behaviour looks like through revisiting s.172 of the Companies Act 2006. In particular, the Government should consider the extent to which the provisions of s.172 drive up responsible behaviour by companies. Section 172 sets out a number of general duties that directors owe to a company. However, it is widely recognised as ambiguously worded and this review presents a clear opportunity to provide greater clarity to company directors.

Section 172 of the UK's Companies Act 2006, imposes on a director the duty to 'act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a

[9] Recommendations for the FCA, 2021, HM Treasury, https://www.gov.uk/government/publications/recommendations-for-the-financial-conduct-authority-march-2021/recommendations-for-the-financial-conduct-authority-march-2021

whole' and, in so doing, to have regard to a range of stakeholders. However, in the absence of clear guidance, the interests of shareholders are often pursued without regard to those of other stakeholders.

Choosing between people, planet and profits is a false dichotomy. By amending Section 172 of the Companies Act the Government can use existing legal principles to empower directors to benefit all stakeholders. For many directors, this change in law will not materially affect their behaviours or the actions of their companies, but by becoming law we can ensure businesses are legally responsible for benefiting workers, customers, communities and the environment while delivering profit.

Specifically we want an amendment to achieve four changes:

- **Aligned interests:** The interests of shareholders are now advanced *alongside* those of wider society and the environment. This establishes a new principle of fiduciary duty within Section 172 of the Companies Act.
- **Empowering directors:** This change must empower directors to exercise their judgement in weighing up and advancing the interests of all stakeholders.
- **Default change:** This change must apply to all businesses by default. It must no longer be optional to benefit wider stakeholders beyond shareholders.
- **Reflected in reporting:** Following this change, businesses must report on how they balance people, planet and profit in a strategic report or impact report, where one is currently required.

I hope our views are clear, but please do not hesitate to contact me at fergus.moffatt@shareaction.org if you have any questions.

Yours sincerely,

Fergus Moffatt
Head of UK Policy