

Financial Reporting Council
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Sent via email: AAT@frc.org.uk

Dear team,

Railpen response | Financial Reporting Council (FRC) | Proposed Revisions to UK Auditor Reporting Standards

About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager for the railways pension schemes and is responsible for c. £34 billion of assets on behalf of over 350,000 members. The Railways Pension Trustee Company Limited (the Trustee) is Railpen's only client, ensuring that all our activities are aligned with the interests of the schemes' members.

Sustainable Ownership is Railpen's approach to incorporating material governance and sustainability considerations into the investments it manages on behalf of members. Railpen's work is enabled by the Trustee's related investment belief: "Incorporating and acting upon climate risk and other environmental, social and governance (ESG) factors is a significant driver of investment outcomes and part of our fiduciary duty."

Railpen operates with a hybrid asset management model, with significant in-house asset management capabilities and resource that enable cost control and transparency, as well as ensuring that investment and stewardship decisions and activities are aligned to client needs. This means that we engage directly with companies, vote most of our holdings directly and review companies' shareholder materials and communications ourselves.

Our view of a well-functioning audit market is one that supports high-quality audits and ensures a company's accounts represent a true and fair view of its financial health. We therefore believe that meaningful, timely and insightful information on a company's audit is vital to investor decision-making to help us achieve good outcomes for members and as such we welcome this consultation.

Our response builds upon our October 2024 report *Acting on Audit*¹, produced with Governance Perspectives Ltd. This report was written from an investor stewardship perspective as a contribution to the emerging policy debate and to encourage others in the industry to do what they can to ensure the audit market works in the interests of shareholders and our beneficiaries. The report made recommendations aimed at different stakeholders within the audit market – and we are delighted to see that several of these new proposals from the Financial Reporting Council (FRC) align with our suggestions.

¹ Railpen and Governance Perspectives Ltd., (October 2024) *Acting on Audit: an investor stewardship perspective* www.railpen.com/knowledge-hub/reports/acting-on-audit/

Our response also builds upon our previous responses to the FRC's consultations on the Audit Committee Standard² and Audit Quality Indicators³, as well as the 2021 consultation from the then Department for Business, Energy and Industrial Strategy on restoring trust in audit and corporate governance⁴. As a large institutional investor with a keen interest in audit issues, we will continue to do what we can with our portfolio companies, but we are strongly supportive of the FRC's work here and elsewhere to ensure shareholders and other stakeholders obtain the information they need from the auditor's report.

Summary

We have responded below to what we deem the most relevant of the individual consultation questions relating to our areas of industry and policy expertise. However, we also outline some broader points that we think are relevant to the stated aims of the consultation, and align with our previous *Acting on Audit* report and its recommendations.

We provide these comments from the perspective of an active investor – we invest with conviction and steward with intent – and as a direct user of audit reporting produced by investee companies. We also increasingly see audit issues as an important system-wide issue, providing the basis for the healthy and sustainable financial markets upon which our portfolio returns depend.

In general, we believe good corporate governance is vital for sustainable economic growth. It supports vibrant capital markets, driving stronger financial performance, enhancing shareholder value, and improving innovation and productivity. By promoting transparency and accountability, good governance also helps prevent costly mistakes and value-destructive decisions, creating a more resilient and innovative UK capital market and economy that works for companies, investors and everyday savers alike⁵. As such, we encourage regulators to be firm in protecting existing UK standards, including on audit as a significant contributor to the trust between companies and their stakeholders that is necessary for thriving capital markets.

The need for more decision-useful audit reporting

We are highly supportive of much of what is proposed by the FRC. Railpen has long advocated for audit reports to focus on meaningful, decision-useful information rather than boilerplate text. In interviewing investors for our *Acting on Audit* report, we heard (and share) concerns that audit reports often contain generic disclosures and unnecessary length, which dilute their value. The information and insights contained in the audit report is a key aspect of how we make informed investment decisions, and either helps or hinders us to exercise effective stewardship of our assets on audit issues.

Although the quality of information on individual audits has generally improved in the UK in recent years, in large part owing to efforts by the FRC and others, there remain areas for improvement. While we acknowledge that the quality of audit reports is already considered to be higher in the UK than in the US and EU (as highlighted by interviewees in our *Acting on Audit* report), we would encourage the FRC to stand firm in this and any further work to improve standards on audit despite pressure from some parts of the market to deregulate as much as possible. In this way, the UK can continue to differentiate itself as the world's 'quality' financial market.

² Railpen response to FRC consultation on Audit Committee Standards. Available to read [here](#).

³ Railpen response to FRC consultation on Firm-level Audit Quality Indicators. Available to read [here](#).

⁴ Railpen response to BEIS consultation on restoring trust in audit and corporate governance. Available to read [here](#)

⁵ A selected list of relevant academic evidence on this can be found at: [Governance for Growth Investor Campaign \(GGIC\)](#).

We strongly support the FRC's stated objectives regarding the updates proposed in this consultation, namely to:

- **Simplify and declutter of the auditor's report, reducing "boilerplate" reporting burdens:** The removal or relocation of repetitive, boilerplate statements would make the core audit report clearer and more concise. A streamlined report will help investors quickly identify key findings and issues from the audit, refocusing the auditor's report on what really matters.
- **Increase the quantity of useful information for users within the auditor's report:** Doing this in a proportionate way should ultimately lead to increased transparency, audit quality and overall trust in the audit process. We believe the proposed approach to minimise additional auditor effort by designing the proposals around auditors' existing requirements for communication with (for example) Audit Committees is very sensible.

Our response – addressing the questions set out in the consultation document

Q1. Do you support the measures proposed by the FRC to simplify and declutter the auditor's report?

We support the FRC's stated aims: we believe the proposal on decluttering the report will improve usability and transparency.

Reporting by exception

From an investor perspective, true reporting by exception is much preferable to boilerplate wording that is not decision-useful. We agree that the FRC's proposed changes on this should ensure the auditor's report does not omit any substantive information, but we encourage regulatory monitoring once the changes have been implemented.

Describing how the audit has intended to detect irregularities, including fraud (ISA (UK) 700)

We would gently challenge the proposal that only auditor's reports for PIEs and other listed entities will be required to provide this description. We appreciate the points made in the consultation document (and the FRC's own reviews) that indicate that relevant descriptions provided for smaller, non-listed companies are typically highly generic (relative to those of larger listed companies) and that producing these descriptions for smaller and less complex entities resulted in a disproportionate amount of work for auditors. However, given the significance to investors of the audit's role in detecting irregularities (including fraud) at portfolio companies of all types and sizes, we would suggest focus is instead placed on working with entities to ensure the descriptions provided for smaller companies and non-listed companies move beyond the current generic descriptions, rather than removing them altogether.

We would also note here the interactions with the ongoing discussion about the current PIE definition as part of the wider audit and corporate governance reform agenda. 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 interest. In our view, the definition of a Public Interest Entity (PIE) should genuinely recognise 'public interest', regardless of whether a company is private or 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, and we would question how consistent this is with the UK government's wider goal to enable greater pension scheme investment in private markets.

It had previously been proposed that any company with more than 750 employees and £750 million in annual turnover be classified as a PIE. We were broadly supportive of this proposed change relative to the current definition, although we recognise there is scope for discussion on the precise threshold⁶. We think that as currently constituted, the PIE definition does not truly recognise ‘public interest’, including for private companies whose successful operation is of vital importance to UK citizens, as well as local and national government.

Q2. Do you believe that the proposed changes to key audit matters will improve the communicative value of the auditor’s report to users?

Yes, we believe the proposed changes to Key Audit Matters (KAMs) could significantly improve the communicative value of the auditor’s report. We support the proposal to make key observations for KAMs across all entities (not just for PIEs) because this has the potential to improve audit quality across a range of different companies, while helping to bring consistency to disclosures. We also support the revision to require auditors to communicate their views on significant quantitative aspects of an entity’s accounting practices.

Railpen has consistently called for more informative audit reporting to investors – in our *Acting on Audit* report with Governance Perspectives Ltd., we noted that investors often find current audit disclosures too generic and want deeper insight into the auditor’s findings. Ultimately, richer KAM disclosures will enhance transparency, help investors understand the auditor’s perspective on critical issues, and reinforce confidence in the audit. We therefore strongly support requiring auditors to include ‘key observations’ for all KAMs and to use entity-specific, plain language.

These improvements would support further engagement by Railpen and other investors by providing better information for us to discuss with Audit Committees. We have encouraged our portfolio companies and their auditors to adopt similar practices (such as graduated findings) voluntarily, so we welcome the FRC’s proposals.

In order to increase the level of decision-useful information disclosed in audit reports, in our *Acting on Audit* report we recommended auditors consider disclosing graduated findings. We acknowledge that, so far, many companies have been reluctant to provide this level of transparency, likely due to concerns about litigation risk and potential liability associated with such disclosures. As a result only a small number of companies have adopted graduated findings. We remain convinced that disclosure of graduated findings would enhance audit quality and strengthen investor trust. While we would not support limiting auditor liability – since doing so might lead to a decline in service quality – if the FRC were to raise standards to encourage the inclusion of graduated findings in audit reports (which we would be highly supportive of), it should also consider introducing appropriate safe harbour provisions for auditors.

Q3. Do you consider that the inclusion of requirements to describe the impact of the entity’s controls on the audit in the auditor’s report, and the level of work required by the auditor as a result, will provide users with useful further insights?

We support the additional disclosure, we believe additional context would be useful to gauge the robustness of management’s controls and risk management. However, we are also mindful here of feedback from audit firms regarding potential increases in workflow as a result of the proposed changes. Where additional testing has been carried out, we would be keen to understand why the auditor did not place reliance on the controls, the additional work that had to be carried out as a result, and the impact of this.

⁶ For more on this see the Governance for Growth Investor Campaign (GGIC), more information available [here](#).

Q4. Do you support the proposed approach to requiring auditors to identify and report any significant deficiencies in internal controls that merit communication within the auditor’s report? Is it appropriate to scope the requirements to discuss the impact of the entity’s controls on the audit and to communicate highly material significant deficiencies in internal controls solely to entities that apply the UK Corporate Governance Code?

We support requiring auditors to include in the audit report significant deficiencies in internal controls that merit communication. In our view, if an auditor discovers such a weakness, then it is in the interest of all investors to be alerted to this fact in the auditor’s report. Such transparency should reinforce accountability, especially given that auditors are already required to report any significant deficiencies within internal controls that have been identified during the course of the audit to the Audit Committee. This also provides an additional hook for investor engagement.

We note that only ‘highly material’ deficiencies would be published i.e. those that indicate an ineffective control environment, currently a higher bar than what is reported to the Audit Committee. We think this makes sense, assuming sufficient clarity is provided on the distinction. A higher materiality threshold should enable focus on the most decision-useful and important deficiencies.

Limiting reporting to companies that apply the UK Corporate Governance Code also makes sense in the first instance, particularly given the upcoming requirement of the Code to provide a declaration of effectiveness of material controls, and where they are not effective, set out actions to improve them. Over time, if the additional reporting is assessed as useful, then extending to a broader range of companies could be considered.

We also support the points made in the ICGN’s response to this consultation⁷ highlighting the importance of clear and consistent terminology (and guidance) to avoid creating unrealistic expectations about the scope of the audit, ensuring it is clear that there is not an expectation for auditors to provide positive assurance on internal controls or a full-scope controls audit.

Q5. Do you support the removal of the distinction between other information and Statutory Other Information to ensure that the auditor’s responsibilities under ISA (UK) 720 focus on other information that is of most relevance to a reader of the annual report?

Yes, we support this proposal to remove the distinction between ‘Other Information’ and ‘Statutory Other Information’, on the basis that it refocuses the auditor’s responsibilities on the information that matters most to readers of the annual report, as well as better alignment with international standards. We agree that the current split does not necessarily reflect what users consider important. As an investor, the narrative sections (such as the strategic report, directors’ report, and increasingly sustainability disclosures) are highly relevant to our evaluation of a company. This change should simplify the auditor’s report and avoid confusion (we expect users often do not understand the difference between the terms anyway).

We would expect that the auditor maintains the responsibility to read and consider this information for material inconsistencies with the audited financial statements or with knowledge obtained during the audit. In case of a material misstatement or inconsistency, the auditor should still continue to respond for example through discussing with management, requesting corrections, and modifying the audit report if unresolved.

⁷ For clarity, we mean the ICGN’s responses to questions 4 and 3.

Q6. Do you support the FRC’s proposed approach to ensuring that the ISAs (UK) remain aligned with the international standards following the changes made by the IAASB as part of their Listed Entity and PIE Track 1 project?

We support the proposed approach, and alignment between the UK standards and IAASB standards more broadly. International consistency is important for investor confidence and comparability, and the proposed updates seem appropriate and proportionate.

Q7. Would you support the FRC making the appropriate limited and technical changes to the ISAs (UK) arising from the IAASB’s Listed Entity and PIE Track 2 project without reverting to a full public consultation, as long as changes are explained through stakeholder outreach?

Given the limited scope of the proposed changes, we would support the FRC adopting those changes without full consultation, provided that they are also proactively and clearly communicated to the relevant stakeholders.

We hope that the views expressed in this submission will be helpful in your work going forward. We would welcome the opportunity to discuss any of the issues raised here.

Yours sincerely,

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