

# Audit reform and corporate governance

Launch of the UK Department of Business,  
Energy and Industrial Strategy consultation



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On Thursday 18 March the UK Department of Business, Energy and Industrial Strategy (BEIS) released its long awaited white paper setting out proposals for audit reform and corporate governance, entitled “Restoring trust in audit and corporate governance”. The white paper, more than 200 pages in length, follows three major reviews in this area commissioned by the Government in 2018:

- Sir John Kingman’s Independent Review of the Financial Reporting Council (FRC Review).
- The Competition and Market Authority’s Statutory Audit Services Market Study (CMA Study).
- Sir Donald Brydon’s Independent Review of the Quality and Effectiveness of Audit (Brydon Review).

This paper seeks to draw out the specific areas of this extremely important consultation document.



# The case for reform



**Against a wider backdrop of economic and societal upheaval, it is arguably more important than ever that our audit and corporate governance procedures are robust.**

One does not have to look far to uncover the impetus for these potentially wide ranging reforms. Several high-profile company failures, have led to a widely acknowledged acceptance of the need for reform. Now, against a wider backdrop of economic and societal upheaval, it is arguably more important than ever that our audit and corporate governance procedures are robust and that the United Kingdom continues to be seen as a safe and effective place to do business.

*As the white paper states:*

*"The UK has long had a hard-earned reputation for high standards of corporate governance and robust protections for investors and other stakeholders. It is vital to making the UK attractive to international business and investment. If that reputation is to be maintained and enhanced action is needed to address the weakness and lack of accountability that the three reviews have highlighted."*

Given the acknowledged need for decisive action, the white paper states that the Government is planning to take forward the vast majority of the recommendations of the three earlier reviews. One issue that has, however, already been highlighted in the media is that there is no clear legislative timetable in the white paper and it remains to be seen how the timetable for reform will unfold over the coming months and years.



# The key targets

So, the first and most obvious questions are what are the key aims of the white paper and who will be most impacted by these proposed reforms? In the foreword, the Secretary of State for BEIS, Kwasi Kwarteng, highlights the key aims of increasing choice and quality in the audit market, establishing clearer responsibilities for the detection and prevention of fraud, and ensuring that the audit product and profession are fit for the future. In doing so, he sets his sights on all of the participants and stakeholders in this process, namely: directors, auditors and audit firms, shareholders, and the regulator. The measures are aimed at improving director accountability and encouraging transparency. Key changes are proposed to the audit profession, bolstered by a new regulator, the Audit, Reporting and Governance Authority (ARGA), with stronger and more wide-ranging powers.



**“The measures are aimed at improving director accountability and encouraging transparency.”**

# Directors

A key focus of the white paper is the importance of directors in running companies and the fact that they bear ultimate responsibility for a company's reports and accounts. Put simply: *"responsible behaviour by directors is the fundamental starting point for high quality and reliable corporate governance and reporting."*

## Directors' accountability for internal controls, dividends, and capital maintenance

Confidence in company reporting depends upon the effectiveness of the internal controls and risk management processes that directors put in place and oversee. The high profile company failures that we previously referenced were seen as eroding that confidence. As such, the white paper proposes new reporting and attestation requirements with regard to internal controls and risk management as well as dividend and capital maintenance decisions and resilience planning.

With regard to internal control reporting, the FRC Review recommended that the UK consider a system similar to that of the United States under the Sarbanes-Oxley (SOX) regime. The Government does not recommend a full import of the SOX framework, but instead proposes an option whereby

directors would be required to carry out an annual review of the effectiveness of their company's internal controls and to make a statement, as part of their annual report, as to whether they consider it to have operated effectively. The proposal also recommends that the regulator should be able to investigate the accuracy and completeness of such statements. It provides that there should be the ability to sanction individual directors where they have failed to maintain and establish an adequate internal control structure and procedures for financial reporting.

Due to recent high profile examples of companies issuing profit warnings, and in some cases, becoming insolvent shortly after paying out significant dividends, the white paper also proposes a new requirement for companies to disclose the amount of reserves that are distributable. In addition, when proposing a dividend, the Government recommends that directors be required to make a statement that the proposed dividend is within known distributable reserves and payment will not threaten solvency over the next two years.







**These proposed changes could have a significant impact on directors' duties and as such they are, no doubt, of potentially great importance to companies and those who run them.**

### **New corporate reporting and supervision of corporate reporting**

The white paper affirms the Government's desire to implement additional reporting requirements, including a resilience statement, an audit and assurance policy and reporting on payment practices. The Government invites consultation on the scope of such reporting, including whether the resilience statement should be the vehicle for reporting climate-related financial disclosures.

The Government also proposes strengthening the regulator's powers with regard to corporate reporting. This includes a proposal to grant ARGA powers to direct changes to annual reports (removing the current necessity for a court order) and to publish their correspondence and summary findings to increase transparency. It also includes a proposal to expand the regulator's power to perform a corporate reporting review to the contents of entire annual reports, meaning companies' entire reports are subject to oversight.

### **ARGA's increased regulatory powers**

The current regulator, the Financial Reporting Council (FRC), has no power to take action against company directors with regard to a director's duties in relation to the preparation of company accounts and reports and the auditing of those accounts and reports, unless they are chartered accountants. To this end,

the Government proposes to give ARGA enforcement powers to investigate and sanction breaches of directors' corporate reporting and audit-related responsibilities. As such, ARGA would be provided with novel powers; to investigate and impose civil sanctions on directors. This new enforcement regime would sit alongside existing arrangements for enforcing directors' duties and statutory responsibilities, such as those currently enforced by the FCA and SFO.

The Government also proposes strengthening malus and clawback provisions in director remuneration agreements. It would do this by changing the UK Corporate Governance Code to include provisions recommending certain minimum conditions are included in director remuneration agreements. The Government suggests a minimum clawback period of two years after any award is made. The Government also suggests that the conditions under which a clawback provision can be triggered should be expanded beyond the common triggers of misstatement of results or errors in performance calculations, to also include triggers such as material failure of risk management controls, misconduct, reputational damage, and failure to protect the interests of employees and customers.

It is easy to see how these proposed changes could have a significant impact on directors' duties and as such they are, no doubt, of potentially great importance to companies and those who run them.

# Auditors

## A NEW DAWN FOR THE PROFESSION?

The Brydon Review recognised the importance of statutory audits in providing independent oversight of companies and their directors with respect to financial reports. The Brydon Review noted that all stakeholders, including shareholders, lenders, and creditors, depend on auditors to conduct thorough reviews that provide honest assessments of corporate financial reporting. The role of the auditor is key to ensuring good corporate business behaviour as well as informed decisions by external third parties.

After analysing current auditing practices in the wake of recent corporate failures, the Brydon Review concluded that current statutory audit practices are inadequate because they focus on past behaviour, related primarily to financial accounting, without taking a wider view of either the company or director conduct, or providing more forward-looking and informative insight. The review suggested that changes were necessary in both practices and scope in order to make audits more informative and valuable to stakeholders. Based on its findings, the Government has proposed the following measures:

- Establishing a new corporate auditing profession that has responsibility for looking beyond just financial statements to things like culture, controls, ESG, and cyber.
- Requiring statutory auditors to consider a wider range of information, including relevant director conduct and other financial and corporate information, when compiling their audit report.
- Implementing new principles for auditors in order to reinforce good audit practice.
- Establishing new obligations on both auditors and directors relating to the detection and prevention of material fraud.

### Promoting competition and diversifying the audit market

To promote greater choice of auditors, dilute the market share of the large audit firms, and thus increase resilience within the market, the Government proposes the introduction of a mandatory managed shared audit regime for UK-registered FTSE 350 companies. In practice, this means a company would still appoint an audit firm to lead the group audit and that firm would bear overall liability for that audit. However, when tendering, the company would also be required to appoint a challenger audit firm independently of the main audit firm to audit a meaningful proportion of

the group's statutory audits (that is, a subsidiary or subsidiaries). A challenger, in this context, is a firm that provides statutory audits to public interest entities, and whose audit revenues did not represent more than 15% of the FTSE 350 statutory audit market by fees in either of the two years.

The challenger would be liable for its audit of the relevant subsidiaries. ARGA would monitor compliance with this requirement by way of information gathering and enforcement powers. Some commentators have already questioned how this challenger procedure would work in practice and, indeed, that remains to be seen.



In the event that the managed share audit initiative does not have sufficient impact, the Government proposes that it will have a reserve power (granted as part of the audit reform legislative package) to introduce a temporary market share cap. Effectively, this would give the Government the ability to review the upcoming FTSE 350 audit tenders and reserve a proportion of them for challengers (although a large audit firm could be appointed alongside to carry out a proportion of subsidiary audits). This reserve power underlines the seriousness of the Government's commitment to diversifying and thus strengthening the resilience of the audit market.

### Operational separation: maintaining audit quality

An objective and independent audit process is integral to providing investors and shareholders with the information needed to take a view of a

company's accounts. The multidisciplinary structure of the large audit firms has led to concerns that large revenues earned by audit firms for non-audit work may have a detrimental impact on audit processes. To address this the Government's proposals seek to reform the balance of incentives and culture while maintaining a multidisciplinary structure. The idea is to create independent audit boards within firms, provide oversight of audit partner remuneration by these boards, and publication of a separate profit and loss account for the audit practice.

### Shareholders

Shareholders, as the owners of companies, have a vital role to play in the corporate governance framework. The white paper notes: "...institutional investors in particular have a stewardship role, seeking to create long term value for their clients through oversight of the companies in which they are invested."

In terms of shareholders and audits, the Brydon Review called for more shareholder involvement in the annual audit planning process through the creation of a formal mechanism whereby shareholders can propose suggestions for the audit plan to the audit committee. According to the Brydon Review, informed and meaningful shareholder engagement in the audit process will improve the audit findings. The Government has agreed with this assessment and has proposed creating a formal mechanism for shareholder participation in the audit process. Similarly, the Government has indicated that it expects companies to provide shareholders with more information when an auditor resigns or is dismissed by the company. Given the sensitivities that could surround this communication to shareholders, the Government has stated that it will reach a final view on the best way to implement this proposal after taking responses on the consultation.

With respect to audit committee oversight, the Competition and Market Authority (CMA) study highlighted the importance of audit committees in protecting the interests of shareholders in relation to a company's external audits. The CMA Study reinforced the importance of audit committees in selecting auditors and managing their performance in order to ensure auditors maintain professional scepticism, challenge directors, and deliver high quality audits. However, based on a survey of audit committees within the FTSE 350, the CMA study found that many committees were not properly exercising their oversight role, thereby jeopardising the effectiveness of the audit process and report. Accordingly, the Government has proposed giving ARGAs new powers to mandate additional requirements as to the audit committee's role in the appointment and oversight of auditors to ensure the committee acts effectively as an independent body responsible for safeguarding the interests of stakeholders.



# ARGA: A new regulator for a new era

The need for a new regulator to replace the FRC is one of the linchpins of the white paper. Sustained criticism of the FRC in recent years — particularly given the high profile and impactful corporate failures — led to the conclusion that a new regulator was required. Indeed, this was the central recommendation of the FRC Review.

The keenly expressed desire in this white paper is that the FRC is replaced with a “modern, proactive regulator”, with clear statutory powers and objectives. As such, the Government intends to introduce legislation to create this stronger regulator, ARGA, as soon as parliamentary time allows.

The new regulator will be a company limited by guarantee, with a general objective to “*protect and promote the interests of investors, other users of corporate reporting and the wider public interest*”. In addition, ARGA will have both quality and competition objectives. The quality objective, which includes promoting high quality audit, corporate reporting and corporate governance work, is seen as crucial. Unsurprisingly, the view expressed is that “*driving up audit quality should be a key priority for the regulator and...given as much prominence as the competition objective*”. The Government has also accepted the recommendation of the FRC Review to revise the funding of the new regulator whose work will now be funded by a statutory levy, rather than the current voluntary levy. The intent, it seems, is to strengthen the appearance of objectivity.



**The Government intends to introduce legislation to create this stronger regulator, ARGA, as soon as parliamentary time allows.**





**The Government means business regarding the overhaul of the audit function and corporate governance that underpin UK commerce.**



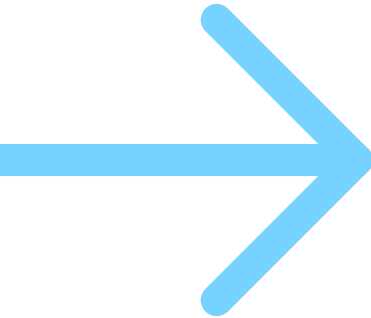
As well as its new statutory objectives and functions, the Government also proposes further changes to the regulator's responsibilities. While it retains many of the responsibilities of the FRC, these will be enhanced and strengthened, for example ARGAs will have a new statutory role in the supervision of actuaries and accountants. Giving ARGAs enhanced powers to strengthen the governance of audit practices is central to the Government's proposals and a fundamental part of improving the resilience of both individual firms and the audit market as a whole.

Other enhanced powers include monitoring competition in the audit market alongside the CMA. This will include information gathering powers, the power to carry out market studies and the ability to make a referral to the CMA to conduct a full market investigation, and enforcement powers. Given the role that insurance plays in protecting audit firms from liability risks, the proposals include giving ARGAs powers to obtain information about an audit firm's insurance arrangements in addition to potentially giving ARGAs the ability to mandate minimum insurance levels and capital requirements. The establishment of this new regulator is, therefore, a key part of the Government's strategy to restore trust in audit and corporate governance.

## Next steps

While some would say a long time coming, this white paper is incredibly ambitious both in terms of its scope and its vision. The stated aim of maintaining the UK's position as a leading hub for corporate activity is its foundation. The proposals made, if implemented, are likely to go some way in achieving this. The lack of a timetable for implementation is, however, seen as a concern by some commentators.

The consultation is open until 8 July 2021 and the Government is requesting views from a broad range of stakeholders. Whether the proposals will come into being to the extent proposed remains to be seen. What is clear, is that the Government means business regarding the overhaul of the audit function and corporate governance that underpin UK commerce. It certainly seems that greater rigour in what is already considered by many to be a gold standard of regulation looks set to be the future for UK business.



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