Restoring trust in audit and corporate governance

A practical guide for Main Market companies outside the FTSE350 and those on the AIM market

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A practical guide to the BEIS White Paper

Prepared for boards and audit committees of Main Market companies and those on the AIM market

The Government published its long-awaited White Paper on 'Restoring trust in audit and corporate governance' in March 2021

The indicated objectives of the reform are to:

- restore public trust in the way that the UK's largest companies are run and scrutinised;
- ensure that the UK's most significant corporate entities are governed responsibly;
- empower investors, creditors, workers and other stakeholders by giving them access to reliable and meaningful information on a company's performance; and
- keep the UK's legal framework for major businesses at the forefront of international best practice.

The White Paper, for which the consultation period ended on 8 July, will potentially have a substantial impact on premium listed companies, other companies on the Main Market and AIM-listed companies both as regards extending their reporting and audit requirements and the strengthening of potential regulatory sanctions on their directors as well as auditors.

In this guide we highlight the main reforms proposed from the perspective of Main Market companies outside the FTSE 350 and those on the AIM market and offer some thoughts on their potential impact on the board and audit committees and how they may respond to them.

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The key elements of the proposals, in so far as they affect Main Market companies outside the FTSE 350 and those on the AIM market, are highlighted below.

More detail is provided in the Appendix.

Some AIM companies to be Public Interest Entities (PIEs) with substantial additional responsibilities

- Companies listed on the Main Market are already PIEs but under the new proposals AIM companies with a market capitalisation of more than 200 million euros would also become PIEs.
- Subsidiaries of PIEs which meet the necessary thresholds would also be PIEs.
- Significant new obligations on PIEs.
- Most significantly, being a PIE in the future will lead to substantial additional responsibilities and a more stringent regulatory regime.

Directors to confirm effectiveness of financial reporting controls

- Directors to be responsible for confirming the effectiveness of controls on financial reporting.

New approach to realised profits and capital maintenance

- Individual companies, or parents in the case of groups, to disclose their realised profits in their annual report. Confirmation should also be provided that the directors' reasonably expect that dividend payments will not threaten the company's solvency over the next two years.

New Resilience Statement to have mandatory assessment period of five years

- A Resilience Statement to be prepared with a mandatory assessment period of five years and to include at least two reverse test scenarios.

New three year Audit and Assurance Policy with shareholder advisory vote

- An Audit and Assurance Policy to be developed every three years setting out the form of assurance obtained on various parts of the annual report and to be subject to a shareholder advisory vote in the case of listed companies. Companies asked to explain what independent assurance, if any, the company plans to obtain in relation to the Resilience Statement and the effectiveness of their internal control framework.

Additional reporting obligations on directors in relation to fraud

- Directors to report on the steps they have taken to prevent and detect material fraud with additional requirements to be placed on auditors as well in relation to fraud detection.

Additional reporting obligations in relation to payment practices

- The annual reports of certain PIEs to provide a summary of how the company, or group as appropriate, has performed with regard to supplier payments.

Whole of annual report to be subject to regulatory review and findings published

- The whole of the annual report to be subject to periodic review by the regulator who will have the power to require changes to be made and to publish correspondence related to the review and a summary of findings.

New sanctions regime for directors

- A new sanctions regime to be introduced for directors on reporting and audit matters with a graduated range of sanctions including fines and a temporary ban on being a PIE director.

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AQR findings to be published

- AQR (audit quality) reports on individual audits to be published by the regulator without the need for consent by the audit firm and audited entity.

New framework for wider aspects of corporate auditing

- A framework for all 'corporate auditing' to be created covering both the auditing of all financial information and also of wider information, e.g. culture, ESG, cyber, controls.

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It will be helpful for the board and its audit committee to consider how to use the proposals in the White Paper to help it build a more sustainably successful business. There is the challenge, however, that some of the proposals are expressed in terms that suggest they may be subject to at least some change following the consultation period.

Nine issues for the board and audit committee to consider:

1. How are we currently performing against the expectations of the White Paper?

The proposals, for example, related to having strong internal controls; only paying dividends if it does not threaten solvency; and having a clear understanding of the organisation's resilience all represent good business practice and so it will be useful for the board to check how it is doing in these areas and to identify where there is scope for possible improvement.

2. How can we best develop a programme to implement the necessary changes?

It will be helpful for the board to consider the extent of changes that are likely to be necessary. If there is significant work needed, questions include how it could be spread over a period of time, who within senior management should lead in particular areas, reporting arrangements with regards to the audit committee, what additional resources will be needed and whether these will best be sourced by strengthening staff teams and/or outsourcing?

3. Are the new requirements likely to impact the company's ability to pay dividends?

It will be important for the board to consider whether it has the information to assess its ability to pay dividends under the new requirements and if not whether it should obtain it as a matter of priority and continue to keep it up to date. If applicable, the board will need to pay particular attention to the potential impact of an expected need to change its dividend policy and to how it should prepare its shareholders for any change.

4. Should the internal audit function be strengthened?

Although not much discussed in the White Paper, a particular area of focus for audit committees of Main Market companies outside the FTSE 350 and for those on the AIM market should be whether there would be merit in strengthening their internal audit function, through recruitment or co-sourcing, given the extra work it is likely to have in providing assurance to the committee on a number of areas covered in the White Paper.

5. What additional work will be required for the Resilience Statement?

In considering the Resilience Statement, the audit committee will need to discuss what are likely to be the additional matters needing to be covered if the period covered goes out to five years in the medium-term section rather than three years, as generally at present, it will also need to consider the content of its two negative stress test scenarios?

6. Which areas will the audit committee cover in its Audit and Assurance Policy?

The audit committee will need to reflect on which areas in addition to the statutory audit it will have assured and the form it will take in terms of internal or external assurance and, if the latter, whether this should be by the statutory auditor or another assurer.

Similarly, on financial reporting controls, is it currently providing assurance or not, e.g. due to a dual listing, and, even if it is, how might any new UK arrangements differ from those it currently applies? Another important area to consider, especially in view of institutional shareholders' growing focus on the topic will be whether to provide assurance on sustainability issues.

In deciding which areas should be covered, in addition to the views of the audit committee insights should also be obtained on likely industry practice and shareholders' views.

7. **How should the board and audit committee engage with its shareholders on likely changes arising from the White Paper?**

The board and audit committee should determine how it can best engage with its institutional shareholders, in particular, on the likely impact of the changes. A possible forum would be in meetings with their heads of corporate governance.

8. **For AIM companies, does the White Paper change the considerations of AIM v the Main Market?**

With significantly increased requirements for larger AIM companies classified as PIEs, and closer than before to those for companies listed on the Main Market, some AIM companies may wish to consider the relative advantages of staying on AIM or joining the Main Market.

9. **How will the structure, composition and behaviour of the board change?**

In considering the appointment of new independent directors in the coming years, in addition to addressing other key issues such as diversity and inclusion and sector or relevant specialist experience, for example with regards to technology, nominations committees are likely to want to have sufficient directors capable of operating successfully in a more heavily regulated environment and with the necessary reporting and audit experience. There may well also be an increase in fees for audit committee members given the extra time commitment that will be needed.

It will also be essential for board members to consider how they can continue to strike the right balance between enterprise and accountability within the new corporate regulatory structure and for the chair, along with all members of the board, to ensure it remains a genuinely unitary board rather than the independent non-executive directors primarily acting in an oversight capacity. Achieving this goal will require particular attention when the board is facing challenging times, for example where there are concerns on the Resilience Statement or on the board's ability to pay dividends.

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A: A fluid timetable

The White Paper says the Government will introduce draft legislation 'when Parliamentary time allows' and that there will be choices to make about when the reforms will come into force. Individual measures could be brought in on a specific date, over a period, or there could be powers given to switch certain reforms on when appropriate. The White Paper adds that once the law is in effect 'there is often a transition period in which special measures apply' indicating that some of the proposals would, for example, apply firstly to premium listed companies and then after two years to all PIEs and the possibility is raised of excluding emerging growth companies from some of the measures for a period of two years after their Initial Public Offering.

B: Substantially increasing the number of PIEs

There were 1945 PIEs in February 2020 and the current definition of a PIE is:

- entities whose transferable securities are admitted to trading on a regulated market;
- credit institutions; and
- insurance undertakings.

The White Paper proposes to add large private companies to the PIE classification applying one of two options:

- **Option 1 –** more than 2,000 employees or turnover of more than £2000m and a balance sheet of more than £2bn (1960 entities).
- **Option 2 –** more than 500 employees and a turnover of more than £500m (1060 entities).

The definition would apply to individual companies or, in the case of a parent company, would be based on the relevant figures in their consolidated financial statements. The Government is also proposing classifying AIM companies with a capitalisation above 200m euros as PIEs and asking whether it should also include Lloyd's syndicates and large third sector organisations such as charities, universities and housing organisations.

The statutory audits of PIEs and their auditors are currently subject to more stringent regulation. The White Paper would significantly increase the additional responsibilities of PIEs, as discussed below.

The Government is 'proposing allowing a significant lead time before activating a new PIE definition.'

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C: Major new reporting and related auditing requirements

1. Reporting on controls

Directors to undertake an annual review of the effectiveness of internal controls on financial reporting and to explain whether they consider the controls are operating effectively and the benchmark used in their assessment.

Deficiencies should be disclosed along with the remedial action being taken and the timeframe over which they are being addressed.

The regulator to prepare or endorse guidance reflecting audit committee best practice in this area.

Directors and investors normally to agree whether directors' effectiveness statement to be subject to external assurance but assurance to be required where serious failures have occurred or where there have been weaknesses over a number of years.

The Regulator to have power to sanction directors where they have failed to maintain effective internal controls on financial reporting.

The new requirements to be introduced in legislation.

The new requirements would initially be applicable to premium listed companies, with possible temporary exemptions for smaller newly listed companies, and applied to other PIEs after two years.

2. Capital maintenance and dividends

Individual companies, or the parent company in the case of groups, should disclose their realised profits in their annual report. The new regulator will provide guidance on the extent to which their profits and losses are realised thereby determining the amount available for distribution. Where the exact figure cannot be determined, it will be acceptable to indicate the distributable profits are 'not less than…'

The parent company should estimate and disclose the amount of potential distributable profits across the group that could be passed to it for paying future dividends, with it able to select on a reasonable basis which group companies to include in the calculation. Narrative disclosures would explain any major constraints on the ability of subsidiaries to pay their distributable profits to the parent company.

Confirmation should be provided that it is the directors' reasonable expectation that payment of the dividend will not threaten the solvency of the company over the next two years in the light of the risk analysis and company position when the dividend is proposed.

The first two items above would be in the financial statements and so subject to audit.

The Government envisages the requirement applying to listed and AIM companies only but is asking whether they should be extended to all PIEs.

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3. Resilience Statement

The Resilience Statement would have short, medium and long-term resilience sections.

The short-term section would incorporate companies' existing going concern statements including disclosure of any material uncertainties subsequently determined not to be material after the use of significant judgement and/or the introduction of mitigating action.

The medium-term section would incorporate the existing viability statement to provide an assessment of the company's prospects and resilience and to address matters which may threaten its ability to continue in operation and meet its financial liabilities as they fall due.

Companies would be asked to include at least two reverse stress test scenarios in their resilience statements. Future specific disclosures would be required in the short and medium-term resilience statements which might cover threats to liquidity, company solvency and business continuity, supply chain issues, digital security, business investment needs, sustainability and climate change risk.

The mandatory assessment period should be five years (rather than the three years currently normally adopted by companies).

Content in the long-term section of the resilience statement would not be prescribed.

The preferred implementation route would be to implement the need for a Resilience Statement through legislation as a new section of the Strategic Report.

The new requirements would initially be applicable to premium listed companies and after two years to all PIEs.

4. Audit and Assurance Policy

The White Paper proposes a new framework to enable companies to set out more clearly the extent to which the annual report and other disclosures are scrutinised by the external auditor or someone else.

The Audit and Assurance Policy would be agreed for a three-year period and be subject to an advisory shareholder vote. It would be introduced by legislation amending the Companies Act, 2006.

The White Paper is inviting views on whether the policy should include the following new disclosures:

- the assurance, if any, the company intends to obtain in the next three years in relation to the annual report and other disclosures beyond that required by statutory audit. The statement should include an explanation of what independent assurance, if any, the company plans to obtain in relation to the Resilience Statement and the effectiveness of the internal control framework;
- a description of the company's internal audit and assurance processes including how the company is planning to strengthen its internal audit and assurance capabilities over the coming three years;
- a description of what policies the company may have in relation to the tendering of external audit services, for example whether the company will allow the external auditor to provide permitted non-audit services; and
- an explanation of whether, and if so how, shareholders and employees' views have been taken into account in formulating the audit and assurance policy.

The requirements would initially apply to premium listed companies which would be given a year after the requirement came into force to develop their Audit and Assurance Policy and to have the advisory shareholder vote on it. It would apply to other PIEs two years later but only listed companies would be required to have an advisory shareholder vote.

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5. Tackling fraud

The Government proposes to legislate to require directors to report on the steps they have taken to prevent and detect material fraud and to require auditors to report on the steps they in turn took to detect any material fraud and assess the effectiveness of relevant controls.

The requirements related to fraud would apply to PIEs.

6. Reporting on payment practices

The White Paper indicates an option is being considered to require the annual reports of certain PIEs to provide a summary of how the company, or group in the case of a parent company, has performed with regard to supplier payments over the previous reporting year and to comment on how this compares to the year before that.

Companies could be required to include the necessary information in their Strategic Report which might comprise:

- the company's supplier payments policy, including the standard payment terms and the shortest and longest standard payment periods;
- the percentage of the company's supplier payments that met its standard terms and, where the figure is less than 80%, an explanation of why this occurred and what actions the company plans to take to improve its payment record; and
- when such an explanation was required in the previous year, an update in the following year's report on the actions that were taken to improve the payments record.

It is said a natural approach would be for this to apply to PIEs that are large companies for reporting purposes. An alternative would be to apply this to PIEs with more than 500 employees which are the companies currently required to include a non-financial information statement in their annual report.

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D: Enhancing shareholder engagement with audit

1. Consulting with shareholders on the Audit and Assurance Policy

The Government considers that a formal mechanism should be established to enable audit committees to gather shareholder views on the Audit and Assurance Policy but recognises that they should be purely advisory in nature and supplementary to those of the auditors to ensure the audit retains its autonomy.

The Government agrees that shareholders would benefit from having access to the latest risk assessment but considers that the audit committee should only be expected to make additional disclosures if there has been a material change to the principal risks facing the company since those disclosed in the last annual or interim report.

ARGA will be asked to consider further in liaison with audit committees, auditors and shareholder bodies how the engagement would work in practice, but it would need to include consideration of the following:

- the timing and methods of engagement with shareholders;
- how the updated risk assessment will be communicated to shareholders; and
- the types of shareholder requests which should require formal consideration, e.g. could be related to size of shareholdings or a materiality test.

The Government considers that the proposal should be implemented through a change to the UK Corporate Governance Code.

The Government is also proposing to encourage better engagement with the auditor at the AGM by inviting the regulator to review its guidelines to audit committees in order to encourage questions from shareholders about the company's audit.

The proposals would initially apply only to the audit committees of premium listed companies.

2. Shareholder engagement on auditor removal or resignation

The Government considers that the existing Companies Act provisions which apply when an auditor ceases to hold office are generally failing to provide meaningful information to shareholders and the regulator as regards the reasons for the auditor's departure in terms of disclosures lacking appropriate specificity. The Government will decide whether to have a follow up on these matters.

Any new requirements would presumably, in principle, apply to all companies subject to audit.

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E: A tougher approach to regulation

1. Key features of the Audit, Reporting and Governance Authority (ARGA)

Overview of ARGA's objectives and regulatory principles

General objective:

- to protect and promote the interests of investors, other users of corporate reporting and the wider public interest.

Quality objective:

- to promote high quality audit, corporate reporting, corporate governance, accounting and actuarial work.

Competition objective:

- to promote effective competition in the market for statutory audit work.

Regulatory principles for ARGA to 'have regard' to:

- promoting innovation in statutory audit work, corporate reporting and corporate governance;
- promoting, brevity, clarity and usefulness in corporate reporting;
- working closely with other regulators from the UK and internationally; and
- anticipating emerging corporate governance, reporting and audit risks by being forward-looking and acting proactively where possible.

The regulator will be required to advance either or both of its quality and competition objectives when it is carrying out its policy-making functions.

The Government will take forward legislation to enable the regulator to raise a levy so that it has a sustainable and independent basis on which to carry out its regulatory activities.

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2. Supervision of corporate reporting

Power for regulator to direct changes to reports and accounts

The regulator will be given power to direct changes be made to reports and accounts rather than having to seek a Court Order to do so. It will also have the power to instigate an expert review into the underlying reasons for an accounting application and to assess what changes may be required.

Power for regulator to publish information on individual CRR reviews

The regulator will have powers to allow it to publish correspondence entered into in the course of a Corporate Reporting Review (CRR) review as well as summary findings. As an interim step the regulator intends to publish summaries of CRR reviews.

CRR review to cover the whole of the annual report

When undertaking reviews, the regulator has been checking the Directors' Report, Strategic Report and annual reports of companies within its scope for compliance with the Companies Act, 2006 and applicable reporting standards. It also keeps under review periodic accounts and reports that are produced by issuers of transferable securities and assesses whether they comply with any accounting requirements imposed by FRC rules. The White Paper proposes that the entire content of the annual report should be brought within the scope of the CRR process. The Government will extend both the existing power to request information from companies and the new power to direct changes to accounts to cover the entire content of the annual report. Ahead of legislation, the Government has asked the FRC to extend the CRR scrutiny to all elements of the annual report.

Extension of volume of CRR activity with main focus of work on PIEs

The Government supports an expansion of the volume of the regulator's CRR activity. The CRR's scope extends to approximately 15,000 companies in total including all large private companies as well as UK listed and AIM-quoted companies. All LLPs are also covered though the Government agrees that the new regulator should focus most of its pro-active CRR work on PIEs but should retain its current powers to investigate reporting by non-PIE companies.

Consideration to be given to pre-clearance service

The Government will ensure that ARGA has the necessary powers to provide a pre-clearance service, including a statutory exemption from liability where it offers this service. The decision on whether and when to offer a pre-clearance service, and whether it should be preceded by a pilot, should be determined by the regulator.

As discussed above, The CRR process applies to public and large private companies but with a primary focus of pro-active work on PIEs.

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3. Sanctions against directors

A new sanctions system for PIE directors on reporting and audit

The Government intends to legislate to provide ARGA with the necessary powers to investigate and sanction PIE directors for breaches of corporate reporting and audit related responsibilities. It is not proposing an authorisation scheme for company directors as exists in financial services.

The new enforcement regime would supplement rather than replace the existing arrangements for taking actions against company directors. All PIE company directors would be in scope for the new civil law enforcement regime and the scope of the regulator's enforcement powers would apply to PIEs which are not companies.

The scope of the enforcement powers would cover:

- the duty to keep adequate accounting records;
- the duty to approve accounts only if they give a true and fair view;
- the duty to approve and sign the annual accounts;
- the duty to approve the directors' report; and
- the duty to provide a statement as to disclosures to auditors and to provide information or explanation at the request of the auditors.

The Government proposes to give the regulator the power to impose more detailed requirements as to how certain statutory duties relating to corporate reporting and audit are to be met by directors.

The regime would operate a 'graduated range' of civil sanctions that could be applied by the regulator where a breach was proven. Proposed sanctions include reprimands, fines, orders to take action to mitigate the effects of a breach or to make declarations of non-compliance, and, in the most serious of cases, temporary prohibitions on acting as a director of a PIE.

New sanctions system applicable to all PIE companies and the Government has indicated all directors will be within scope (not just those in specified roles).

4. Publication of Audit Quality Review reports

The Government intends to legislate to allow AQR (Audit Quality Review) reports on individual audits to be published by the regulator without the need for consent by the audit firm and audited entity. The regulator will be free to decide whether this publication is 'in full' or in summary form. The Government will put in place safeguards to protect the publication of sensitive information about audited entities.

The FRC is already planning to publish the results of all AQR inspections of individual audits, including an assessment of the quality of the audit work, using its revised reporting template, where consent is obtained from both the audited entity and the audit firm. The Government welcomes this initiative but is concerned by the regulator's need to seek consent from the audited entity and the audit firm for publication of its reports in any form.

Issues relating to the publication of audit reports are applicable to PIEs and certain other entities.

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5. Independent appointment of the auditor by the regulator

Whilst the Government is not persuaded that it is appropriate to give ARGA independent powers to appoint the auditor in certain circumstances at this stage, it is considering whether to legislate to provide flexibility for this to happen in the future. The circumstances where it is considered this may be helpful would be where:

- quality issues have been identified around the company's audit;
- a company has parted with its auditor outside the normal rotation cycle; and
- there has been a meaningful shareholder vote against the auditor's appointment.

Any new requirements would presumably, in principle, apply to all companies subject to audit.

6. Framework for corporate auditing

The Government is proposing to create a framework for all 'corporate auditing' covering both the auditing of all financial information and also the auditing of wider information, e.g. culture, ESG, cyber, controls, Alternative Performance Measures (APIs) and Key Performance Indicators (KPIs), and mineral reserves. It believes that a new professional body for corporate auditors should be created to help create a climate for wider audit and to enable good audit practice to thrive across corporate audit disciplines.

The Government is minded to introduce a new legal framework to empower the regulator to set and enforce new principles of auditing that could apply to both statutory auditors and those appointed to provide wider audit services under the Audit and Assurance Policy.

To the extent the principles applied to statutory audits, they would presumably apply to all companies subject to it. The main change, however, would relate to PIEs in so far as the requirements relating to wider audit services would be strengthened.

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