Restoring trust in audit and corporate governance

A practical guide for Large Privately Owned businesses

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A practical guide to the BEIS White Paper

Prepared for the boards and audit committees of Large Privately Owned Companies

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

Indicating the 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 large privately owned businesses that are reclassified as Public Interest Entities (PIEs) if the proposals in the White Paper are subsequently enacted 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 large privately owned businesses that may be reclassified as Public Interest Entities (PIEs) 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 large privately owned companies are highlighted below.

More detail is provided in the Appendix.

Some large privately owned companies to be PIEs with substantial additional responsibilities

- Unlisted banks and other credit institutions and insurance companies are already PIEs but under the new proposals around 1,000 or 2,000 additional privately owned companies would become PIEs if either of the two options set out in the White Paper is enacted in legislation.
- Subsidiaries of PIEs which meet the necessary thresholds would also be 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, are 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 scenario.

Audit and Assurance Policy to be developed every three years

- An Audit and Assurance Policy is to be developed every three years setting out the form of assurance obtained on various parts of the annual report. Companies are to be 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.

Directors to disclose steps taken to prevent and detect material 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.

New suppliers' payments disclosures

- 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 periodic review

- 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 and publications of companies' AQR reports

- 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.
- 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 all 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.

Prepared for the boards and audit committees of Large Privately Owned Companies

It will be helpful for the board and audit committee to consider how to use the White Paper's proposals to help build a more sustainably successful board whilst bearing in mind that some, including the proposed definition of a PIE of which there are already two options, may be subject to change by the Government.

The following are among some of the issues boards and audit committee of large privately owned companies may wish 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. How strong is its current system of internal controls on financial reporting?

Whilst any new legal requirements on internal controls are likely to be limited to those on financial reporting, it will be helpful for the audit committee, or board as appropriate, to discuss with the auditors and business advisers, the extent to which relevant controls are likely to need to be strengthened. In making the assessment, it will be helpful to review problems which have arisen in relation to the preparation of the financial statements in recent years and adjustments that have needed to be made as a result of the audit.

5. What additional focus is likely to need to be placed on resilience?

Many large private companies will need to spend significant time getting ready to make disclosures in line with the proposed Resilience Statement including those relating to discussing the results of applying negative stress test scenarios.

6. Should the internal audit function be strengthened?

Although not much discussed in the White Paper, a particular area of focus for audit committees of large privately owned companies 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. If the company currently does not have an internal audit function, it will be helpful to consider whether it should establish one whether internally staffed, co-sourced or outsourced- to enable it to prepare for the potentially significantly increased regulatory burden.

7. 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.

8. What will the changes mean for the structure, composition and behaviour of the board?

Private company boards that may be reclassified as PIEs would do well to consider, if they do not already have independent directors, whether they should appoint some with relevant audit, reporting and regulatory expertise to enable them to move smoothly towards the new regulatory expectations. Similarly, when considering new appointments or reappointments, boards with independent directors will need to have regard to necessary additional areas of regulatory and related expertise that they will need in the future.

It will be equally important, however, in making new board appointments for boards also to take account of the need for additional expertise in other areas such as technology and for them to ensure the board is diverse both in composition and in thinking. Above all, it will be critical for the board to ensure it has the appropriate composition to strike the right balance between entrepreneurship and accountability in board appointments and in how the board operates.

In considering how to respond to the White Paper, there will be merit in private company boards considering the Government's response to the consultation on the White Paper, due to be published in the autumn, to see if the definition of PIEs has become clearer. It should also be borne in mind that it is proposed that there will be time before the definition of PIEs is extended and a transition period before the main new requirements apply to unlisted PIEs.

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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. 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.

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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 though they would not 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.

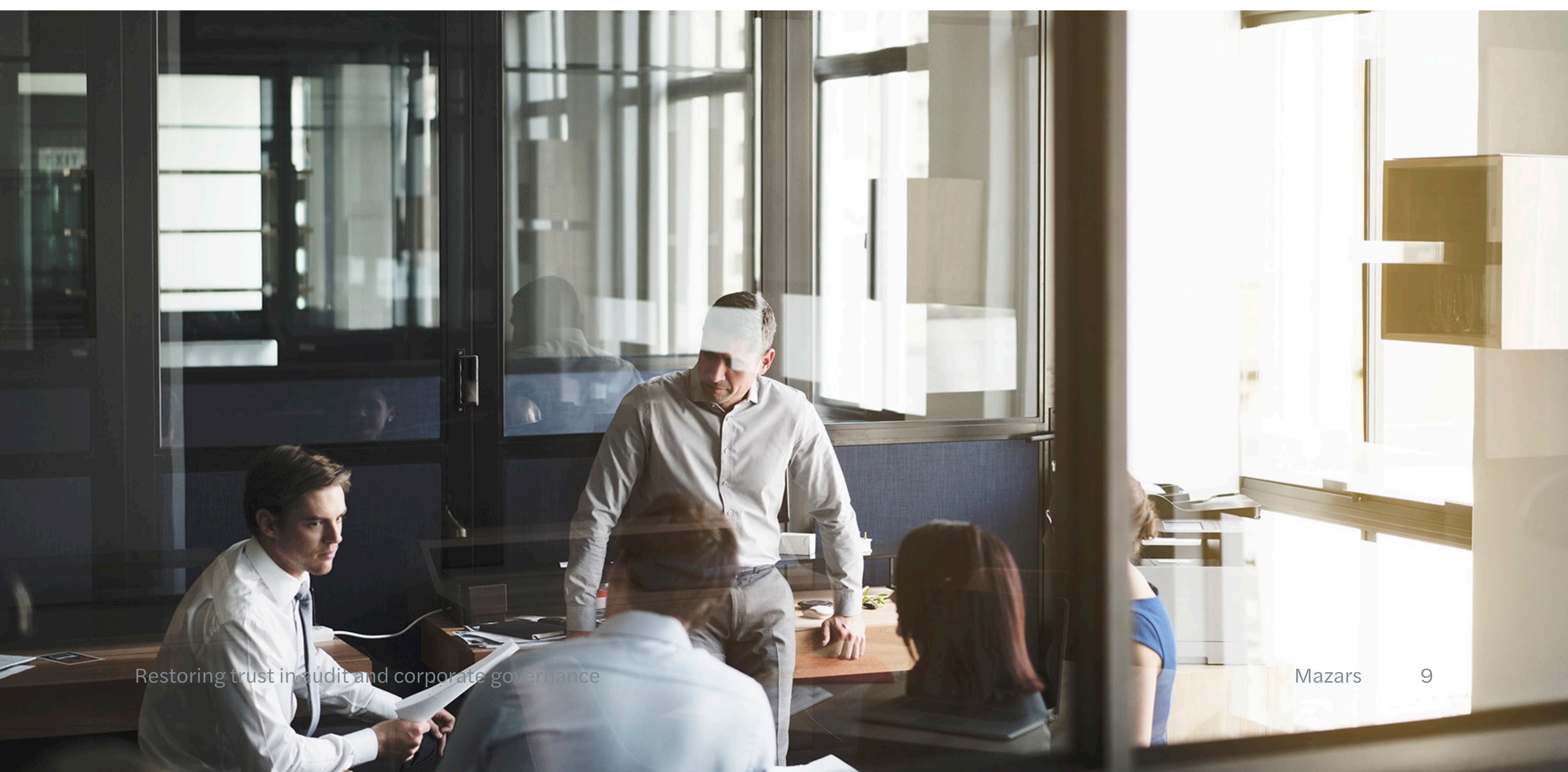
6. Reporting on payment practices

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

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.

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) as well as summary findings. As an interim step the regulator intends to publish summaries of CRRs.

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 report 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 professional accountants or 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 proposed principles are made applicable 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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