Paying Attention

The government's recent white paper on restoring trust in audit and corporate governance will be closely watched in boardrooms

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On 18 March 2021, Kwasi Kwarteng, the new business secretary, published a white paper containing long-awaited proposed reforms to director liability. The proposals are very similar in nature to the infamous Sarbanes-Oxley regime, which was introduced in the US to regulate accounting fraud following the collapse of Enron. The white paper has a 16-week public consultation period, with more than 150 recommendations, across 232 pages.

The document sets out the proposed approach to reforming corporate reporting and audit requirements, in light of the findings of the three independent reviews commissioned by the government and the work of the BEIS Select Committee. The proposals represent "a comprehensive and holistic package of reforms that will protect and promote the public interest in trustworthy and informative corporate reporting and audit".

Dominance of the Big Four

Key proposals include action to tackle the dominance of the 'Big Four' firms in the market, who were collectively responsible for all of the FTSE-100 company audits in 2019. Large companies will be required to use 'challenger' firms to conduct a portion of their annual audit and, if competition does not improve, there could be a cap on the Big Four's market share of FTSE 350 audits, subject to future consultation.

It is also suggested that the existing operational separation of audit and advisory work undertaken on a voluntary basis at the Big Four accounting firms, should be extended to the next tier down of auditors. The government envisages that challenger firms would most likely undertake work on one or more subsidiaries and be liable for that work (but not jointly or severally liable for the group audit).

The PIEs

The white paper looks at options of extending the definition of Public Interest Entities (PIEs) to include very large private companies, certain AIM companies, and potentially companies with a public benefit purpose, which will need to meet more stringent requirements and additional regulatory measures. This would result in some of the UK's largest non-listed companies being subject to strict financial reporting obligations, however, the white paper reassures companies that any new requirements will not deter companies from listing in the UK.

Two alternative proposals are put forward to achieve this: (i) adopting the test already used to identify those large companies that must include a corporate governance statement in their directors' reports, or (ii) a narrower test which incorporates the threshold for additional non-financial reporting requirements used by existing PIEs.

PIEs Reporting

The white paper agrees with the proposals made in Sir Donald Brydon's report, and proposes to introduce a statutory requirement on PIEs to publish an annual Resilience Statement.

The government accepts the Brydon Review proposal 'in principle' subject to consultation on the specific implementation options. Initially, it is proposed that only premium listed companies will be required to produce a Resilience Statement, as they are currently more familiar and have more experience with risk and viability reporting and disclosure obligations.

However, the government intends to extend this requirement to other PIEs within two years, subject to the possible exclusion of recently listed companies. The Resilience Statement will cover three distinct time periods: (i) short-term, incorporating a company's existing going concern statement and disclosure of material uncertainties, (ii) medium-term, outlining the existing viability statement requirements to provide an assessment of the company's prospects and resilience, and (iii) long-term, comprising the main long-term challenges to the company and its business model, and how these are being addressed.

Accountability and Transparency

Auditors and directors are to be given new reporting obligations on detecting and preventing fraud, and the audit scope will be extended to consider wider performance metrics, such as on progression on climate targets. There are a range of proposals to increase the accountability of directors of large companies, including fines and suspensions for the most serious failings.

The white paper seeks interested parties' views on three options for strengthening internal controls: (i) an annual review by directors of the effectiveness of the company's controls resulting in a statement in the annual report as to their effectiveness, (ii) a description in the audit report of the work undertaken for the audit to understand the company's internal control systems, and a statement of how that work has influenced the audit, and (iii) a formal opinion by the auditor on the directors' annual attestation as to the effectiveness of the company's internal controls.

The white paper proposes changes to strengthen attestation requirements relating to dividends and capital maintenance to ensure that when distributions are made, directors are required to state that any proposed dividend is within known distributable reserves and that it will not, to the best of their knowledge and opinion, threaten the company's solvency over the next two years. This marks a significant change to the current regime, and the final proposals will merit careful scrutiny.

'Malus and Clawback' Provisions

Chapter five of the white paper sets out proposals to give the audit regulator investigating and enforcement powers in relation to wrongdoing by directors of PIEs and to strength malus and clawback provisions within executive directors' remuneration arrangements.

The strengthened malus and clawback arrangements involve the identification of minimum clawback conditions which would apply in all cases and have a minimum two-year application period. These conditions, if implemented, could include clawback for serious misconduct, a material misstatement of results or an error in performance calculations and failures of internal controls and risk management. It is proposed that these changes would be implemented by the regulator through changes to the UK Corporate Governance Code.

A New Regulator

The reforms propose the establishment of a new regulator, the Audit, Reporting and Governance Authority (ARGA), to replace the Financial Reporting Council (FRC), with the power to impose an operational split between accountancy firms' audit and non-audit functions to reduce the risk of conflicts of interest that may affect the standard of the audits that accounting firms provide.

The ARGA will have stronger powers than the FRC and will be able to enforce mandatory requirements on companies to re-state their accounts, instead of requiring a court order, and will be able to investigate and sanction civil breaches of corporate reporting and audit responsibilities by directors of public companies.

The ARGA will be funded by a statutory levy on market participants and will receive strategic direction from the Government and will be directly accountable to Parliament. The general objective proposed for ARGA is "to protect and promote the interests of investors, other users of corporate reporting and the wider public interest. It will also have two operational objectives, on quality and competition, and several regulatory principles set out in legislation". Overall, audit and assurance professionals will be encouraged to work towards a new audit profession, rather than being a subset of the accountant profession and directors will be held personally responsible, rather than the board of the company, for the accuracy of their company's financial statements, with any major failures and defaults leading to potential fines and bans.

The Implementation

The government appear to be balancing the urgency of audit reform against the requirement to manage additional obligations on businesses, ensuring that the market remains competitive and attractive for investors (particularly in light of the weakened economy). It has been suggested that the legislation required to implement the changes could be watered down by the time it is introduced into parliament as a bill.

The government have decided to approach the reforms in stages, ensuring that the most crucial changes are implemented first. The measures that do not have a direct impact on companies will be implemented more quickly, such as the establishment of the new regulator, ARGA, whilst the measures that will significantly impact business will be phased in over time. The white paper makes clear that the larger listed and premium-listed companies are likely to be subject to new reporting obligations before smaller listed and non-listed companies.

Conclusion

The consultation on the proposals in the white paper is open until 8 July 2021 and the government states that responses to the reforms will inform the draft legislation laid before parliament. Commenting on the government's consultation paper, Jon Holt, head of audit at KPMG UK said: "This is a once in a generation opportunity to reform the corporate regulatory landscape and positively redefine Britain's role in a post-Brexit world. The proposed reforms will demonstrate we are a fantastic country to invest in – safe, sustainable and trusted to deliver economic growth".

However, the extra obligations imposed on British companies as a result of the proposed reforms may result in higher compliance costs, An analysis of the impact assessment by the Financial Times published alongside the white paper consultation into the proposals found that more than £430m could be added to business costs under the government's preferred options. Given the fragility of the economy, buffeted by the dual shocks of Brexit and COVID-19, developments will be watched closely. n