



RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

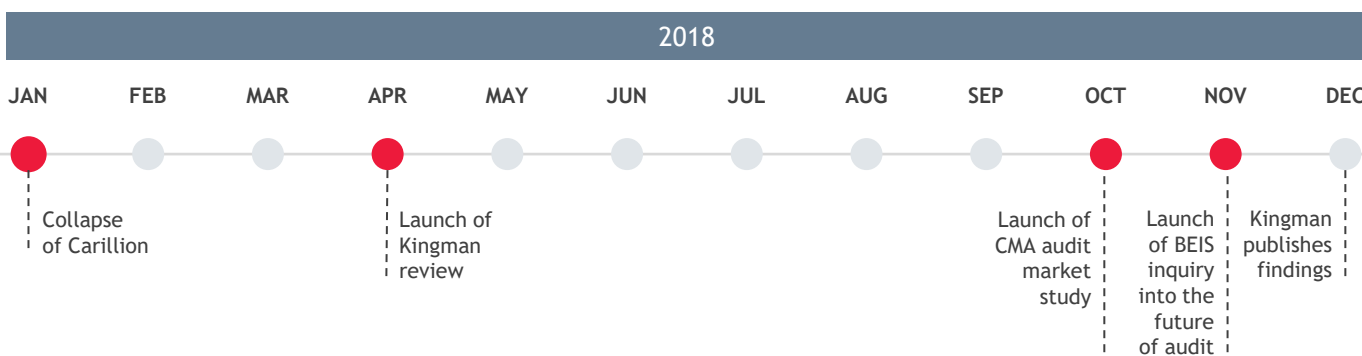
Summary of BEIS consultation
issued March 2021

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RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

TIMELINE



The collapse of Carillion at the start of 2018 precipitated a root and branch review of how the audit market works with three main components, all reporting to the Secretary of State for Business Energy and Industrial Strategy ('BEIS').

BACKGROUND AND OVERVIEW

The final BEIS consultation has been published following Sir John Kingman's review of the FRC, Sir Donald Brydon's review of the quality and effectiveness of audit and the CMA's market study on statutory audit and combines the 155 recommendations proposed as part of these inquiries.

As set out by the Business Secretary in his foreword, the consultation outlines 'the Government's ambitious plans to strengthen the UK's audit and corporate governance framework and empower shareholders'. It will 'increase choice and quality in the audit market, establish clearer responsibilities for the detection and prevention of fraud, and ensure the audit product and audit profession are fit for the future.'

Consultation timeframe: 18 March - 8th July 2021

<https://www.gov.uk/Government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms>

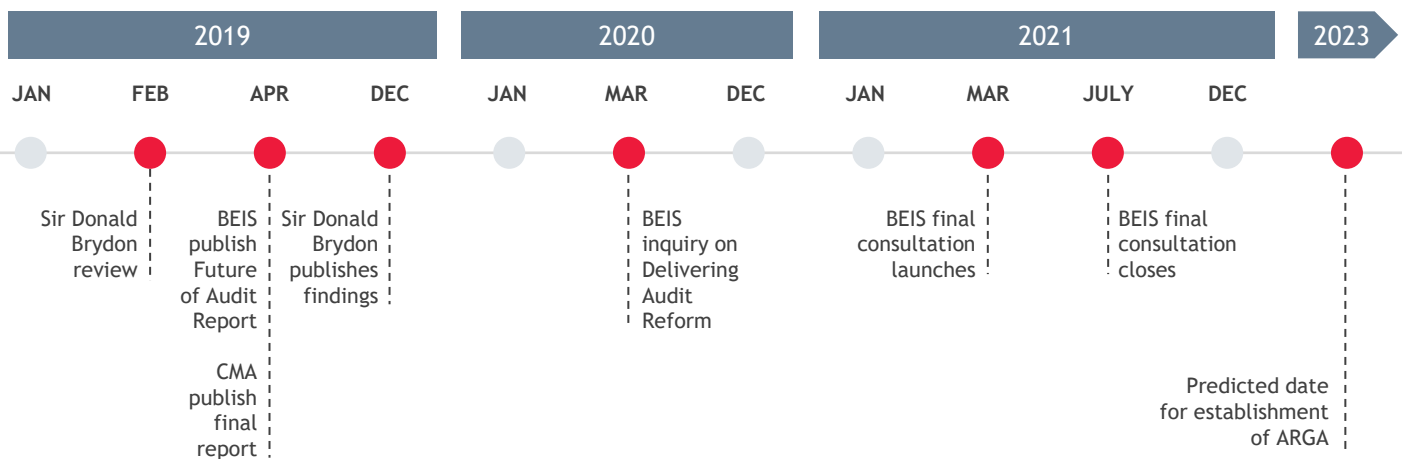
GOVERNMENT PROPOSALS AT A GLANCE

SECTION ONE - EXPANDING THE DEFINITION OF PUBLIC INTEREST ENTITIES ('PIES') TO INCLUDE LARGE PRIVATE COMPANIES AND 'LARGE' AIM QUOTED COMPANIES

The Government proposes two possible tests to extend the definition of PIEs:

- ▶ Adopt the test used to identify companies already required to include a corporate governance statement in their directors' report. This covers all companies with either:
 - More than 2,000 employees; or
 - A turnover of more than £200 million and a balance sheet of more than £2 billion
- ▶ Adopt a narrower test which incorporates the threshold for additional non-financial reporting requirements for existing PIEs. This would cover companies with both:
 - Over 500 employees; and
 - A turnover of more than £500 million.

This would not capture many AIM-quoted companies. The Government is, therefore, proposing that any new definition of PIE should also include companies on the exchange-regulated AIM market with market capitalisations above €200 million (currently circa £171 million). It is predicted there would be around 105 AIM companies in scope.



SECTION TWO - INCREASING THE ACCOUNTABILITY OF DIRECTORS

The Government proposes:

- ▶ Implementing a UK Sarbanes-Oxley style regime to strengthen the UK's approach to Internal Controls over Financial Reporting including stronger disclosure and potential attestation requirements
- ▶ Requiring companies to report on their distributable reserves and the legality and affordability of proposed dividends
- ▶ Legislating to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud (see also Section Six).

The key provisions are aimed at addressing the internal controls over Financial Reporting for the management of public companies. This will result in management being required to assess and report annually on the effectiveness of their company's internal control structure and procedures for financial reporting. The company's auditor may then be required to attest to and report on this assessment, similar to the Sarbanes-Oxley regime in the US. The proposal also places responsibility for a company's financial statements and internal controls with the Board as a whole, or possibly with the CEO and the CFO as individuals.

In order to take this recommendation forward, the Government is considering a set of options.

Option A - Is concerned with ways to strengthen the responsibility and accountability of Board members for the effectiveness of internal control and risk management procedures and requires an explicit directors' statement about the effectiveness of these.

Option B - Explores ways in which auditors' existing work on internal controls could be made more visible to investors and other readers of accounts and requires auditors to report more about their views on the effectiveness of companies' internal control systems.

Option C - Considers a stronger and expanded role for external auditors in providing assurance that companies' internal controls are effective and requires auditors to express a formal opinion on the directors' assessment of the effectiveness of the internal control systems.

The Government have proposed a preferred option that involves some choice over whether the directors' assessment is subject to independent audit.

This section of the consultation also includes proposals to require companies to report on their distributable reserves and for directors to be required to make a formal statement about the legality and affordability of proposed dividends. The Government proposes to:

- ▶ Assign responsibility for defining realised profits and losses to the Audit, Reporting and Governance Authority ('ARGA' - replacing the FRC) and enhancing the legal status and enforceability of the definition
- ▶ Implement new requirements to disclose distributable reserves through:
 - Disclosure of the distributable reserves in the financial statements
 - Disclosure of estimates of a group's dividend-paying capacity.
- ▶ A new directors' statement about the legality of proposed dividends and the effect on the future solvency of the company.

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SECTION THREE - NEW CORPORATE REPORTING REQUIREMENTS

The Government proposes:

- ▶ A requirement for PIEs to produce an annual Resilience Statement
- ▶ A requirement for PIEs to have an Audit and Assurance Policy where directors have to describe their approach to seeking assurance.



The Resilience Statement

The Government intends to take forward the recommendation provided by Sir Donald Brydon to introduce a statutory requirement for PIEs to publish an annual Resilience Statement. This new statement consolidates and builds upon the existing going concern and viability statements.

The Government proposes that the Resilience Statement should be required initially of Premium Listed companies and should extend to other public interest entities two years later.

The Brydon Review proposed that the Resilience Statement should set out the approach to exploring and mitigating risks and uncertainties, significant judgements and mitigating actions over the short term (1- 2 years), medium term (5 years) and long-term (an indefinite period to be determined by the company).

In doing so, the Statement would incorporate and build on the existing going concern and viability statements, including greater transparency on the potential 'material uncertainties' considered by companies in their going concern assessment and greater use of scenario testing, including at least two reverse stress testing scenarios.

For publicly quoted entities, this would be subject to an advisory shareholder vote at the time of its publication.

SECTION FOUR - STRENGTHENING THE SUPERVISION OF CORPORATE REPORTING

The Government proposes:

- ▶ Giving ARGAs more power to direct changes to company reports and accounts
- ▶ Increased transparency for the Corporate Reporting Review ('CRR') process
- ▶ An extension of the CRR process to the whole of the annual report and accounts.

STRONGER POWERS FOR THE REGULATOR

The Government is proposing that the regulator will now have to power to direct changes to a company's annual reports and accounts without the need to seek a court order. The Government intends to legislate to 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, including both the legally required and voluntary elements.

The FRC Review suggested that the regulator's CRR work should be more transparent to ensure that there is greater visibility for investors and other users of accounts about any deficiencies and shortcomings identified. It recommended that CRR findings should be reported publicly and that the regulator will have the power to publish full correspondence following all CRR reviews.

SECTION FIVE - PROVISIONS CONCERNING COMPANY DIRECTORS

The Government proposes:

- ▶ Giving the regulator investigation and enforcement powers in relation to breaches of corporate reporting and audit-related responsibilities by all directors of PIEs
- ▶ Strengthening malus and clawback provisions within executive director remuneration.

ENFORCEMENT AGAINST COMPANY DIRECTORS

The FRC currently has no means of taking enforcement action against directors who have breached their duties relating to corporate reporting and audit, where those individuals are not Chartered Accountants. However, the Government proposes to give the regulator investigation and enforcement powers to hold company directors of PIEs to account. This would allow the regulator to take action against breaches of corporate reporting and audit-related responsibilities by PIE directors.

Due to the principles of collective responsibility and a unitary board, all directors of PIEs would be in scope. It is suggested that the regulator could mitigate the risk of deterring directors when exercising their enforcement powers by applying the proportionality principle, taking into account the directors' backgrounds and considering the size and complexity of the entity concerned.

STRENGTHENING MALUS AND CLAWBACK PROVISIONS

The Government will look to implement a regime that gives further attention to contractual provisions in directors' remuneration arrangements concerning malus and clawback to ensure that remuneration can be withheld or recovered in the event of serious director failings. Proposals include enhancing the 'minimum clawback requirements' and considering whether to extend this to all listed companies.

SECTION SIX - CHANGES TO AUDIT PURPOSE AND SCOPE

The Government proposes a new definition of audit 'To help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.'

Changes to audit purpose and scope include:

- ▶ A new corporate auditing profession
- ▶ New overarching principles for auditors
- ▶ A new duty for auditors to take a wider range of information into account
- ▶ New obligations on auditors and directors relating to the prevention and detection of fraud.

THE SCOPE OF AUDIT

The Government has stated that it agrees with the ambitious vision set out by the Brydon Review that companies and their shareholders should be able to decide on the scope of the external auditing which is obtained beyond the statutory audit of the financial statements, making auditing more trusted, informative and valuable to the UK. This would also include specific responsibility to consider relevant director conduct in reaching their judgment. As part of this, the Government will seek to introduce a regulatory framework to cover both audits of financial statements (statutory audit) and other types of information which companies decide to have audited through the Audit and Assurance Policy process.

TACKLING FRAUD

Brydon's review of the quality and effectiveness of audit proposed a package of measures, including greater clarity regarding the respective roles of directors and auditors in detecting fraud.

The Government proposes to legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud. This is intended to reinforce director's responsibilities for fraud prevention. Similarly, the Government also supports the recommendation that auditors be required to report on the steps taken to detect any material fraud and assess the effectiveness of relevant controls.

In line with the Brydon Review's recommendation, the Government intends to legislate to require auditors of PIEs, as part of their statutory audit, to report on the work they performed to conclude whether the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually accurate.

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SECTION SEVEN - CHANGES TO AUDIT COMMITTEE OVERSIGHT AND ENGAGEMENT WITH SHAREHOLDERS

The Government proposes:

- ▶ Additional requirements for Audit Committees in the appointment and oversight of auditors
- ▶ Increased engagement between a company and its shareholders.

AUDIT COMMITTEES - ROLE AND OVERSIGHT

The Government proposes to require ARGA to impose additional requirements on Audit Committees, including in relation to the appointment and oversight of auditors. These requirements will cover the need for Audit Committees to continuously monitor audit quality, and consistently demand challenge and scepticism from auditors. This is intended to ensure the Committee acts effectively as an independent body responsible for safeguarding the interests of shareholders and other users of accounts.

As part of this the regulator will develop minimum standards applicable to at least all FTSE 350 Audit Committees and, over time, potentially the wider PIE community.

The Government also proposes to impose a duty on ARGA to monitor compliance with the new audit committee requirements, including through a power to require information and/or reports from Audit Committees, and a power to place an observer on Audit Committees if necessary. ARGA may also be given powers to take action in relation to breaches of new audit committee requirements.

The Government is also proposing regulatory powers for ARGA where problems exist, such as when an auditor resigns, when a PIE is unable to find an auditor and when there are issues with audit quality.

INDEPENDENT AUDITOR APPOINTMENT

The Government has stated that it will not give the regulator independent powers of appointment at this time. However, the Government is considering whether to legislate to provide flexibility for the regulator to be given such powers by the Government in the future.

SHAREHOLDER ENGAGEMENT WITH AUDIT

The Government is looking to establish measures to ensure that shareholders are able to engage more effectively with audits and with matters affecting audit quality and is considering introducing a formal mechanism to enable Audit Committees to gather shareholder views on the audit plan. The Government agrees with Brydon's recommendation that the Audit Committee's annual report should set out which shareholder suggestions put forward for consideration had been accepted or rejected by the auditor.

In order to increase engagement, the Government proposes to do this by inviting the regulator to revise its guidance on Audit Committees to encourage questions from shareholders about the company audit. This is instead of proposals to issue a standing AGM agenda item.



SECTION EIGHT - IMPROVED COMPETITION, CHOICE AND RESILIENCE IN THE AUDIT MARKET

In order to improve the overall quality of the audit market, including enhancing competition, choice and resilience, the Government is proposing the following reforms:

- ▶ Giving the new regulator stronger powers and duties to increase choice and competition in the FTSE 350 audit market. This will include a managed shared audit regime which will apply to the appointment of a Big Four audit firm but with an exemption for the appointment of a 'challenger firm'
- ▶ Requiring the operational separation between the audit and non-audit practices of firms, which will be determined by the new regulator. In terms of scope, the Government envisages that the measures will be applied to audit firms which carry out statutory audits of 15% or more of the FTSE 350 by audit fees
- ▶ Giving the regulator statutory powers to monitor the resilience of audit firms and the market, require audit firms to address concerns and to act in the event of audit firm failure.

SECTION NINE - GREATER SUPERVISION OF AUDIT QUALITY

The Government proposes:

- ▶ Making the regulator responsible for approving the auditors of PIEs
- ▶ Improving the transparency of Audit Quality Review reports.

APPROVAL AND REGISTRATION OF STATUTORY AUDITORS OF PIEs

It is proposed that the regulator should carry out the task of determining whether individuals and firms are eligible for appointment as statutory auditors of PIEs.

MONITORING AUDIT QUALITY

The Government intends to legislate to allow Audit Quality Review reports on individual audits to be published by the regulator without the need for consent from the audit firm and the audited entity. The regulator will have the option to publish this in full or in summary form and there will be safeguards that prevent the publication of sensitive information.

SECTION TEN - A NEW AND STRENGTHENED REGULATOR, THE AUDIT, REPORTING AND GOVERNANCE AUTHORITY

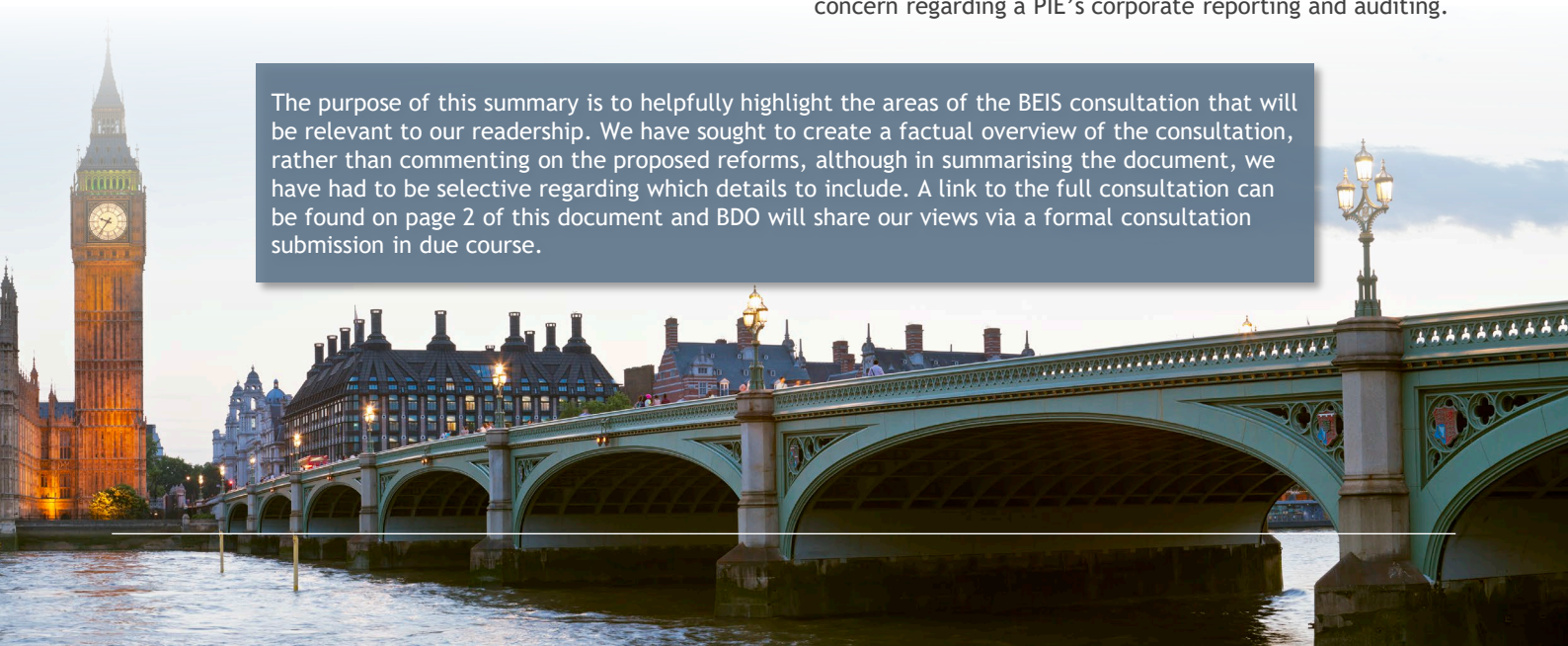
The Government will seek to establish new rules for ARGAs by bringing forward the necessary legislation when Parliamentary time allows. The regulator will be given the power to make rules requiring market participants to pay a levy to meet the regulator's costs of carrying out its regulatory functions. ARGAs will consult publicly on those rules before they are made.

SECTION ELEVEN - ADDITIONAL CHANGES TO THE REGULATOR'S RESPONSIBILITIES

The Government has stated that the new regulator should be more proactive in identifying and taking action where there are matters of serious concern in PIEs. However, new powers to address serious concerns will be limited to the areas where the regulator has existing enforcement powers (that is corporate reporting and audit).

To take this forward, the regulator will have the power to require an expert review, where it has identified significant concern regarding a PIE's corporate reporting and auditing.

The purpose of this summary is to helpfully highlight the areas of the BEIS consultation that will be relevant to our readership. We have sought to create a factual overview of the consultation, rather than commenting on the proposed reforms, although in summarising the document, we have had to be selective regarding which details to include. A link to the full consultation can be found on page 2 of this document and BDO will share our views via a formal consultation submission in due course.



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