REFORM OF THE UK AUDIT AND GOVERNANCE REGIME: WHAT HAPPENS NEXT?

Briefing for Corporates: June 2022

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50:50 THE EQUALITY PROJECT

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INTRODUCTION

The government has published its much anticipated response (**Response**) to its consultation on 'Restoring trust in audit and corporate governance', which set out proposed reforms to the UK's audit and corporate governance regime (the **White Paper**).

The Response is the latest milestone on the reform journey though we have not arrived at the final destination yet given detailed rules and guidance still need to be developed and, in some cases, will require Parliamentary approval.

We have previously reported on the White Paper proposals that would have most impact on companies and their directors, many of which the government plans to progress (see below for reference). This paper focuses on certain key areas affecting corporates where the government has taken on board concerns raised during the consultation and has decided to modify its approach.

Key proposals in the White Paper that are retained in the Response include:

1. Powers for ARGA to investigate and bring disciplinary enforcement action against directors for breach of new regulatory duties, and new behavioural standards in relation to corporate reporting and audit. These will reflect the existing duties in the Companies Act 2006. ARGA will have the power to impose unlimited fines and temporary bans on directors.

2. Power for ARGA to set minimum requirements for audit committees in relation to the appointment and oversight of auditors, and to impose sanctions.

3. Disclosure of distributable reserves of in-scope companies and groups.

4. Strengthening malus and clawback arrangements in directors' remuneration packages, requiring minimum "trigger points" and a minimum two-year period of application after an award is made (although the "trigger points" will be the subject of further consultation).

WHICH ENTITIES ARE IN SCOPE?

The majority of the reforms in the Response – and ARGA's enforcement powers – are targeted at companies falling within an expanded definition of "Public Interest Entities" (**PIEs**), including large private companies.

The expanded definition will capture all companies with both:

- 750 or more employees, and
- An annual turnover of £750 million or more.

These thresholds are an increase on the 500 employees and £500m turnover that was included as an option in the White Paper, with the government accepting these higher thresholds are more proportionate.

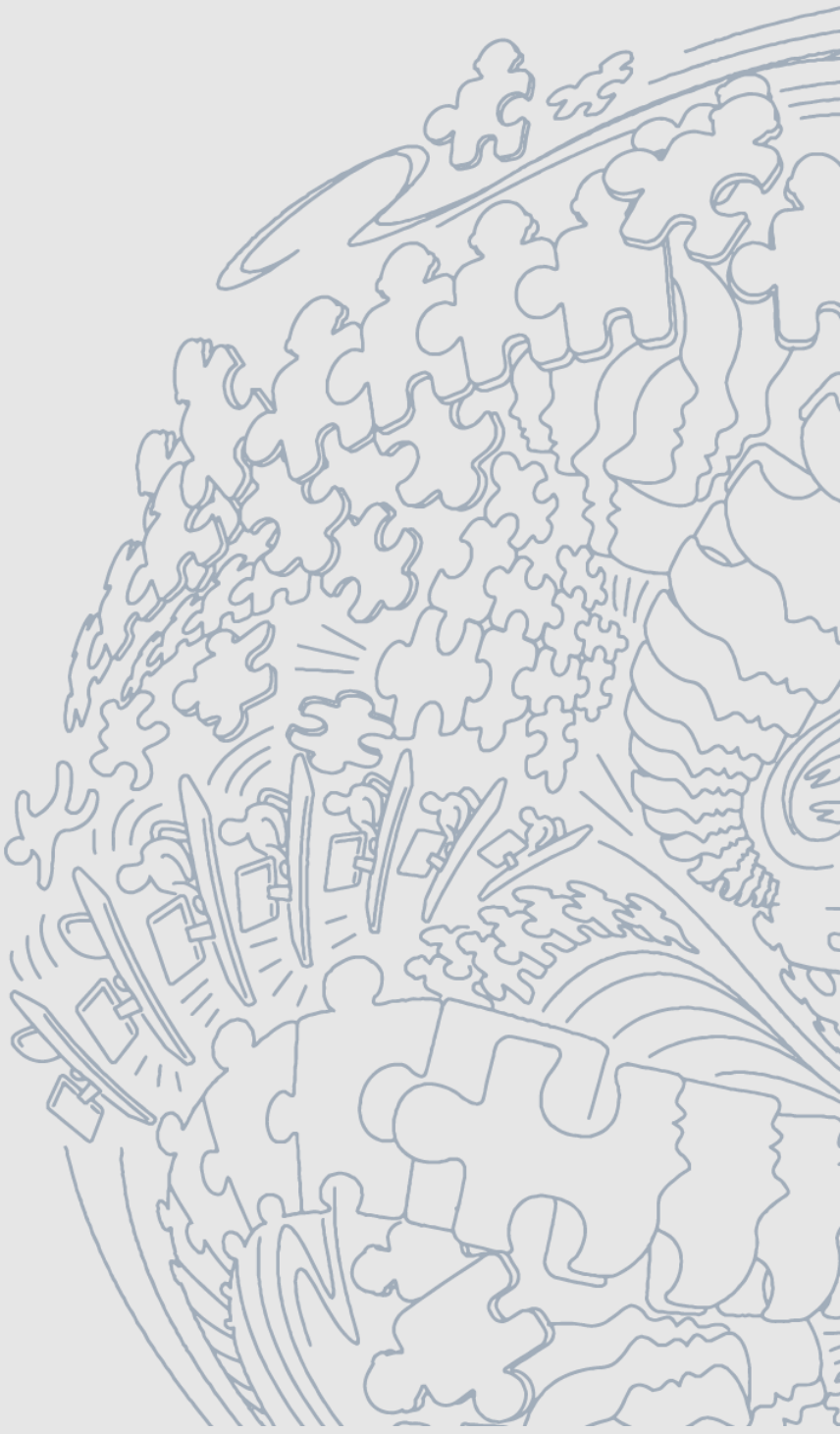
AIM companies will also be in scope, but only if they satisfy the 750:750 size threshold. This is a welcome departure from the White Paper, which proposed that AIM companies with a market capitalisation of more than EUR200 million would be caught. All companies with a premium or standard listing on the Main Market are already classed as PIEs – regardless of their size – and will continue to be PIEs under the new regime.

APPLICATION TO GROUPS AND SUBSIDIARIES

Where a UK parent company prepares consolidated accounts for a group, and that group when aggregated meets the size threshold, the parent company will be treated as a PIE.

Equally, where an entity that is a PIE in line with the 750:750 size threshold is a subsidiary of a UK incorporated parent, the parent will also qualify as a PIE.

The government will consider mechanisms to remove or reduce the risk of duplication of reporting within a group structure – e.g. an option of either reporting at a subsidiary level or reporting on a consolidated group basis. This was an issue that gave rise to particular concern in response to the White Paper.



NEW DIRECTOR DISCIPLINARY POWERS

Regulatory duties – audit and corporate reporting

The Response confirms the government's intention to empower ARGA to investigate and sanction directors of PIEs for breach of a set of new regulatory duties. These will be modelled on existing directors' duties in the Companies Act 2006 concerning corporate reporting and audit, most likely some or all of those duties listed in the White Paper being:

- to keep adequate accounting records (s386);
- to approve accounts only if they give a true and fair view (s393);
- to approve and sign the annual accounts (s414);
- to approve the directors' report (s419); and
- to provide a statement as to disclosure to auditors and provide information or explanations to the auditors (ss418 and 499).

Regulatory duties – general behavioural standards

The government is also pressing ahead with the introduction of behavioural standards owed to the regulator which it says will be based on those already set out in Part 10 of the Companies Act 2006 and includes day-to-day duties such as the duty to promote the success of the company and duties around management of conflicts. It describes these as *"well established values…which directors of PIEs would already be expected to understand and ascribe to*." It notes that ARGA will "*be able to investigate the nature of directors' decisions and take action in cases where the directors have complied with the letter of the law but are nevertheless engaged in dishonest or improper conduct."*

The government has not said exactly which of these duties will be included as regulatory standards.

It appears to be the government's intention for ARGA to enforce these behavioural standards only as they apply to audit and corporate reporting matters and not more generally to other conduct.

Which directors will enforcement apply to?

All directors of PIEs – applying the expanded definition – will be within scope. Enforcement will not be limited to directors with particular roles or qualifications such as finance directors, and will include non-executive directors.

The government is also considering further whether "in exceptional cases" it is in the public interest for ARGA to investigate and enforce directors' duties on directors of companies which do not meet the definition of a PIE.

Interpretation

The government will work with the FRC to elaborate on these existing duties and set out what is reasonably expected of PIE directors. The government hopes that this will: (i) reassure directors that they will only be accountable for what could reasonably be expected of a person in their position; and (ii) perhaps somewhat optimistically, minimise the risk of the new enforcement regime increasing directors' and officers' insurance premiums.

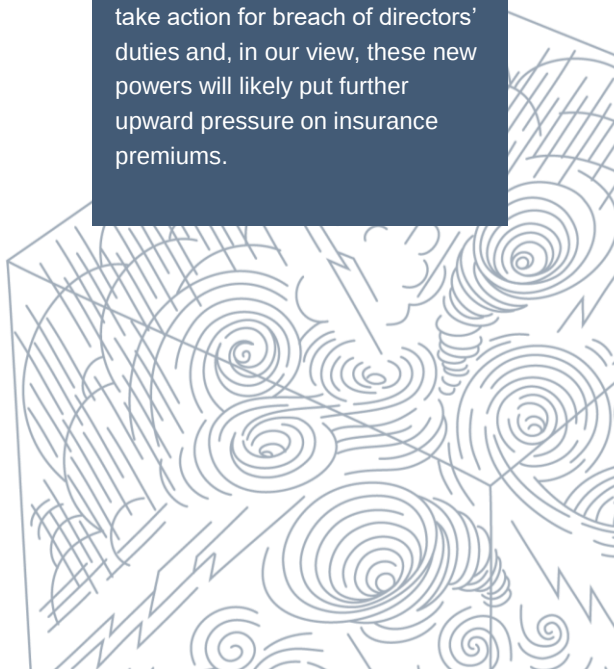
Overlap with other regulatory powers

ARGA's powers relating to investigation and disciplinary sanctions on directors' duties will overlap with those of other regulators, but the government expects this to be managed through coordination and cooperation between regulators.

What does this mean for directors and companies?

While some of the key details are still to be confirmed, particularly behaviours that will fall short of the standards that ARGA will expect of directors, the fact that the regulator will be able to take enforcement action for breach of directors' duties in respect of corporate reporting and audit is a major increase in liability and risk for directors, most of whom (outside financial services) will be personally regulated for the first time.

Previously only companies could take action for breach of directors' duties and, in our view, these new powers will likely put further upward pressure on insurance premiums.



DIRECTORS' ACCOUNTABILITY FOR INTERNAL CONTROLS

Directors' statement on accounts – Code-based, not statutory

The White Paper's proposal to introduce a controversial statutory requirement that directors publish an annual statement on the effectiveness of their internal control framework (emulating the SOX annual statement requirements applicable in the US) has been modified. Instead, it is proposed that this requirement be included in the UK Corporate Governance Code and as such apply on a 'comply' or 'explain' basis.

While the Code only applies to premium listed companies, it is also proposed that all PIEs (above the new 750:750 size threshold) state as part of the proposed minimum content for the new Audit and Assurance Policy, whether or not they plan to seek external assurance of any reporting on their internal control arrangements.

How significant is this change?

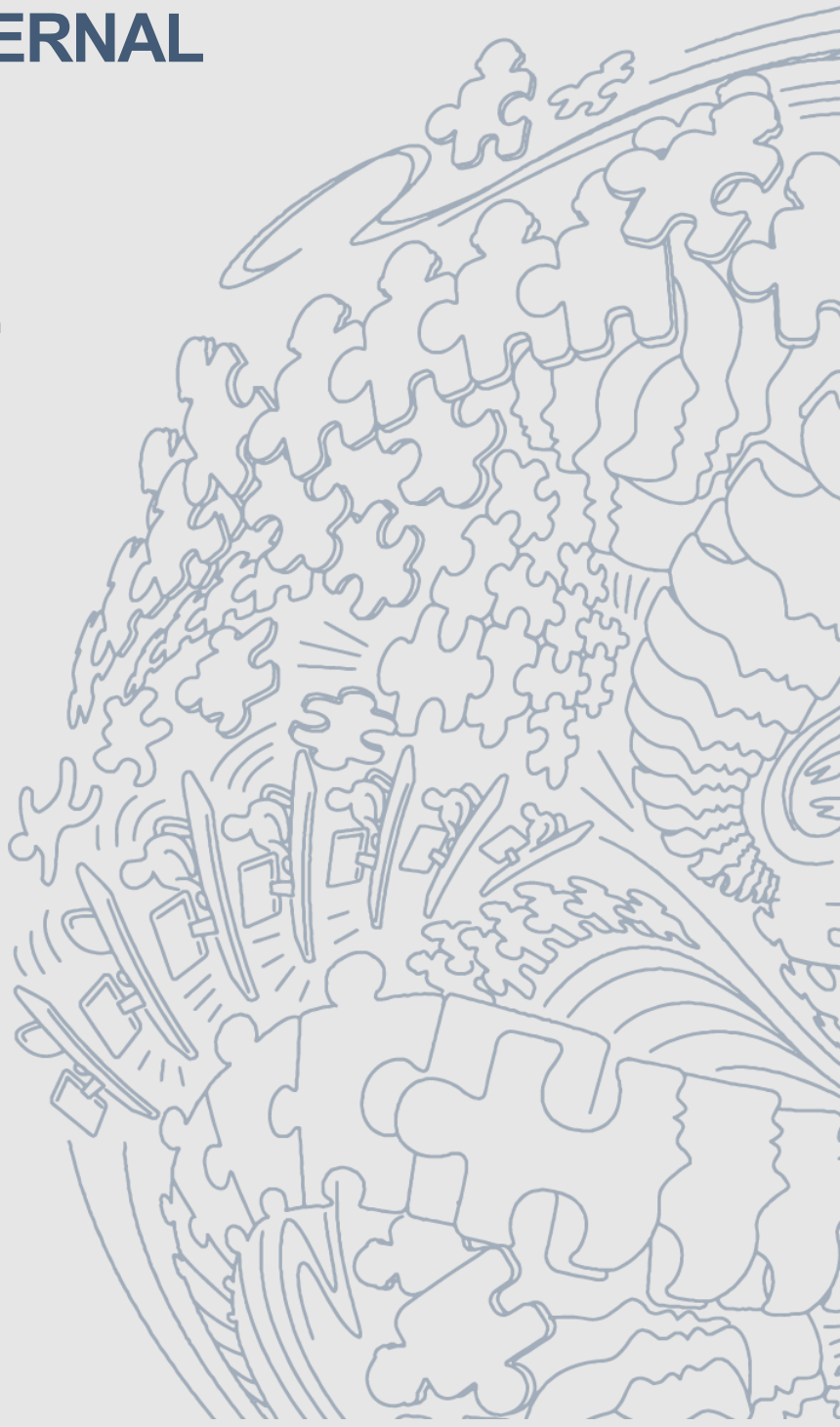
The full impact of the change will depend on further guidance around standards that need to be met by PIE boards in giving these annual confirmations.

Despite the decision not to put these rules on a statutory footing, the change marks a shift in directors' responsibilities and stakeholders will expect more transparency when it comes to disclosure of controls, particularly against the backdrop of proposed requirements on PIEs to report publicly on steps taken to prevent and detect fraud, and the need to disclose plans around seeking external assurance on internal controls reporting.

In practice, we expect that the circumstances in which non-compliance in this area is likely to be acceptable to stakeholders will be very limited. This will result in additional costs for companies in preparing the annual statements and they will need to consider what lessons can be learned from SOX implementation to review and focus internal controls on key risks and to draft statements which are focused, appropriately caveated, and cost-effective.

Impact on directors' personal regulatory liability

We should not lose sight of the fact that including this new governance measure in the UK Corporate Governance Code will still mark a shift in directors' responsibilities, even under the 'comply' or 'explain' regime, and shareholders will expect more transparency when it comes to controls. The new regulatory duties on directors could still be engaged in relation to the annual statement, for example, where directors sign off on a statement which is materially inaccurate. We wait to see exactly what the civil enforcement regime might look like for directors who do not fulfil their corporate reporting duties to assess this risk further.



REGULATORY POWERS TO ADDRESS SERIOUS CONCERNS/ORDER EXPERT REVIEWS

The White Paper proposed that ARGA be given the power to require a rapid explanation from a company about reasonable concerns it had in respect of corporate reporting and audit. In another welcome step, the government has decided not to proceed with this proposal, having concluded that the FRC's existing powers in relation to a company's statutory audit are sufficient and should be transferred to ARGA.

The government will consider how to ensure that the existing corporate reporting powers are sufficient to enable ARGA to prescribe a timetable for responding to requests which a court would be able to enforce.

The Response retains the proposal to give ARGA a new power to require that an expert review be carried out (at the company's expense) where it has identified concerns relating to a PIE's corporate reporting and audit.

However, the government has stressed that this power should only be used in exceptional circumstances where ARGA cannot obtain information it requires directly from a company or its auditor. The regulator will have powers to publish summaries where it is in the public interest to do so and subject to relevant confidentiality requirements. The regulator will also be expected to publish its policy and procedures for the use of these powers.

What are the likely impacts on companies and directors?

- The expert review proposal seeks to emulate the Skilled Persons reviews that can be compelled by the PRA and FCA. In practice, expert reviews are likely to present a similar risk for companies to those reviews, in that they may be used for gathering information and evidence leading to enforcement investigations by the regulator, which could rely on the review report to build its case.
- In many cases, companies will need to approach these expert reviews with the same support, advice, preparation and thought as an investigation.

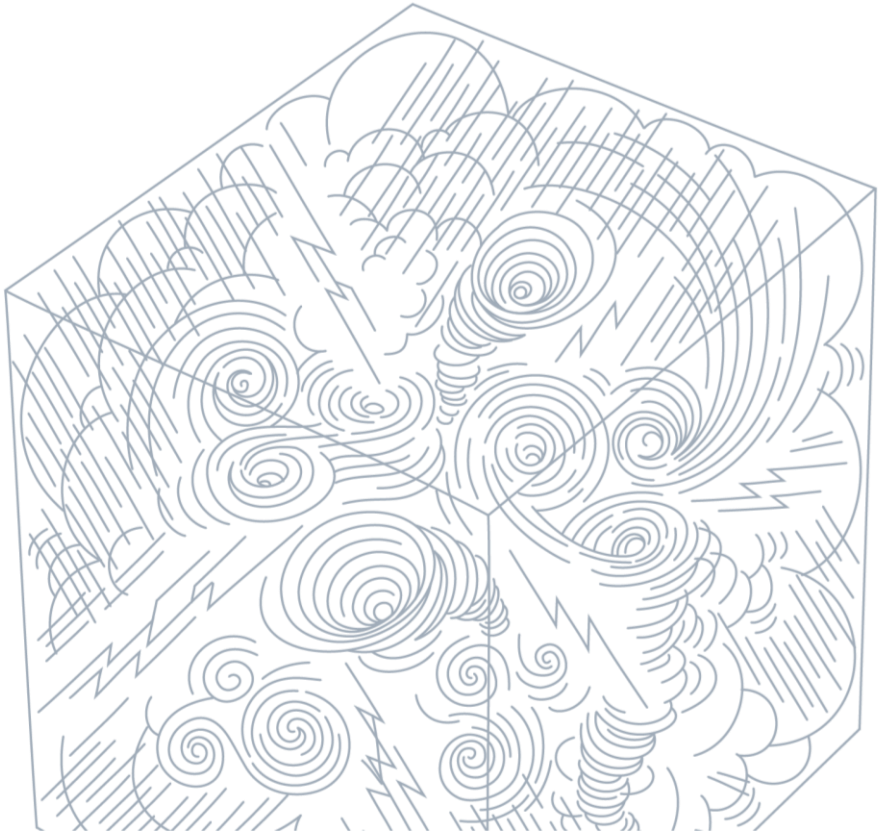
ABANDONMENT OF LEGAL PRIVILEGE PROPOSALS

The White Paper had tabled a statutory provision proposal which would enable ARGA to override legal professional privilege to obtain legally privileged material belonging to a company which is on the audit file or otherwise in auditors' hands when ARGA is investigating the auditors. If passed, ARGA would have been the first regulator or authority to hold such a broad power in those terms. We had considerable reservations about the fairness and operability of this intrusion into a company's privileged material which we expressed in our response to the White Paper, including the risk of collateral use by ARGA against the company or its directors and the risk of the material becoming available to third parties.

Fortunately, the government has taken note of concerns raised by the legal profession and decided not to proceed with this proposal. Instead, the government has urged legal and audit professionals to work with the regulator to resolve any issues that arise from instances where privileged documents shared by the company with the auditor are not available to the regulator for quality review and enforcement purposes. For example, by providing access to key documents via a data room so that the regulator can see the document but not retain it. The Response states the position will be kept under review.

How significant is this reversal?

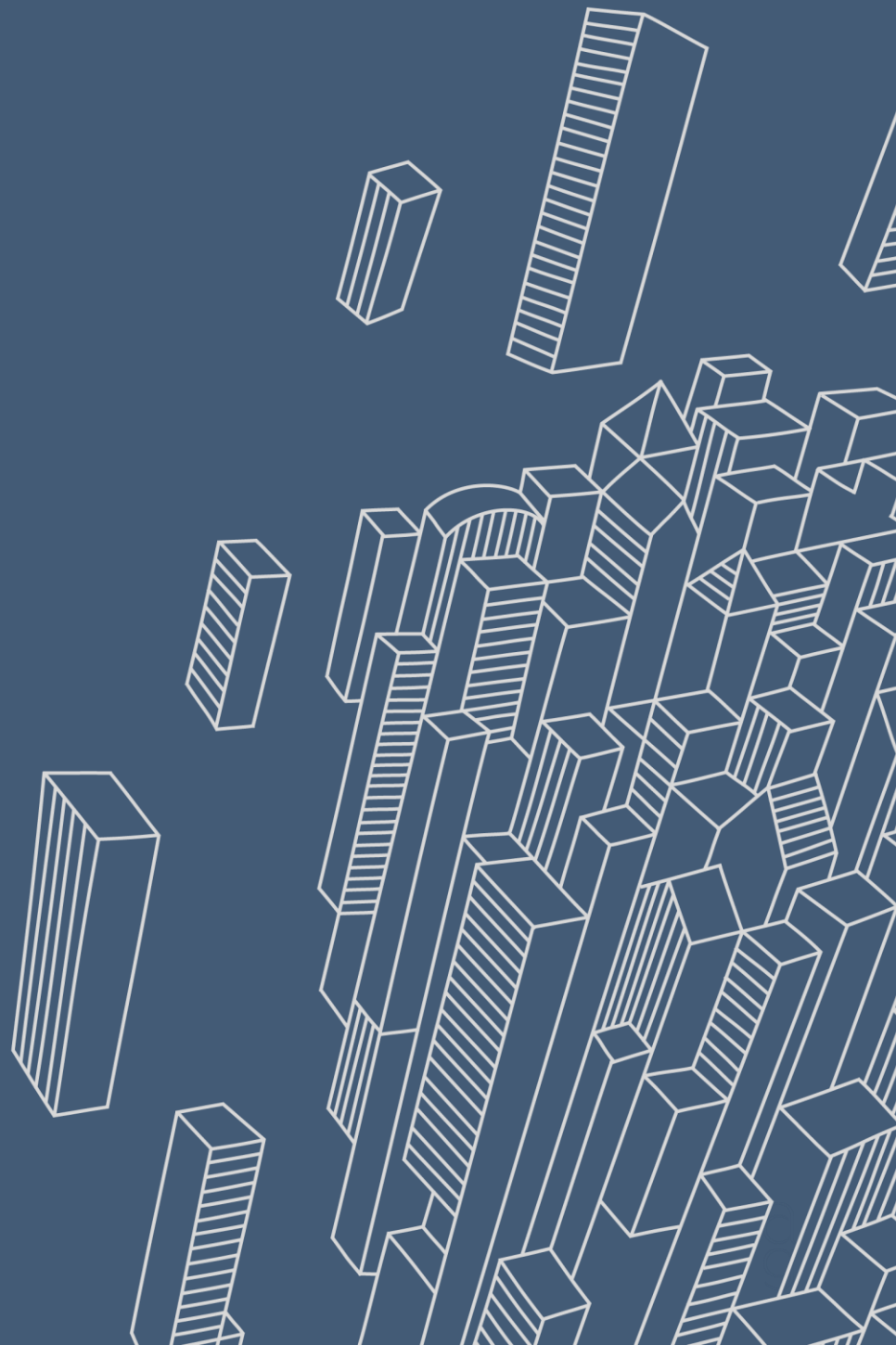
This was a controversial proposal which would have had far reaching consequences so we are pleased to see it has been abandoned. Legal professional privilege is a fundamental legal principle and the proposals would have put legally privileged documents at risk of becoming available to third parties and for use by regulators. A company will, however, still need to exercise caution in order to protect legally privileged material when responding to documentation requests from auditors.



TIMETABLE FOR IMPLEMENTATION

The government has not put any target dates for implementation of the proposals in the Response, but it is worth noting that:

- It has repeatedly emphasised that it will introduce the reforms at a pace that balances the need for action with the time needed for those affected to prepare properly.
- Companies will be given at least a full annual reporting period after exceeding the new 750:750 threshold before they are subject to any new requirements as a PIE.
- Some of the reforms require primary legislation that is, of course, dependent upon the availability of Parliamentary time (and Parliament's support for the proposals), but other aspects can be progressed without primary legislation. This means we will see multiple strands of reform progressing at different speeds over a period of time.
- The government still plans to create ARGA at the earliest possible juncture, and it had been anticipated that ARGA would be up and running in 2023, but this is not now expected to happen until 2024.
- We can expect to see a number of further consultations and draft regulations being published in the next months, as more flesh is put on the bones of the proposals in the Response.



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