

BEIS Audit Reform White Paper – Brief



Yesterday (18 March 2021), the Business Secretary, Kwasi Kwarteng MP, published the long-awaited consultation on the three audit-related reviews, which will run for 16 weeks. The consultation proposes a major overhaul of the UK's audit and corporate governance regimes in the wake of some significant corporate failures in recent years.

Collectively, each proposal within the consultation is of significant importance to the QCA and the small and mid-sized quoted company ecosystem.

We highlight the following proposals as specific areas of interest to QCA members (which we discuss in greater detail below):

1. The expansion of the definition of Public Interest Entities (PIEs) to include some AIM-quoted companies;
2. Increasing the accountability of directors through new requirements in relation to internal controls (Sarbanes-Oxley) and dividends and capital maintenance;
3. New reporting requirements through a Resilience Statement and Audit and Assurance Policy;
4. Giving the new regulator more power to direct changes to company reports and accounts;
5. Giving the new regulator greater enforcement powers against directors of PIEs and strengthening malus and clawback provisions;
6. Increased director responsibilities regarding the detection and prevention of fraud
7. Increasing audit committee oversight and engagement with shareholders.

We highlight the following as specific areas of interest to our accountancy firm members (which we discuss in greater detail below):

1. The expansion of the definition of PIEs;
2. Changes to audit purpose and scope; and
3. Shared audit, operational separation and increased regulator monitoring powers.

Background and overview

The consultation has been published following the three audit-related reviews (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 put forward within these reviews.

The consultation has a focus on breaking up the dominance of the "Big Four" audit firms, as well as requiring large businesses to be more transparent about their finances in a bid to help avoid additional corporate failures in the future. In addition, there are a host of proposed reforms aimed at "strengthen[ing the] UK's position as a world-class destination for investors by improving the quality of corporate reporting and sharpening [the] focus on [the] long-term success of large companies".

The Government has stated that it will work to ensure that "reforms are implemented in a way that it does not prove burdensome to businesses".

Broadly, the reforms include:

- 1. Resetting the scope of regulation by expanding the definition of Public Interest Entities to include large private companies and “large” AIM quoted companies.**
- 2. Increasing the accountability of directors by:**
 - a. Implementing a UK Sarbanes-Oxley and internal controls over financial reporting; and
 - b. Requiring companies to report on their distributable reserves and the legality and affordability of proposed dividends.
- 3. New corporate reporting requirements, including:**
 - a. A requirement for PIEs to produce an annual Resilience Statement; and
 - b. A requirement for an Audit and Assurance Policy where directors have to describe their approach to seeking assurance.
- 4. Strengthening the supervision of corporate reporting, including:**
 - a. Giving Audit, Reporting and Governance Authority (ARGA) (which replaces the Financial Reporting Council) more power to direct changes to company reports and accounts;
 - b. Increased transparency for the Corporate Reporting Review (CRR) process;
 - c. An extension of the CRR process to the whole of the annual report and accounts.
- 5. Provisions concerning company directors, including:**
 - a. Giving the regulator investigation and enforcement powers in relation to wrongdoing by all directors of Public Interest Entities; and
 - b. Strengthening malus and clawback provisions within executive director remuneration.
- 6. Changes to audit purpose and scope, including:**
 - a. A new corporate auditing profession;
 - b. New overarching principles for auditors;
 - c. A new duty for auditors to take a wider range of information into account;
 - d. New obligations on auditors and directors relating to the prevention of fraud.
- 7. Changes to audit committee oversight and engagement with shareholders, including:**
 - a. Additional requirements for audit committees in the appointment and oversight of auditors; and
 - b. Increased engagement between a company and its shareholders.
- 8. Improved competition, choice and resilience in the audit market, including**
 - a. The implementation of a managed shared audit regime;
 - b. The operational separation of certain accountancy firms; and
 - c. Statutory powers for the regulator to monitor the resilience of the audit market.
- 9. Greater supervision of audit quality, including:**
 - a. Making the regulator responsible for approving the auditors of PIEs; and
 - b. Improving the transparency of Audit Quality Review reports.
- 10. A new and strengthened regulator, the Audit, Reporting and Governance Authority**

11. Additional changes to the regulator’s responsibilities

Please note that some of the proposed measures will not apply to new public interest entities immediately in order to give these companies time to adjust (see below for further detail).

Key proposals

In this section we attempt a more detailed analysis of the key proposed reforms of note for small and mid-sized quoted companies, as well as how they may be applied. All of these measures are proposals, subject to the outcome of this consultation.

Resetting the scope of regulation and expanding the definition of PIEs

The Government intends to introduce a wider definition of ‘public interest entity’ (PIE) to ensure that large businesses and those that are of public importance are subject to appropriate regulation. At present, PIEs are defined in the Statutory Audit Directive as “entities whose transferable securities are admitted to trading on a regulated market”, meaning that they currently only apply to companies listed on the Main Market. As a result, PIEs are subject to more stringent regulation.

However, **the Government intends to extend the definition to of a PIE to include other large entities, such as large private companies and “large” AIM-quoted companies.** As part of this, the Government is considering two options for the definition of a PIE:

1. 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:
 - a. More than 2,000 employees; or
 - b. a turnover of more than £200 million and a balance sheet of more than £2 billion.
2. Adopt a narrower test which incorporates the threshold for additional non-financial reporting requirements for existing PIEs. This would cover companies with both:
 - a. Over 500 employees; and
 - b. A turnover of more than £500 million.

This would not necessarily 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 €200m (currently circa £171 million).**

- This would mean these companies would be subject to the range of existing and proposed requirements which will apply in respect of PIEs. It is predicted there would be around **105 AIM companies in scope.**

The Government is considering how to ensure that the thresholds are applied appropriately.

- One option they are considering is that **a company is required to meet the thresholds for three consecutive financial years** or to meet the thresholds for two out of the last three years before qualifying as a PIE.

The Government is also considering whether to make compliance with some or all of the proposed new PIE requirements option for a period of time after a company’s IPO. This is intended to “ensure the attractiveness of listing in the UK is not reduced”.

The Government will consider whether it is appropriate to **allow for a phased introduction for a new PIE definition**, which would allow for the definition of PIE to be introduced in two or more stages. This would permit further time for companies to prepare, as well as to avoid a significant growth in the number of PIEs, which would have implications for audit services.

Increasing directors' accountability

Sarbanes-Oxley and internal controls

The key provisions contained within Sarbanes-Oxley are for the management of public companies to **assess and report annually on the effectiveness of their company's internal control structure and procedures for financial reporting**. The company's auditor would then be required to attest to and report on this assessment. Sarbanes-Oxley also places responsibility for a company's financial statements and internal controls with the CEO and the CFO. The CEO and CFO must certify for each annual and quarterly report that they have reviewed the report, acknowledged their responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal controls. Brydon recommended that Government give consideration to mandating an 'Internal Controls Statement' consisting of a signed attestation by the CEO and CFO.

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

1. 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 the internal control and risk management systems**.
2. 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**.
3. 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's preferred option is for a directors' responsibility statement, which is supported by an annual review of internal control effectiveness and new disclosures. This should be guided by principles and guidance from the regulator, with the decision to seek external audit and assurance being decided by the audit committee and shareholders.

The regulator will have powers to investigate the accuracy and completeness of the directors' internal control disclosures and, if necessary, order amendments or recommend an external audit of the internal controls. The requirements will apply to all Premium Listed companies **first**.

There will be possible exemptions for newly listed companies and the requirements will expand to other PIEs, including the AIM companies who are caught, after two years.

Dividends and capital maintenance

This section of the consultation 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 ARGAs 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 effects on the future solvency of the company.

New corporate reporting

The Resilience Statement

The Government intends to take forward the recommendation provided by Sir Donald Brydon to **introduce a statutory requirement on public interest entities 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 Resilience Statement would implement minimum reporting requirements, including:

- A short-term section which would incorporate companies' existing going concern statement, including disclosure of any material uncertainties considered by management during their going concern assessment.
- A medium-term section which would incorporate the existing viability statement requirements to provide an assessment of the company's prospects and resilience with a mandatory assessment period of five years.
- A long-term section which will not be prescribed but should set out what the directors of the company consider to be the main long-term challenges to the company and its business model, and how these are being addressed.

Audit and assurance policy

The Government agrees with the Brydon Review recommendation and proposes to **introduce a statutory requirement on PIEs to publish an annual Audit and Assurance Policy**. This would describe the company's approach to seeking assurance of its reported information over the next three years.

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

In terms of implementation, the **Policy would be required initially of Premium Listed companies, and extended to other PIEs two years later**.

The content of the Audit and Assurance Policy would include:

- An explanation of what independent assurance, if any, the company intends to obtain in the next three years in relation to the annual report and other company disclosures beyond what is required by statutory audit.
- A description of the company's internal auditing and assurance processes.
- A description of what policies the company may have in relation to the tendering of external audit services.

- An explanation of whether, and if so how, shareholder and employee views have been taken into account.

The Government will **not take forward the recommendations provided by Brydon in relation to the audit of Alternative Performance Measures (APMs), Key Performance Indicators (KPIs), and company statements on Section 172 of the Companies Act.**

The Government intends that the Audit and Assurance Policy would only be required initially of premium listed companies, **with other listed and unlisted PIEs having a further two years to prepare and publish their Policy.**

Reporting on payment practices

An option being considered by the Government is whether to require the annual reports of PIEs to provide a summary of how the 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. This could be achieved by requiring companies to include this information in their strategic report.

Public Interest Statement

The Government will not, at present, introduce a statutory requirement for a public interest statement as this is currently being considered by the FRC as part of their Future of Corporate Reporting project.

Supervision of corporate reporting

The Government proposes to **broaden the regulator's review powers so that it can scrutinise the entire contents of a company's Annual Report and Accounts.** As part of this, the regulator will have the power to direct changes to be made to a company's report and accounts and increase the transparency of the regulator's review work through the publication of more information about its findings.

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 Government will give the regulator powers allowing it to publish correspondence entered into during the course of a CRR review, as well as summary findings.

Company directors

Enforcement against company directors

The FRC currently has no means of taking enforcement action against directors who are not chartered accountants where they have breached their duties relating to corporate reporting and audit. However, **the Government proposes to give the regulator investigation and enforcement powers to hold company directors of public interest entities 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 public interest entities would be in scope**. It is suggested that the regulator could mitigate the risk of deterring directors when exercising their enforcement powers by applying their proportionality principle, taking into account the directors' backgrounds and considering the size and complexity of the entity concerned.

The duties in scope of new enforcement powers, include:

- 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 disclosure to auditors and to provide information or explanations at the request of the auditor.

Strengthening clawback and malus 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.

Audit purpose and scope

The purpose of audit

The Government proposes to introduce a statutory requirement of auditors by giving them a specific responsibility to consider relevant director conduct and wider financial or other information in reaching their judgements.

The scope of audit

The Government has stated that it agrees with the Brydon Review that companies and their shareholders should be able to decide the scope of the external auditing which is obtained beyond the statutory audit of the financial statements. 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.

Principles of corporate reporting

The Government intends to establish a binding set of principles which will be determined and enforced by the regulator. The principles would apply to both statutory auditors and those providing wider auditing services through the Audit and Assurance Policy.

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. As such, **the Government proposes to legislate to require directors of Public Interest Entities to report on**

the steps they have taken to prevent and detect material fraud. The Government will also seek to require auditors to report on the steps they have taken to detect material fraud and assess the effectiveness of relevant controls.

Auditor reporting

Auditors should seek to report in a clear, concise and transparent manner to increase the value of their reports to shareholders and other users.

True and fair view requirement

The Government supports the development of a new user guide to audit, which the FRC has agreed to take forward. The Government considers this is likely to prove more effective in improving user understanding than replacing “true and fair” in audit reports with “present fairly, in all material respects”.

Audit committee oversight and engagement with shareholders

Audit committees – role and oversight

The Government will seek to **give ARGA powers to set additional requirements regarding the audit committee’s role in the appointment and oversight of 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. The Government is also proposing regulatory powers for ARGAs 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 that **a formal mechanism is introduced to enable audit committees to gather shareholder views on the audit plan.** The Government also 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.

The Government also agrees with Brydon’s recommendations that auditors who resign, choose not to re-tender or are dismissed from PIEs provide a statement of reasons for the departure to be provided to the company, shareholders and the regulator.

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.
- 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 who 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.

Supervision of audit quality

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 of 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.

A strengthened regulator

The Government will seek to establish new rules for ARGA 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.

Additional changes in 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 PIEs corporate reporting and auditing.