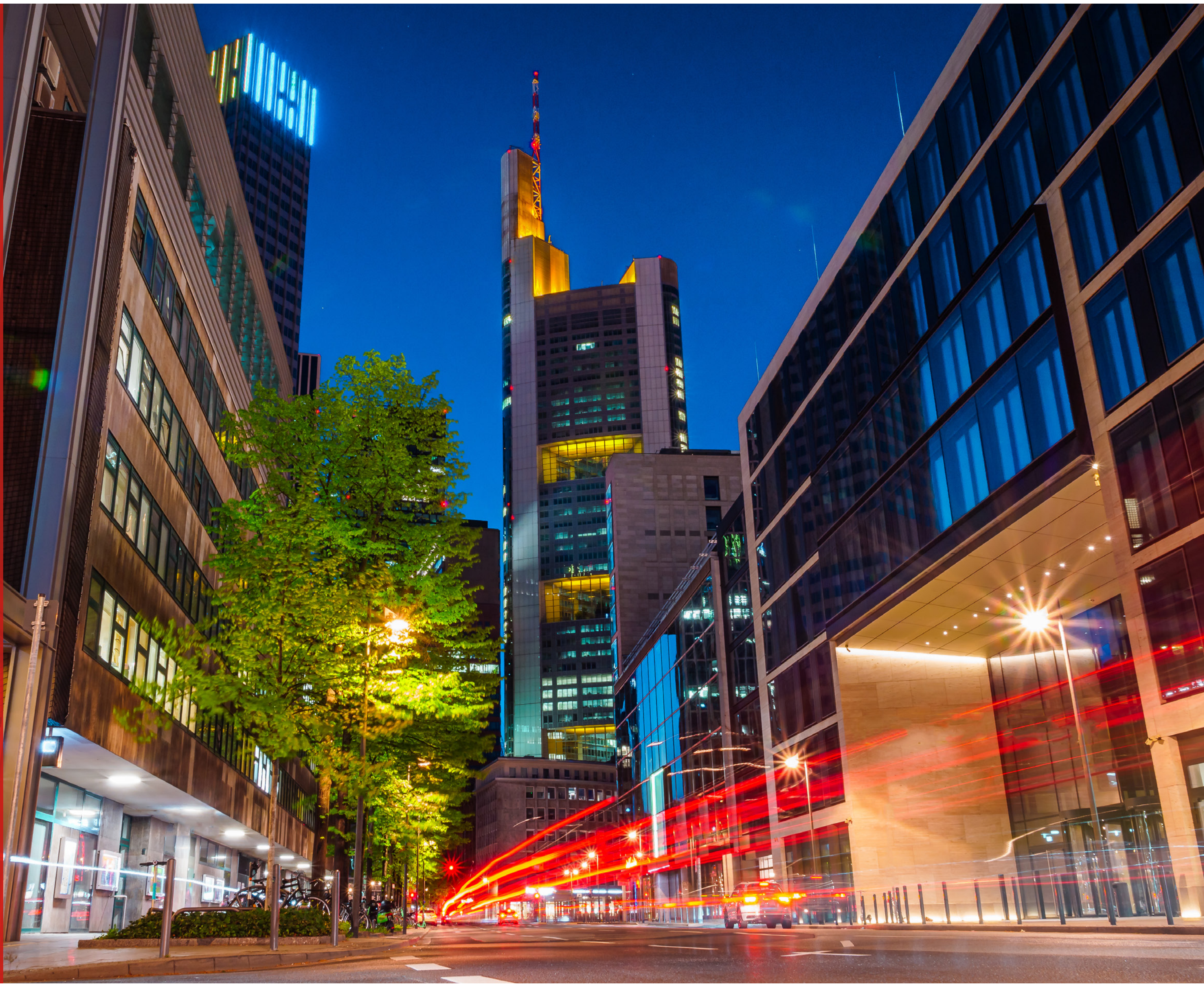
NORTON ROSE FULBRIGHT

Restoring trust in audit and corporate

A look at the Government's response to the White Paper consultation and next steps

June 2022



Introduction

On May 31, 2022 the Department for Business, Energy and Industrial Strategy (BEIS) published a document (the Response Document) summarising responses to the consultation proposals set out in the White Paper it published in March 2021 concerning wide-ranging reforms to the UK's audit and corporate governance framework, and setting out its plans for action in light of those responses.

Many of the proposed reforms in the White Paper stemmed from recommendations made by three independent reviews of audit and corporate reporting, namely the 2018 Independent Review of the Financial Reporting Council (FRC Review) led by Sir John Kingman, the 2019 Review into the Quality and Effectiveness of Audit led by Sir Donald Brydon (Brydon Review), and the Market Study of Statutory Audit Services led by the Competition and Markets Authority (CMA Study) in 2019. These reviews identified a number of weaknesses and a lack of accountability in certain areas which the White Paper sought to address and our earlier briefing considered a number of proposals in that White Paper.

The Government states in the Response Document that its objectives, which govern its overall approach, are to: (i) build trust and credibility in the UK's audit, corporate reporting and corporate governance system; (ii) ensure accountability for those playing key roles in that system; and (iii) to increase resilience and choice in the statutory audit market. It believes that these objectives will further increase trust in the UK as a place to invest and obtain investment and to achieve this, it plans to put in place a new UK approach to regulating in this area, in line with its wider approach to regulators and regulation more generally (as set out in its January 2022 publication, The benefits of Brexit: How the UK is taking advantage of leaving the EU).

This briefing looks at the measures that the Government now intends to take forward in relation to public interest entities (PIEs) and other matters. These are summarised below and considered in more detail in the briefing.

Ongoing requirements to be applicable to PIEs as currently defined (and not those that simply meet the new 750:750 size threshold)[1]
To have an audit committee
To retender the audit every 10 years
To rotate the auditor every 20 years
New reporting requirements for current and new PIEs (listed and unlisted) above the 750:750 threshold
Resilience Statement to be published annually
Audit and Assurance Policy to be published every three years
Directors' statement on measures taken to detect and prevent fraud
Distributable reserves to be disclosed (or a 'not less than' figure)
Narrative explanation of board's long-term approach to amount and timing of shareholder returns and application of distribution policy
Directors' statements confirming legality of dividends paid and to be paid
New requirements applying to all PIEs (listed and unlisted) regardless of size
Within remit of ARGA, the new regulator
ARGA will be able to investigate and sanction breaches of corporate reporting and audit-related responsibilities by all PIE directors
New requirements for FTSE 350 companies only[2]
Will need to apply new minimum requirements for audit committees
UK-incorporated FTSE 350 companies will need to appoint challenger firm as sole group auditor or challenger firm to conduct a meaningful proportion of subsidiary audits within a shared audit
Will need to comply or explain against any new/ strengthened UK Corporate Governance Code provisions (e.g. in relation to internal controls)

1 This refers to the extended PIE definition relating to listed and unlisted entities with 750 or more global employees and an annual turnover of £750m or more (the 750:750 threshold).
2 Will also apply to any other companies that 'comply or explain' against the UK Corporate Governance Code.

Timetable for introduction of the reforms

Since it will take several years to introduce all the proposed reforms, the Response Document outlines actions to be taken, rather than a precise timetable.

The reforms will be introduced in a number of different ways. Some will be introduced through market developments and others through work of professional bodies. The new regulator, the Audit, Reporting and Governance Authority (ARGA), is being asked to make changes to the UK Corporate Governance Code and to improve audit standards. Secondary legislation (in the form of statutory instruments) will be required to introduce certain of the reforms and primary legislation (in the form of a Bill in Parliament) will be needed to, among other things, establish ARGA and set its powers, objectives and duties. That Bill is currently being prepared and will be published in draft initially so that it can be introduced when Parliamentary time allows.

Wider definition of 'public interest entity'

The reforms in the White Paper focused on the largest UK-incorporated companies, 'public interest entities' (PIEs), and proposals to extend the group of companies that are PIEs were set out so that large businesses of public importance are subject to appropriate regulation.

Large companies as PIEs

The White Paper proposed extending the PIE definition to include certain large companies, whether or not they are traded on a regulated market, including large private companies, and two options for identifying large companies for these purposes were suggested:

Option 1: The test used to identify those large companies which are already required to include a corporate governance statement in their directors' report – these are companies with either more than 2,000 employees, or a turnover of more than £2m and a balance sheet of more than £2bn.

Option 2: A narrower test which incorporates the threshold for additional non-financial reporting requirements for existing PIEs – these are companies with both over 500 employees, and a turnover of more than £500m.

In light of responses, the Government is introducing a variant of Option 2, with the PIE definition to be extended to large companies with both 750 or more employees and an annual turnover of £750m or more (the 750:750 threshold). The employee figure will be based on global rather than UK only employees.

Companies quoted on MTFs such as AIM as PIEs

While the White Paper focused on AIM companies, which are not currently PIEs, the Government now thinks all companies traded on Multilateral Trading Facilities (MTFs) should be treated in the same way. As a result, companies traded on MTFs, including AIM, will come within the PIE definition if they meet the same threshold as for large private companies (ie the new 750:750 threshold).

Lloyd's Syndicates, third sector entities and LLPs

Views were sought in the White Paper on whether Lloyd's Syndicates and other large third sector entities such as universities, charities and housing associations should be included in any new extended PIE definition.

The Government has concluded that Lloyd's Syndicates should not be included as the current system that regulates them is effective. However, third sector entities that meet the new 750:750 threshold will be included.

All Limited Liability Partnerships (LLPs) that meet the 750:750 threshold will also be included in the PIE definition.

No temporary exemption for private companies listing on a regulated market

So as not to deter private companies from listing, the Government did consider in the White Paper whether to make compliance with some or all of the proposed new PIE requirements (that will otherwise automatically apply on listing) optional for a period of time after flotation. However, in light of responses, including the view that newly listed companies should be subject to the PIE requirements as they can pose a greater risk than established listed companies, there will be no temporary exemptions from PIE requirements for newly listed companies.

Time to prepare and phased introduction

Given the significant implications of being designated a PIE, the Government will allow an adequate period between an entity exceeding the new 750:750 threshold and being subject to any new requirements. The detail will be set out in legislation, but will be a full annual reporting period as a minimum.

Qualifying and ceasing to qualify as a PIE

So it is clear which businesses are PIEs at any given time, entities will have to continue to meet the PIE requirements for a set period after they qualify as a PIE, even if they drop below the 750:750 threshold. Details of this period will be included in legislation.

Group and subsidiaries

Where a UK parent company prepares consolidated accounts for a group, and that group, when aggregated, meets the 750:750 threshold, then the parent company of that group will become a PIE.

Where an entity that is a PIE by virtue of the new 750:750 threshold is a subsidiary of a UK-incorporated parent, the parent will also be a PIE. Since this could result in a risk of duplication of reporting within a group structure, a mechanism to remove or reduce this risk ahead of introducing primary legislation will be considered. For example, there could be an option of either reporting at subsidiary level or reporting on a consolidated group basis.

Tiered approach

To ensure that the additional regulation businesses will face as PIEs is proportionate, the Government does not intend to apply current PIE requirements to have an audit committee, to retender the audit every 10 years and to rotate the auditor every 20 years to entities that are PIEs because of the new 750:750 threshold, as these are the costliest requirements for PIEs.

In addition, as part of a more proportionate approach to regulation in relation to the new corporate reporting requirements (the Resilience Statement, Audit and Assurance Policy, directors' statement on fraud measures and the new disclosures about dividends and distributable reserves – see further below), while in general ARGA's remit will extend to all PIEs in view of their substantial public interest, the Government believes smaller PIEs should not be subject to these new corporate reporting requirements. This is in line with the Government's determination to make the UK listings market even more attractive, both to UK companies considering an IPO and to overseas companies considering where to list.

As a result, the Government will introduce a tiered approach to reporting and apply the new corporate reporting requirements referred to above only to PIE companies that meet the 750:750 threshold. The Response Document notes that UK listed companies below the 750:750 threshold will still be subject to the Listing Rules and Companies Act 2006 (CA 2006) requirements on risk reporting, and credit and insurance companies below that threshold will still be regulated by the FCA and PRA, so making such entities comply with these additional reporting requirements would be of less value.

Creating scope for deregulation and fine-tuning of PIE audit requirements

Since a significant number of respondents suggested excluding some smaller entities from the PIE definition altogether, the Government intends to consider this further, particularly since the UK is no longer legally required to follow the EU's PIE definition.

The Government plans to review the existing regulatory framework for PIEs to identify further deregulatory opportunities and will legislate so that Ministers can disapply PIE requirements from particular entities or categories of entities in secondary legislation, according to further consideration of the potential benefits and disadvantages of a more targeted approach. Since 'public interest' may evolve over time, and the PIE definition may need to evolve with it, the legislation will also permit Ministers to amend the size threshold by secondary legislation in future, as well as including or excluding groups with specific characteristics such as sector or company type, if it proves necessary to change the scope in the light of changes in circumstances.

Directors' accountability for internal controls

Both the FRC Review and the Brydon Review made recommendations about strengthening the UK's internal control framework. The FRC Review suggested that lessons could be learned from the US Sarbanes-Oxley regime which requires 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 is then required to attest to and report on this assessment.

As a result, the White Paper set out three possible options for strengthening the UK's internal controls framework as follows:

Option A: Require an explicit directors' statement about the effectiveness of the internal control and risk management systems.

Option B: Require auditors to report more about their views on the effectiveness of companies' internal control systems.

Option C: Require auditors to express a formal opinion on the directors' assessment of the effectiveness of the internal control systems.

The Response Document notes that while a large majority of respondents agreed that there was a case for strengthening the internal control framework, views on how this should be achieved, and the degree of reform needed, differed significantly. While there was strong support for strengthening it based around a more explicit statement by directors about whether they regard their company's internal control framework to be effective and operating effectively, the Government believes that there are risks in putting the requirement for a directors' statement on a legislative footing.

The Response Document points out that the consultation has also shown that there are important issues that need further deliberation and resolution. For example, if there is to be a statement about internal controls, what benchmark or standard should be used?

What are the minimum steps that directors should be expected to take to demonstrate that their statement is soundly based? Should the statement only relate to the internal controls over financial reporting or extend to the effectiveness of controls over operational and compliance risks as many investors want?

In light of this, the Government is to do the following:

- Invite the FRC to consult on strengthening the internal control provisions in the UK Corporate Governance Code to provide for an explicit statement from the board about their view of the effectiveness of the internal control systems (financial, operational and compliance systems) and the basis for that assessment. This would be underpinned with guidance on how boards should approach the preparation of the statement, which would be developed following a review of the FRC's existing Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. This guidance would cover the identification of acceptable standards, benchmarks or principles and address definitional issues and the circumstances in which external assurance might be considered appropriate.
- Require PIEs above the 750:750 threshold to 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 the company's reporting on internal controls. Directors would not have to seek such assurance but this would help ensure that they had at least considered the possibility and provide shareholders with an opportunity to raise the matter and press for more assurance if they have concerns.
- Ask the FRC to explore with investors and other stakeholders whether and how the content of the auditors' report could be improved to provide more information about the work auditors have undertaken on the internal controls over financial reporting. This would be limited to observations based on work carried out as part of the statutory audit and would not amount to assurance of the control system.

Directors' accountability for dividends and capital maintenance

The Government is seeking to strengthen the laws on dividends and capital maintenance and the White Paper highlighted several issues with the current legal framework. It set out a number of proposals to strengthen the law in this area and, having considered responses to these proposals, the Government intends to take the following steps:

- ARGA will be given formal responsibility for issuing guidance on what should be treated as 'realised' profits and losses for the purposes of section 853 CA 2006. The guidance will be subject to full prior consultation.
- Qualifying companies or, in the case of a UK group, the parent company only, will be required to disclose their distributable reserves, or a 'not less than' figure if determining an exact figure would be impracticable or involve disproportionate effort. The distributable reserves figure at the balance sheet date will also be made subject to audit to help address criticism that compliance with the capital maintenance rules is not properly enforced.
- Disclosing an estimate of the dividend-paying capacity of the group as a whole will be encouraged rather than be a required element of reporting. Guidance issued by the regulator and by institutional investors (where they would value the information) should be used to improve transparency about the group's overall dividend position.
- Companies will be required to provide a narrative explaining the board's long-term approach to the amount and timing of returns to shareholders (including dividends, share buybacks and other capital distributions) and how this distribution policy has been applied in the reporting year. As part of this narrative, companies will also be expected to explain any relevant legal and financial constraints and risks to the policy, including the availability of distributable reserves and cash within the wider group, any significant barriers to subsidiary companies paying up dividends to the parent and any competing demands for capital such as investment. The regulator will be expected to issue guidance to underpin this new narrative reporting requirement reflecting best practice and investor needs.
- Directors will be required to make explicit statements confirming the legality of proposed dividends and any dividends paid in year to meet concerns that directors sometimes pay insufficient heed to the capital maintenance rules and their wider duties. However, the proposal for a directors' assurance that a dividend would not be expected to jeopardise the future solvency of the company over a period of two years is not being taken forward, although the Government does expect the proposed Resilience Statement to take into account the company's dividend policy.

These new disclosures and the legality statement will apply to listed and unlisted companies that are PIEs above the 750:750 threshold.

New corporate reporting requirements – Resilience Statement

The Brydon Review argued that company reporting should do more to evidence directors' plans to maintain the resilience of their business over the short, medium and long-term, and to explain the directors' approach to seeking internal and external assurance of key business information and processes. It recommended the introduction of two new reporting requirements, a Resilience Statement and an Audit and Assurance Policy, to bring together relevant information and the White Paper set out proposals for implementing both these recommendations.

The Response Document notes that there was general support for the Resilience Statement proposal so this will be introduced and apply to listed and unlisted companies that are PIEs above the 750:750 threshold. In connection with this, the following is proposed.

Identification of material resilience matters

Legislation will be introduced to require in scope companies to report on matters that they consider a material challenge to resilience over the short and medium term, together with an explanation of how they have arrived at this judgement of materiality. In doing so, companies will be required to have regard to the following:

- any materially significant financial liabilities or expected refinancing needs occurring during the assessment period of the short and medium term sections of the Resilience Statement;
- the company's operational and financial preparedness for a significant and prolonged disruption to its normal business trading;
- significant accounting judgements or estimates contained in the company's latest financial statements that are material to the future solvency of the company;
- the company's ability to manage digital security risks, including cyber security threats and the risk of significant breaches of its data protection obligations;
- the sustainability of the company's dividend policy;
- any significant areas of business dependency with regard to the company's suppliers, customers, products, contracts, services or markets which may constitute a material risk; and
- the impact on the company's business model of climate change, to the extent that this is not already addressed by the company in other statutory reporting.

The regulator will prepare guidance that sets out more detail of how the potential materiality of these matters should be considered, as well as on the Resilience Statement as a whole. In preparing the implementing legislation for the Resilience Statement, and the supporting guidance, the Government and the regulator will consider how the Resilience Statement can effectively reference, make links to and provide a coherent reporting framework with wider sustainability disclosures.

Assessment period

The five-year mandatory assessment period previously proposed for the combined short- and medium-term sections of the Resilience Statement is to be replaced with an obligation on companies to choose and explain the length of the assessment period for the medium term section. Companies will be required to include a description of how resilience planning over the chosen period aligns with the company's strategy and business investment cycle. If the assessment period is the same as the one chosen in the previous year, the company will need to explain why it continues to be justified.

High-level narrative

The Resilience Statement should contain a high-level explanation of the company's approach to maintaining or enhancing its operational and financial resilience over the short and medium term which clearly sets out how the company's assumptions on resilience planning and risk management are influenced by and relate to its strategy on the one hand, and also the main trends and factors that are likely to affect the future development, performance and position of the company's business. This reporting should precede the company's specific reporting on individual risk and resilience issues and supporting guidance issued by the regulator will provide more detailed advice on good practice.

Disclosure of principal risks and uncertainties

To enable integrated and holistic reporting on risk and resilience, the existing Strategic Report requirement on companies to describe the principal risks and uncertainties facing them will be incorporated within the Resilience Statement. Companies within scope will be given the flexibility to report these risks within the short and/or medium term sections of the Resilience Statement, as different kinds of risk or uncertainty may crystallise or resolve over different time periods.

As the new requirements may overlap with existing requirements to describe principal risks and uncertainties, the implementing legislation will give companies flexibility to meet the existing requirement through their assessment of risk and resilience issues over the short to medium term. The implementing legislation will also require companies to report, for each risk or resilience issue identified over the short to medium term:

- the likelihood of the risk and its impact on the company's operations or financial health if it were to materialise;
- the time period over which the risk is expected to remain, and potentially crystallise, if known;
- what mitigating action, if any, the company has put or plans to put in place to manage the risk; and
- any significant changes to any of the above since the previous year's Resilience Statement.

Reverse stress testing

The Government intends to continue with its proposal that companies within scope of the Resilience Statement should perform reverse stress testing. However, in light of the consultation feedback, companies will be required to perform at least one reverse stress test rather than a minimum of two. In addition, recognising the need for consistency between this new requirement and existing reverse stress testing obligations covering banks and insurance companies, the Resilience Statement will require a company to:

- identify annually a combination of adverse circumstances which would cause its business plan to become unviable:
- assess the likelihood of such a combination of circumstances occurring; and
- summarise within the Resilience Statement the results of this assessment and any mitigating action put in place by management as a result.

The summary would not be required to include any information which, in the opinion of the directors, would be seriously prejudicial to the commercial interests of the company and the process should be documented and carried out according to the nature, size and complexity of the business. The Government will address in its design of the implementing legislation how banks and other financial service companies which already carry out mandatory reverse stress testing may rely on this existing activity to comply with the Resilience Statement requirement.

Material uncertainties

In order to balance the need for proportionality with legitimate and wider investor interest in the going concern assessment process, companies within scope of the Resilience Statement will need to identify any material uncertainties to going concern that existed prior to the taking of mitigating action or the use of significant judgement, which the directors consider are necessary for shareholders and other users of the statement to understand the current position and prospects of the business.

Viability statement and Going Concern statement

For companies within scope of the Resilience Statement, the existing viability statement provision in the UK Corporate Governance Code (Provision 31) which extends to premium listed companies will be incorporated and adapted within the statutory requirements for the Resilience Statement.

The Government and the FRC intend that Provision 31 of the UK Corporate Governance Code will no longer apply after the Resilience Statement enters into force, subject to consultation about its removal. The FRC also intends to consult on removing Provision 30, covering the Going Concern statement, from the UK Corporate Governance Code. This will also be included and built on within the Resilience Statement and all companies subject to the UK Corporate Governance Code will continue to provide a Going Concern statement as required by accounting standards and company law, irrespective of whether they are subject to the new Resilience Statement requirement.

Safe harbour

The Resilience Statement will form part of the Strategic Report so information provided by directors in it will be covered by the existing 'safe harbour' provision in section 463 CA 2006. This means directors will be liable to the company for untrue or misleading information in the Resilience Statement only if they knew the information was untrue or misleading (or were reckless as to whether it was so) or if they dishonestly concealed a material fact.

New corporate reporting requirements – Audit and Assurance Policy

The White Paper proposed the introduction of a statutory requirement on PIEs to publish an annual Audit and Assurance Policy (AAP) that describes the company's approach to seeking assurance of its reported information over the next three years. This would enable companies to set out more clearly to users the extent to which the annual report and other disclosures have been scrutinised, whether by the existing company auditor or someone else.

The Response Document notes that there was general support for the proposal so this will be introduced and apply to listed and unlisted companies that are PIEs above the 750:750 threshold.

The AAP will have to be published every three years rather than annually, to give companies sufficient time to review their existing assurance arrangements and gather shareholder and other views before bringing forward a new AAP. However, the AAP will be complemented by an annual implementation report, in which the directors (typically through the audit committee) provide a summary update of how the assurance activity outlined in the AAP is working in practice. Companies will also be free to update their AAP from year to year should they judge this necessary – for example, if issues arise that highlight or increase the value of seeking further internal or external assurance in particular areas of company reporting or activity.

The Government is not proceeding with the proposal that the AAP should be subject to an advisory shareholder vote but companies will have to state within the AAP how they have taken account of shareholder views in its development. Companies will also be required to state whether, and if so how, they have taken account of employee views.

The AAP should set out whether, and if so how, a company intends to seek independent (external) assurance over any part of the Resilience Statement or over reporting on its internal control framework (whether this is required or provided voluntarily). Companies must also describe their internal auditing and assurance process, including how management conclusions and judgements are challenged and verified internally as the Government considers it important that companies explain how they are ensuring the integrity of their internal assurance process, and considering whether any improvements are needed in light of experience.

The AAP will require a description of the company's policy in relation to the tendering of external audit services, including whether a company is prepared to commission non-audit services from its statutory auditor. Audit committees of premium listed companies are already required to develop and implement such a policy under the UK Corporate Governance Code and the Government believes that it is appropriate that this should be a requirement of all companies within scope of the AAP.

To enable shareholders and other users of AAP reports to be able to understand whether, and if so how, any independent (external) assurance commissioned by a company beyond the statutory audit will be carried out according to a commonly recognised assurance standard or model, the AAP will have to state whether any independent assurance proposed within it will be 'limited' or 'reasonable' assurance (as defined in the FRC's Glossary of Terms), or whether an alternative form of engagement or review, as agreed between the company and the external provider, will be undertaken. The AAP will also be required to state whether any independent assurance beyond the statutory audit will be carried out according to a recognised professional standard, such as the International Standard on Assurance Engagements (ISAE) (UK) 3000 (covering assurance other than audits of historical financial information).

ARGA will develop guidance on the AAP and that guidance will offer advice on how companies can document clearly within their annual report the different kinds of assurance or review that have been carried out. This would include the existing review carried out by the statutory auditor of information in the annual report that sits outside the financial statements.

For PIEs that are required to produce an audit committee report, the triennial AAP and the annual implementation report on the AAP should be published within the same section of the annual report as the audit committee report. For companies that are PIEs by virtue of the new 750:750 threshold, which will not be required to have an audit committee, the Government is considering whether this reporting should be in the Strategic Report or elsewhere in the annual report.

New corporate reporting requirements – Reporting on payment practices

The White Paper sought views on how improved reporting on payment policies and performance could best be achieved in respect of PIEs by drawing on existing reporting under the Payment Practices Reporting Duty (PPRD).

The Response Document notes that the Government recently completed a statutory post-implementation review of the existing Reporting on Payment Practices and Performance Regulations 2017. As confirmed in that review, the Government now intends to consult on whether these Regulations should be amended to further enhance transparency and accountability in supplier payment reporting, taking account also of responses to the proposal in the White Paper, and whether the Regulations as a whole should be extended beyond their current expiry date of April 6, 2024.

New corporate reporting requirements – Public Interest Statement

The Brydon Review recommended the introduction of a public interest statement, but most respondents to the White Paper supported the Government's position not to make this a statutory requirement. As a result, the Government will not legislate to create a new public interest statement reporting requirement, given the risks of confusion with or duplication of existing corporate reporting which already addresses public interest matters. Instead, the Government and the FRC will keep under review whether, and if so how, the UK's corporate reporting framework could provide a more holistic picture of how companies assess their impacts on the public interest.

Supervision of corporate reporting

The Government wishes to strengthen the regulator's corporate reporting review (CRR) powers and extend its CRR activities, in line with the recommendations of the FRC Review. To achieve this, new powers for ARGA were proposed in the White Paper.

The Response Document notes that the Government intends to proceed with these proposals other than in respect of pre-clearance. For example, this means ARGA's review powers will extend to the entire annual report, including the voluntary elements, and ARGA will have the power to require or commission an expert review.

To enable ARGA to order companies to amend their reporting, rather than having to seek a court order, the current powers enabling the Secretary of State and, by delegation, the FRC, to require information and secure changes to a company's report and accounts, will need to be modified. The Government intends to give ARGA these new powers in its own right, not through delegation, consistent with its full statutory status. ARGA will set out its approach to the use of these new powers, but its main focus will be on reporting by PIEs. The Government will consider what powers the Secretary of State needs to retain in this area and will also ensure that there are fair processes in place to allow companies to challenge ARGA's decisions.

ARGA will have powers to publish summaries of reviews but the Government has decided it does not need specific powers to publish correspondence. In giving ARGA powers to publish summaries, the Government will ensure that there are safeguards for commercially sensitive information and privilege.

In terms of ARGA being able to offer a pre-clearance service, consultation responses highlighted significant difficulties in providing such a service in practice, including resourcing issues for ARGA, timing issues for companies and concerns about whether ARGA should be intervening in the dialogue between a company and its auditor on accounting standards issues. As a result, the Government will not give ARGA new powers to provide a pre-clearance service.

In light of an FRC Review recommendation that the FRC and the FCA should consider the case for strengthening qualitative regulation of a wider range of investor information than is covered by the FRC's existing CRR work, the FRC and FCA have conducted a pilot study of preliminary results and investor presentations, to establish the extent of any inconsistencies between this information and the subsequent annual report and accounts. Since the pilot study did not identify any areas of concern, no further steps will be taken to strengthen the regulator's powers to scrutinise a wider range of investor information.

Company directors and enforcement

While directors of PIEs (like other company directors) have various statutory duties in relation to the preparation and auditing of their company's accounts and reports, the FRC currently has no direct powers to enforce these duties unless the particular PIE director in breach is a chartered accountant. The FCA's powers only extend to the companies it regulates and do not cover directors of AIM companies or of large private companies operating outside of the financial sector.

As a result, in the White Paper, the Government proposed that ARGA be given effective powers in respect of PIE directors' duties relating to corporate reporting and audit that can be exercised whether or not a director is an accountant.

The Response Document notes that the majority of respondents agreed that there is a significant public interest in having an effective enforcement regime that holds directors of PIEs to account where they fail to fulfil their duties relating to corporate reporting and audit as there are many other people who have an interest in how a PIE is managed, such as creditors, customers, pensioners, and employees.

The Government believes that it would undermine the effectiveness of the new regulatory regime, and ARGA's credibility as a regulator, if ARGA were able to take enforcement action against the auditors of a PIE's accounts and reports, but not against the directors responsible for preparing them and signing them off. As a result, ARGA will be given the necessary powers to investigate and sanction breaches of corporate reporting and audit related responsibilities by PIE directors. The Government also intends to ensure that, where appropriate, the scope of ARGA's enforcement powers apply to UK-incorporated PIEs which are not companies.

Relationship with existing enforcement regimes

The Government wishes to avoid overlap or duplication between the role of ARGA and the existing scope or powers of the FCA and other regulators wherever possible although a degree of overlap in powers is necessary as the remits of the different regulators are complementary. There may be cases that fall within the FCA's remit but where it has been decided that it is not appropriate for a case concerning the conduct of the director to be addressed by the FCA. ARGA will therefore need powers to enable it to take enforcement action against directors for corporate reporting and audit related failings in all PIEs, including in the case of listed companies and financial services entities. However, the Government is clear that companies and directors should not face any unfairness as a consequence of parallel or competing investigations by two different regulators into essentially the same circumstances and believes that where ARGA's powers relating to directors' enforcement necessarily overlap with those of other regulators, this can be managed through effective coordination and cooperation.

As set out in the White Paper, the new directors' enforcement regime will not replace existing arrangements for taking action against company directors, for example in respect of offences under the CA 2006 or breaches of the FCA's Listing Rules, the FCA's Transparency Rules or the Market Abuse Regulation. Similarly, it will not prevent the Insolvency Service from taking action under the Company Directors Disqualification Act 1986. ARGA's powers to take civil regulatory enforcement action against PIE directors will work in tandem with those of other regulators, including the FCA, the Insolvency Service and the Serious Fraud Office. ARGA will not have any powers to prosecute offences and will refer relevant cases on to other regulators, for example the Serious Fraud Office or the Insolvency Service.

Directors in scope of new enforcement powers

The Government continues to believe that all directors of PIEs ought to be in scope due to the principles of collective responsibility and a unitary board. However, the new directors' enforcement regime will be targeted and proportionate, taking account of an individual director's role, responsibilities, and experience so they are only accountable for what could be reasonably expected of a person in their position.

Companies and organisations in scope of new enforcement powers

All PIEs will be in scope of the new directors' enforcement regime. If a subsidiary company meets the 750:750 threshold for a PIE, its parent company will also be a PIE (if it is UK incorporated), irrespective of whether the parent company meets the PIE definition in its own right. As a result, the directors of both companies will be subject to the new directors' enforcement regime. A parent company will also be a PIE (provided it is UK incorporated) if the consolidated accounts of the group collectively meet the new 750:750 threshold, even if the parent company does not meet the PIE definition in its own right. In these circumstances, the directors of the parent company will be subject to the new enforcement regime. However, the directors of a subsidiary in such a group would not be subject to the directors' enforcement regime unless the subsidiary company meets the definition of a PIE in its own right.

The Government is considering whether, in exceptional cases, ARGA should have powers to investigate and take action against directors of non-PIEs, where it is in the public interest for the regulator to do so. For example, in the case of non-PIE subsidiaries of a parent company which is a PIE, this may be appropriate to ensure that the directors of the subsidiary companies are accountable for the reporting that feeds into the group's annual report and financial statements. The Government also wants to ensure that the new regime does not lead to corporate structures being used as an avoidance measure. However, any exceptional cases will have to be both genuinely exceptional and genuinely in the public interest.

The Government has considered whether the directors of third sector organisations, including charities, should be exempt from the directors' enforcement regime, even where those organisations are PIEs, and concluded that such an exemption would not be in the spirit of the overall proposals and approach. The measures being put in place are intended to apply to all PIEs in view of the significant public interest in the trustworthiness of their reporting.

Duties in scope of new enforcement powers

ARGA's new enforcement powers will apply to breaches of the directors' statutory duties relating to corporate reporting and audit and, in relation to this, ARGA will need to set out what it reasonably expects of PIE directors by way of compliance with their legal duties.

The White Paper proposed that ARGA should have powers to set further requirements which elaborate on directors' statutory duties relating to corporate reporting and audit and clarify how directors would be expected to demonstrate that they have complied with these duties. This approach would potentially make the new directors' enforcement regime more transparent and the Government also wants to make it as easy as possible for directors to understand their legal obligations. As a result, the Government will work with the FRC to determine how best to elaborate on directors' statutory duties, so that regulatory enforcement applies effectively to all directors in scope of the new regime.

Behavioural requirements

The Government believes that it is in the public interest for directors of PIEs to be held to account if their conduct falls short of certain behavioural expectations, in the context of directors' duties relating to corporate reporting and audit. Examples given in the Response Document are where key decisions taken by the directors were improper, perhaps because the decision-making was dishonest or tainted by bias. These questions are potentially more serious than whether the financial statements strictly complied with the legal requirements. The intention is that PIE directors may be held to account if they fail to comply with well-established values that are already embodied in directors' existing general duties in statute. 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 believes that there may be exceptional cases where it is in the public interest for ARGA to investigate and enforce directors' duties, notwithstanding that the entity in question is not a PIE and is considering how and whether the behavioural aspect of the new directors' enforcement regime should apply in such cases.

The Government believes an effective enforcement regime should promote compliance with the law and with what stakeholders can reasonably expect of PIE directors, so the aim of the new civil enforcement regime is not to catch directors out, but to improve standards of corporate reporting and engagement with audit, in the public interest.

Implications for UK company law

In response to concerns that the new civil enforcement regime would have implications for UK company law, the Government states in the Response Document that it recognises that the directors' general duties in Part 10 of the CA 2006 are owed to the company itself and it has no intention of interfering with the relationship between the directors and shareholders (acting on behalf of the company). Shareholders will still be able to seek redress through the courts to the same extent that they can now. Such proceedings may or may not be taken in parallel with investigations and enforcement action taken by ARGA which will act in line with its own objectives, on behalf of the public interest, not on behalf of shareholders.

Strengthening clawback and malus provisions in directors' remuneration arrangements

The White Paper included proposals to strengthen malus and clawback provisions in directors' remuneration arrangements to complement the stronger powers to take enforcement action against PIE directors and ensure that remuneration can be withheld or recovered if there are serious director failings.

However, in light of comments received, while the Government continues to believe that companies that follow the UK Corporate Governance Code should explain more clearly to shareholders and other interested parties what malus and clawback conditions they have in place and be encouraged to consider a range of possible conditions, it does accept that the proposed conditions in the White Paper could benefit from increased clarity, and that there are risks in prescribing a one-size-fits-all approach for every remuneration committee to follow. The Government also accepts that it is important for remuneration committees to retain flexibility to design and enforce their own malus and clawback polices so that they can be tailored to a company's specific circumstances.

As a result, the Government will invite the FRC to consult on how the existing malus and clawback provisions in the UK Corporate Governance Code can be developed to deliver greater transparency and to encourage consideration and adoption of a broader range of conditions in which executive remuneration could be withheld or recovered, beyond that of 'gross misconduct' or 'material misstatements' (which account for the majority of malus and clawback conditions currently). For example, the UK Corporate Governance Code could set out an illustrative set of malus and clawback conditions, taking account of stakeholder feedback on the conditions proposed in the White Paper, which remuneration committees should consider in developing their own arrangements.

Audit purpose and scope

The Brydon Review looked not only at issues around audit performance but also at what audit is for and what should be expected of it. In light of the Brydon Review's findings on audit, the White Paper included a number of proposals in this area, for example, a new purpose statement for auditors, enforceable by ARGA, a new statutory duty for auditors to consider wider information and enhanced auditor reporting.

Making audit fit for purpose

The Response Document notes that while consultation responses generally supported the Government's aim for audit to become more trusted, more informative, and so more valuable, they raised a number of issues about how best to achieve this in practice.

The Government notes that a decision on whether to develop a non-binding purpose statement for audit, and its content, will be for ARGA but it continues to believe there needs to be a shift along the broad lines proposed by the Brydon Review, in terms of auditor mindset and behaviour. However, the Government agrees with respondents that this impact on auditor mindset and behaviour can be achieved through changes to standards, additional guidance, and enforcement by ARGA, rather than through additional legislation. As a result, ARGA will seek to deliver change in this area through ongoing improvements to auditing standards and guidance, to help ensure auditors are fully and consistently considering wider information in reaching their audit judgements.

The Government also believes that ARGA should consider the Brydon Review's recommendations to provide users of audit with more meaningful and useful information, while also ensuring that reports are clear, concise and accessible.

Widening the scope of audit

While the Government continues to share the Brydon Review's long-term vision of corporate auditing, for audit to expand beyond the scope of financial statements in order to become more informative for users of audit, it accepts that it will take some time for the market to develop to the point at which a regulatory framework is needed. As a result, the Government will leave the market to shape the development of an enhanced wider assurance services market in the coming years, stimulated by the requirement to publish an AAP. It will then monitor the market-led development of wider assurance to determine when regulatory oversight is necessary.

Rather than establish in law principles of corporate auditing, ARGA will be expected to seek to raise standards of auditor behaviour using its existing powers, for example by incorporating aspects of the principles proposed in the Brydon Review that are not already covered into existing standards, in order to improve audit quality.

True and fair view requirement

The Government will retain 'true and fair' as the standard for company financial reporting. The Response Document notes that there is a general view that this is meant to be functionally identical to the alternative formulation of 'present fairly, in all material respects,' so any change is likely to be of limited value in practice.

Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs)

The Government will leave directors and investors to decide whether specific assurance on APMs and KPIs is necessary through the AAP process. ARGA will be asked to consider whether further guidance is required, as part of any wider AAP guidance, for the reporting and assurance of APMs and KPIs.

Auditor liability

The Government will not make legislative changes in regards to auditor liability at this stage. While the Government is keen to see increased innovation and competition in the audit market, it does not believe that changes to auditor liability in either direction are the most effective way of addressing this. The Government is concerned that auditor liability reduction could have perverse outcomes in terms of audit accountability, while any moves to increase auditors' liability could lead to greater risk-aversion in audits.

Tackling fraud – Directors' responsibilities and related reporting

In the White Paper, the Government set out proposals to legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud.

In light of responses, the following steps are to be taken:

- Given the support among respondents for the proposal for a directors' statement on fraud, and the wide acceptance that the board (and management) have primary responsibility for the prevention and detection of fraud, the Government intends to proceed with the proposal that directors should report on the steps they have taken to prevent and detect material fraud. This requirement will apply to PIEs above the 750:750 threshold.
- The Government has decided that auditors' existing requirements to identify and report material inconsistencies in directors' reporting will be sufficient in reporting on directors' fraud statements.
- The Government proposed that auditors should report on the steps they have carried out to detect fraud and to assess relevant controls. The Response Document notes that SA (UK) 700 (the standard which establishes the requirements about how auditors report) and the FRC's recent revisions to audit standard ISA (UK) 240, clarify the auditors' responsibilities and require that auditors provide context-specific explanations of the extent to which their audit was considered capable of detecting irregularities, including fraud. As a result, before considering further action, the Government will wait to see if these revised standards have the anticipated effect in clarifying what is expected of auditors in explaining the work they have done to detect fraud and to assess the effectiveness of relevant fraud controls.

Audit Committee oversight and engagement with shareholders

In the White Paper, the Government proposed giving ARGA powers to set additional requirements as to the audit committee's role in the appointment and oversight of auditors as well as new regulatory powers for ARGA where problems exist, such as when an auditor resigns, when a PIE is unable to find an auditor and when a persistent issue with audit quality is identified.

Additional requirements for audit committees

The Government continues to believe that new requirements on audit committees will increase consistency and ensure that auditor appointments are made based on auditor competence and their ability to challenge the company critically. The Government therefore intends to proceed with giving ARGA the power to set minimum requirements on audit committees in relation to the appointment and oversight of auditors. This will ensure the requirements are enforceable, which the Government regards as preferable to the 'comply or explain' approach of the UK Corporate Governance Code in this case, which only premium listed entities are currently required to apply. As part of the standards, ARGA will also include appropriate provisions to encourage shareholder engagement with an audit.

ARGA will be tasked with drafting clear and concise minimum standards that do not conflict with other requirements imposed on audit committees and the draft standards will be consulted on before they are introduced. The scope of these requirements will be set out in legislation and the Government intends that they should apply initially to FTSE 350 companies. Once the requirements have been implemented, ARGA will monitor their impact and the Government will consider whether it would be proportionate to extend them to a wider community of PIEs.

Monitoring compliance with new audit committee requirements

In line with the White Paper proposals, the Government will also empower ARGA to monitor compliance with the new requirements on audit committees. Monitoring will be conducted through reviews of publicly available information as well as new powers to obtain information and reports.

In cases of failures of compliance, ARGA would also have power to impose sanctions.

The Government has concluded that it is not appropriate or necessary to provide a power for ARGA to place an independent observer on the audit committee, as proposed in the White Paper. An appropriate monitoring system will be possible through information provided by other means and, where necessary, through expert reviews. The Government envisages that an expert reviewer would be appointed to consider the work of an audit committee only in very limited cases, such as when a company has parted with its auditor outside the normal rotation cycle or audit quality issues have been identified and the audit committee appears to be implicated by audit failings.

Independent auditor appointment

In the FRC Review, Sir John Kingman recommended that ARGA should be given powers to independently appoint auditors in certain circumstances, including where quality issues have been identified around the company's audit or a company has parted with its auditor outside the normal rotation cycle. However, for a number of reasons, the Government stated in the White Paper that while it did not consider it appropriate to give ARGA these powers currently, it was considering whether to legislate to provide flexibility for ARGA to be given such powers in the future.

While the Response Document notes that Sir John Kingman's recommendation received some support, the Government has concluded that it would risk undermining the independence of the audit committee, would be difficult to implement without a supplementary power to compel the auditor to undertake an audit and would present significant challenges to ARGA's ability to supervise and inspect any such audits independently. As a result, the Government has decided not to legislate to provide flexibility for ARGA to be given such powers in the future. Instead, the Government will continue to rely on the powers in the CA 2006 for the audit committee, directors and ultimately shareholders to appoint the auditor. The existing fall back provisions for the Secretary of State to do so will be amended as part of an enhanced framework for the enforcement of tendering, rotation and managed shared audit requirements by ARGA, which is being developed.

Shareholder engagement with audit

The Brydon Review called for more informed and meaningful shareholder engagement in the annual audit planning process through the establishment of a formal mechanism, where shareholders can share their suggestions for the audit plan with the audit committee. The White Paper sought views on this, on shareholder engagement on audits at general meetings and on shareholder engagement on auditor removal or resignation.

The Government continues to believe that a formal mechanism should be established to enable audit committees to gather shareholder views on the audit plan and it continues to believe that shareholders should have better opportunities to ask questions about the audit at an AGM, although it does not believe a standing AGM item is necessary or sufficient to achieve greater shareholder engagement.

The Government now believes that the most appropriate way to encourage shareholder engagement with audits is to include appropriate provisions in the audit committee requirements that ARGA will have the power to put in place. Those powers will need to be wider than those proposed in the White Paper to allow the new audit committee requirements to cover the ability for shareholders to consider and respond on the audit plan and to consider the risk report. The changes would also enable greater engagement with the auditor at the company's AGM. Alongside this, and when appropriate, ARGA will also put forward revisions to the Stewardship Code along the lines proposed in the White Paper to promote greater engagement from investors on matters relating to audit quality. ARGA will consult on specific proposed changes in due course and consider how they might enhance engagement by shareholders at AGMs.

Having considered views in relation to the information provided to shareholders when an auditor ceases to hold office, the Government plans to introduce legislation to improve notices of auditors ceasing to hold office for PIE audits. This will implement proposals in line with Brydon Review recommendations, to require certain positive statements by the auditor relating to their recent relationship with the company and its audit committee.

Competition, choice and resilience in the audit market

The CMA Study recommended a suite of measures to improve quality and competition in the audit market and the White Paper set out a number of proposed reforms to increase choice, competition and resilience in the audit market. These included a managed shared audit requirement for UK-registered FTSE 350 companies with limited exceptions, so that when tendering the statutory audits of entities within the group, such companies would be required to appoint a challenger audit firm to conduct a meaningful proportion of the statutory audits. Another was that, if in due course a review of managed shared audits concluded that they were not making sufficient progress in supporting challenger firms to become sole auditors of FTSE 350 companies, the Government would make use of a reserve power to introduce a market share cap. This would require a proportion of audits to be tendered exclusively for challenger firms, based on their capability and capacity.

Market opening measures – managed shared audits for UK FTSE 350 companies and market cap

The Response Document notes that the managed shared audit proposal received mixed views, raising complex operational and definitional questions that will need addressing by the Government and ARGA when implemented. However, the Government is confident those questions can be addressed and is to proceed with the market opening measures, which will be implemented over time and in a phased manner as audits fall to be tendered under the existing tender cycle. In connection with this, the following should be noted:

- Meaningful proportion – In defining the boundaries of 'meaningful proportion', the Government plans to legislate to give ARGA the power to set this percentage. This approach will allow ARGA to amend and to increase the percentage over time as challengers grow in capacity and capability, and as ARGA learns more about the effectiveness of the overall managed shared audit regime. ARGA will also be able to define the percentage in terms of revenues, profits, assets or audit fees and to set requirements and issue guidance accordingly.

- Legal subsidiaries to be basis – In determining the composition of the meaningful proportion, many respondents were concerned about the prospect of legal subsidiaries being used as the basis of the managed shared audit regime. The Government notes these concerns, but believes that in many cases the appointment of challengers to one or more legal subsidiaries will continue to be the cleanest and simplest basis for UK incorporated FTSE 350 companies to divide the group audit, to appoint challenger firms, and to meet the meaningful definition threshold set by ARGA. In addition, the use of subsidiaries also enables challengers to take sole responsibility for their audit and to be accountable to the audit committee. As a result, legal subsidiaries will remain the primary basis of the managed shared audit regime, but if companies believe they can reach the minimum threshold in other ways, they will be able to do so in exceptional circumstances. To enable this, some flexibility will be provided to those companies to seek alternative approaches to identify a meaningful proportion through the exemptions regime in collaboration with ARGA.
- International subsidiaries – UK incorporated FTSE 350 companies will have flexibility to include international subsidiaries when allocating a meaningful proportion if they choose to do so as this will help challenger firms develop stronger international networks, and removing international subsidiaries from scope would restrict challenger firms' ability to demonstrate the necessary experience to win a group audit in future. This means audit committees will have the option to appoint a challenger firm to conduct audits of one or more international subsidiaries in order to meet the minimum threshold as defined by ARGA, but the audit committee will not be required to include an international subsidiary when deciding how to allocate the group audit under the managed shared audit regime.
- Exemptions framework – This will be built into the market opening measures as circumstances may arise where challenger firms may not be able to act as sole group auditor or may not wish to bid for a meaningful proportion of an audit, and where a lack of experience or capacity may significantly compromise audit quality. In addition, the Government acknowledges that the minimum meaningful proportion threshold may represent a very large quantity of audit work in absolute terms for the very largest companies in the FTSE 350. As a result, the Government and ARGA will develop an exemptions framework that will allow ARGA to grant exemptions under limited circumstances and to impose conditions on those companies that are granted exemptions, where appropriate.
- Market share cap – While not to be introduced initially, powers will be made available to introduce a market share cap in future if it becomes clear that choice in the FTSE 350 has not significantly improved. This will include a proportion of audits being reserved for challenger firms based on challenger firm capacity and capabilities.

Operational separation between audit and non-audit practices

The CMA Study concluded that the multidisciplinary structure within large firms has resulted in behavioural and financial incentives that undermine independence and professional scepticism and sometimes lead to poor quality audits. The Government shares these concerns and, while it recognises that a multidisciplinary structure brings advantages, announced in the White Paper that it had decided to take forward the CMA's central recommendation to strengthen the oversight of audit practice through an 'operational separation' between the audit and non-audit sides of firms.

In light of responses to the proposals the Government is to take the following steps:

- While acknowledging the progress the FRC has made in implementing operational separation on a voluntary basis with the Big Four firms, the Government believes it is important to underpin these voluntary arrangements with legislation so will legislate to give ARGA powers to design and deliver an operational separation.
- The Government wants to see increased transparency in relation to the financial statements of the audit practice and remuneration policies that set audit partner pay so ARGA will have powers to increase transparency in both of these areas, including rules to require the publication of separate profit and loss financial statements for audit practices.
- Separate profit pools within multidisciplinary firms will not be mandated as this would not be proportionate at this stage.

- The Government will seek a power to make regulations to deliver full structural separation of audit and non-audit parts of the business if operational separation fails to yield an increase in audit scepticism, independence and quality.

Resilience of audit firms and the audit market

The CMA Study and the FRC Review recommended a suite of measures, that taken together, would improve the resilience of individual audit firms and the PIE audit market. To give these measures effect, the Government proposed enhancing the range of statutory powers available to the regulator so that it has a more powerful role in monitoring these areas.

In light of responses to the proposals, the following will be done:

- The FRC's duties (and ARGA's in due course) to monitor developments in the PIE audit market will be extended to the whole statutory audit market in line and ARGA will have the power to require information to monitor the health and viability of firms.
- To supplement its information gathering powers, ARGA will also have powers to require audit firms to address any audit quality and resilience concerns identified and powers to enforce against any non-compliance if firms fail to comply with information requests or with ARGA's use of its powers to address viability concerns.
- The Government proposed giving the regulator the power to commission an expert review of audit firms and since respondents broadly supported this, ARGA will have similar powers to those in section 166 Financial Services and Markets Act 2000. This power will be available in relation to all statutory audits but the proposals to require minimum insurance levels and capital requirements are not being adopted.
- Some respondents proposed a statutory liability cap as a mechanism to improve resilience in the market. The Government believes a liability cap would limit the ability of companies and shareholders to seek sufficient resolution in the event of audit failure so is not pursuing this. However, ARGA will be given the power to operate a market share cap if a major audit firm fails. This measure is intended to give ARGA the ability to react quickly and to limit further concentration in the FTSE 350 audit market in the event of audit firm failure.
- The Government intends to extend the market monitoring powers under the Enterprise Act 2002 to ARGA, so that ARGA can effectively conduct market studies. However, the Competition Act 1998 powers will not be extended to ARGA.

Supervision of audit quality

Both the FRC Review and the Brydon Review made recommendations about the regulator's role in supervising statutory auditors and audits to ensure their quality, including the approval of auditors and audit firms carrying out audits of PIEs, monitoring the quality of their audits and responding to shareholder concerns relating to individual audits, and regulating component audit work undertaken outside the UK. Proposals to implement these recommendations were set out in the White Paper.

Approval and registration of statutory auditors of PIEs

The FRC Review recommended that the approval and registration of audit firms carrying out PIE audits should be carried out by the regulator, rather than by Recognised Supervisory Bodies (RSBs), professional accountancy bodies recognised by the FRC, as is currently the case. Since there was more support for this proposal than disagreement, the 2016 Ministerial Direction that currently directs the FRC to delegate all those tasks which the law permits to be delegated to the RSBs, other than in certain circumstances, will be retracted. A new Ministerial Direction which achieves this retraction will come into effect on July 31, 2022 so that the regulator can move forward with reclaiming the function of determining the eligibility criteria for approval of statutory auditors of PIEs.

Monitoring of audit quality

Currently, the FRC is required to carry out inspections of statutory auditors of PIEs and certain other entities. These inspections, Audit Quality Reviews (AQRs), must be performed at least once every three years, although in some cases the inspection can be carried out every six years. To ensure higher levels of transparency as to the performance of PIE auditors, the Government proposed legislating to allow AQR reports on individual audits to be published by the regulator without the need for consent from the audit firm and the audited entity.

In light of responses, rather than legislating specifically for the publication of AQR responses by the regulator, the Government is asking the FRC to look at non-legislative ways of improving the AQR process and continuing to seek consent from audit firms and audited entities where possible before publication. In addition, the Government is asking the regulator to engage with investors and other users to improve the usefulness to them of the information published on AQR.

Regulating component audit work done outside the UK

The FRC Review identified a potential source of difficulty with monitoring audit quality where a UK group auditor depends on the work of one or more auditors of overseas components in relation to a UK entity's group accounts. The FRC Review called for the FRC's monitoring approach in respect of the work of overseas component auditors to be changed, on a risk-based basis. As a result, the Government proposed to provide the regulator with its own powers to require a UK group auditor to provide it with access to overseas component working papers, instead of relying on the RSB rules, in order to enable the regulator to assess more thoroughly how well the UK group auditor has discharged its responsibilities.

However, having considered comments received and discussing them with the FRC, the Government has concluded that current arrangements already allow the regulator to obtain access to overseas component working papers, without needing to rely solely on RSB rules, subject to the issue of restrictions imposed by other countries. As a result, the existing arrangements on access to overseas component working papers will be maintained.

The application of legal professional privilege in the regulation of statutory audit

The FRC identified that its inspections and investigations of statutory audit risk were being hampered because certain documents that may be crucial to the auditor's work are sometimes inaccessible to the regulator, since they are covered by the audited entity's legal professional privilege. The Government sought views on this to help it decide if a proportionate and effective solution is possible.

Having considered comments on this, and while believing it is undesirable for the regulator's access to important audit documents to be restricted, the Government acknowledges the real challenges to finding a workable solution to this complex issue. As a result, it wants legal and audit professionals to work with the regulator to resolve any issues that arise from instances where privileged documents shared with the auditor are not available to the regulator's quality review system and enforcement system. The Response Document notes that auditors who cannot share key documents will find it hard to demonstrate the quality of their audit, and may need to convince audited entities to provide access to the regulator in some mutually acceptable manner. This might, for example, involve a data room or other confidentiality mechanism that allows the regulator to see a document but not retain a copy.

If lack of access to documents due to claims of legal professional privilege pose ongoing difficulties for effective regulation, the Government expects this to be identified as part of its planned Post-Implementation Review. [3]

A strengthened regulator

The FRC Review concluded that the FRC should be replaced with a new statutory regulator with clear statutory powers and objectives and, in the White Paper, the Government set out its proposals to establish ARGA as this new regulator, with a general objective 'to protect and promote the interests of investors, other users of corporate reporting and the wider public interest.'

This general objective received widespread support, as did the other proposals regarding the operational objectives and governance arrangements for ARGA, as well as proposals to fund the regulator through a statutory levy. As a result, the formulation set out in the White Paper is largely to be proceeded with.

3 The Post-Implementation Review is to be carried out five years after its reform legislation first comes into force.

Additional changes in the regulator's responsibilities

Other responsibilities and powers to complement ARGA's role were proposed in the White Paper, including powers to act on serious concerns relating to corporate reporting and audit. These included proposed powers to require rapid explanations from companies about reasonable concerns identified by the regulator and to require an expert review where the regulator identifies concerns relating to a PIE's audit or corporate reporting.

Investor stewardship and relations – UK Stewardship Code

The FRC Review recommended that a fundamental shift in approach was required to ensure that the UK Stewardship Code differentiated 'excellence in stewardship' and that signatories were transparent about the activities and outcomes of their stewardship, rather than solely on their stated approach or policies. As a result, the Stewardship Code was amended with effect from January 2020 but the White Paper stated that a review into the regulatory framework for effective stewardship would be undertaken in due course.

The Response Document announces that the FRC, working with the FCA, the Department of Work and Pensions (DWP) and The Pensions Regulator (TPR), will carry out this review in 2023. The review will assess whether the Stewardship Code is creating a market for effective stewardship and the need for any further regulation in this area, and the Government will work with these bodies to determine the criteria by which the success of the Stewardship Code will be measured.

Powers of the regulator in cases of serious concern about a PIE

In light of its agreement with the FRC Review that it is important that PIE auditors report to the regulator when they have viability or other serious concerns about a PIE during the course of an audit, the Government included proposals in the White Paper to prompt auditors and the regulator to identify and act on serious concerns in PIEs at an earlier stage, so as to limit the likelihood of corporate failure as far as possible. This included building on the regulator's use of market intelligence and consideration of the disclosures that auditors are required to make to the regulator.

The Response Document notes that the FRC continues to develop and strengthen its use of market intelligence to give it a more holistic view of emerging risks and the Government believes this should enable the FRC to take a more proactive approach to ensuring compliance and to target its enforcement activities more effectively.

Given existing auditing standards, the Government has decided not to introduce any additional matters to be reported to the regulator at the moment as this could result in over-reporting to the regulator and loss of transparency between the auditor and company being audited. However, the regulator will be asked to consider whether amendments to the auditing standards or the introduction of standalone guidance may be helpful to improve clarity on the circumstances in which reports should be made by auditors, especially with regards to concerns around viability and resilience.

Powers to address serious concerns about PIEs

The FRC Review recommended that the regulator be given various powers to investigate and take action when it has serious concerns about a PIE. It recommended that the regulator be given powers to require rapid explanations from the company about concerns, to commission an expert review (at the company's expense) akin to the 'skilled person reviews' commissioned by the FCA and PRA, and to take further action including publishing the expert review or requiring the company to take certain steps to address any serious issues identified. For the most extreme cases, the FRC Review recommended that the regulator should be able to issue a report to the company's shareholders.

The Government has decided, following further analysis, that the regulator's powers with respect to a company's statutory audit are already sufficient and should be transferred to ARGA. The powers in respect of corporate reporting are also considered adequate, although the Government will consider further how to ensure that these powers are sufficient to enable ARGA to prescribe a timetable for responding to requests which a court would be able to enforce.

So far as the power to require an expert review is concerned, the Response Document notes that responses to the White Paper supported the case for giving ARGA powers to commission expert reviews of matters of concern in relation to corporate reporting. The FRC's existing corporate reporting review powers allow it to request information from a company and, if necessary, to secure changes to the report and accounts but it is pointed out that there are challenges for the regulator in directing changes to matters involving significant judgements such as accounting for long-term contracts and impairment reviews. The power to commission an expert review will allow the regulator to instigate a review into the underlying reasons for an accounting application and allow it to make a better assessment of any required changes.

The Government believes the power to commission an expert review will only be used in exceptional circumstances where ARGA has been unable to obtain the information and explanations it requires directly from a company or its auditor. ARGA will be given powers to publish summaries of these reviews where it is in the public interest to do so and subject to the need to safeguard commercially confidential material. ARGA will be expected to publish its policy and procedures for the use of these powers.

Conclusion

While the Government states in the Response Document that the majority of respondents accepted the need for reform set out in the White Paper, inevitably views differed, and will continue to differ, on individual proposals, and there were particular concerns about the impact of the reforms on smaller PIEs. Many will be relieved that the Government has taken proportionality into account so that, by raising the PIE size threshold to the 750:750 threshold, not as many companies will now come within the PIE regime.

Directors of PIEs will welcome the decision not to put the directors' statement on internal control effectiveness on a statutory footing, as in the United States, nor to require the directors to make a solvency statement when proposing to pay dividends, but they may have concerns about some of the other new reporting requirements they will have to meet. For the directors of the largest PIEs, these will include a Resilience Statement, an AAP and confirmations as to the legality of dividends they propose to pay. Large private companies and those on MTFs such as AIM, which come within the new PIE 750:750 threshold, will need time to put in place the necessary procedures and processes to enable them to meet these requirements.

Although it is welcome that the Government acknowledges this, concerns remain that these increased responsibilities could deter some from becoming a PIE director.

Similarly, some directors and potential directors of PIEs are also likely to be concerned about ARGA's new enforcement powers in relation to breaches and potential breaches of the new corporate reporting and audit requirements. Given the Government's acknowledgement in the Response Document that this will result in some degree of overlap and duplication with the powers of other regulators, the possibility of parallel or competing investigations by different regulators into essentially the same circumstances will alarm some. They will not necessarily be convinced by the Government's claim that this should not result in unfairness to the companies or directors concerned.

It remains to be seen whether giving ARGA, as the new regulator, greater powers than the FRC currently has, will necessarily result in more trustworthy and informative corporate reporting and audits. What is clear as far as corporate reporting and audits are concerned, is that companies will have to incur extra costs in relation to the assurance of a wider range of information going forward, and for UK incorporated FTSE 350 companies, the proposals around managed share audits will give audit committees plenty to consider.

The timing of many of the requirements, and the precise detail surrounding them (including best practice guidance in many cases), is still unclear.

As with the White Paper, the 'devil will be in the detail' and that will now be keenly awaited.

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43348_EMEA – 06/22