NORTON ROSE FULBRIGHT

Restoring trust in audit and corporate governance: A look at the Government's White Paper proposals

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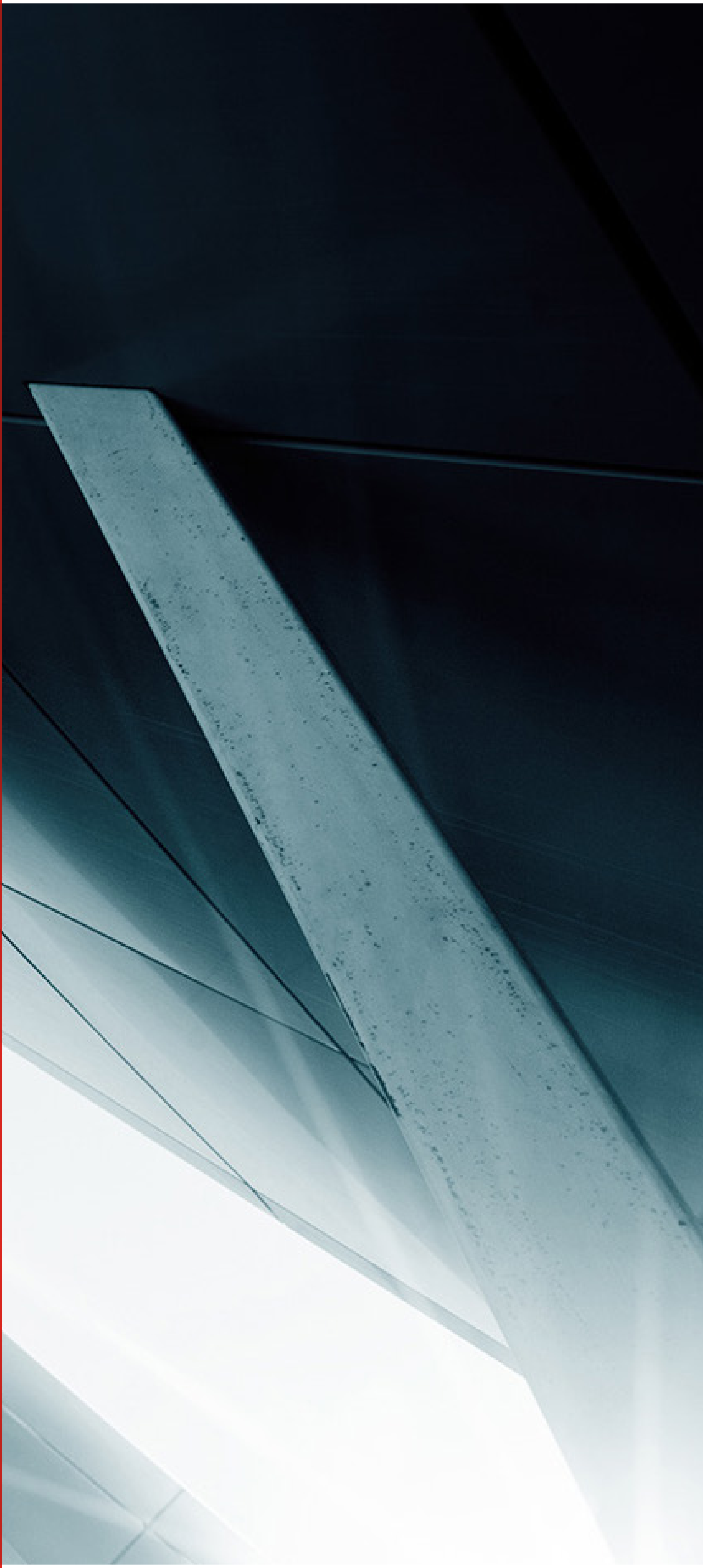

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Introduction

On March 18, 2021 the Department for Business, Energy and Industrial Strategy (BEIS) published the Government's long-awaited White Paper setting out wide-ranging reforms to the UK's audit and corporate governance framework.

Many of the proposed reforms stem from recommendations made by three independent reviews into audit and corporate reporting. These comprise 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 is looking to address and this briefing considers the reforms proposed.

Timetable for introduction of the reforms

The White Paper includes 98 consultation questions, with the consultation period ending on July 8, 2021. The reforms are to be introduced *"over an appropriate timetable".* Some measures will require primary legislation that will be introduced when Parliamentary time allows, some may be introduced by secondary legislation and some will not require legislation at all.

To balance the urgency of audit reform with its desire to manage additional requirements on businesses, the Government intends to take the following overall approach to the introduction of the proposed reforms:

- Measures that do not directly impact on businesses would generally be brought into effect quickly, for example, measures associated with establishing the new regulator, the Audit, Reporting and Governance Authority (ARGA).
- Measures with significant impacts on those regulated by ARGA would be commenced quickly, but transition periods and/or phasing (particularly for those newly in scope of ARGA) may be introduced to ensure a smooth introduction.
- Measures with significant impacts on wider business are most likely to be considered for later commencement, a transition period and/or phasing. In particular this would include the proposed extension of the definition of Public Interest Entities and introduction of a stronger internal controls regime (see further below).

Wider definition of "public interest entity"

The reforms in the White Paper focus on the largest companies, "public interest entities" (PIEs), as the Government believes that this is where there is greatest public interest in ensuring that audit and corporate reporting are functioning effectively. At the same time, it proposes extending the group of companies that are PIEs.

PIEs, defined currently as entities whose transferable securities are admitted to trading on a regulated market, credit institutions or insurance undertakings, are already subject to more stringent requirements and oversight than other entities. The Government proposes expanding the PIE definition so that existing requirements for PIEs, together with those proposed in the White Paper, apply to more large businesses in which there is public interest, either because their purpose has public benefit or they are of wider economic significance so increased investor protection is needed.

Large companies as PIEs

Since the Government sees size as a significant factor in determining whether a company is a PIE, it proposes extending the PIE definition to include certain large companies, whether or not they are traded on a regulated market, including large private companies.

Two options for identifying large companies for these purposes are 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 could be adopted. These are companies with either more than 2,000 employees, or a turnover of more than £200 million and a balance sheet of more than £2 billion.

Option 2
This would be a narrower test which incorporates the threshold for additional non-financial reporting requirements for existing PIEs. This would extend the PIE definition to large companies with both over 500 employees, and a turnover of more than £500 million.

The thresholds used under either option would apply to all companies in their own right. Additionally, in the case of parent companies, the thresholds would be applied to the group headed by that company so a parent company would qualify and be regulated as a PIE if the relevant thresholds for Options 1 or 2 were met when applied to the accounts of the group headed by that company (i.e. its consolidated financial statements), where the parent company is required to file group accounts in the UK.

AIM companies as PIEs

AIM companies are not currently PIEs although the Financial Reporting Council (FRC) has monitoring and sanctioning powers in relation to the audits of UK-incorporated AIM companies with a market capitalisation of more than Euro 200 million. While these AIM companies may not meet the size criteria in Options 1 or 2 above, as they offer their shares publicly, the Government considers them to be of public interest and so proposes that such AIM companies with market capitalisations above Euro 200 million should become PIEs.

Possible temporary exemption for private companies listing on a regulated market

If a private company seeking a listing on a regulated market is not a "large company" for the purposes of the new PIE definition, the listing will in itself result in the new PIE requirements applying to that company. So as not to deter private companies from listing, the Government is considering whether to make compliance with some or all of the proposed new PIE requirements optional for a period of time after flotation, subject to gross revenues remaining below a specified threshold.

Application of thresholds over an appropriate period

Given the significant implications of being designated a PIE, the Government will consider what provision should be made to ensure that the thresholds are applied over an appropriate period.

For example, a company might be 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. Consideration will also be given as to whether similar provisions could be applied for ceasing to qualify where these are not met.

Other possible entities as PIEs

Views are sought on whether Lloyd's Syndicates (already subject to enhanced audit monitoring and enforcement by the regulator) should become PIEs, whether large third sector entities such as universities, charities and housing associations should be included if they do not fall within the definitions proposed for large private companies, and whether any other entities should be included within the PIE definition.

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.

The White Paper sets out three possible options for strengthening the UK's internal controls framework (which are not mutually exclusive) as follows:

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

The UK Corporate Governance Code 2018 (Code), which premium listed companies are required by the FCA's Listing Rules to "comply or explain against", requires the board to establish a framework of prudent and effective controls which enable risk to be assessed and managed (Principle C) and Provision 29 calls on the board to monitor the company's risk management and internal control systems and, at least annually, to carry out a review of their effectiveness and report on that review in the annual report.

However, there is no specific requirement for boards to report whether they consider the internal control system to be adequate or effective, although many companies do provide such an assessment.

The White Paper notes that this aspect of the UK's framework could be strengthened by requiring the CEO and the CFO (or alternatively, the board collectively) to:

- Explain the outcome of the annual review of the risk management and internal control systems and make a statement as to whether they consider the systems to have operated effectively (this statement could cover all aspects of the company's internal control and risk management procedures or be restricted to the internal controls over financial reporting).
- Disclose the benchmark system, if any, that has been used to make the assessment.
- Explain how the directors have assured themselves that it is appropriate to make a statement.
- If deficiencies have been identified, set out the remedial action that is being taken and over what timeframe.

These new reporting provisions could be implemented via changes to the Code or through legislation to put the requirements on a full statutory footing (including a requirement to carry out an annual review).

In making this internal control statement, directors would need to explain the basis for making it so the board would need to decide on the benchmark or standard of effectiveness against which the internal controls were being assessed and decide on the degree of assurance it needed to satisfy itself that the control framework was effective in terms of both its design and implementation. For example, it could choose to rely on work by the internal auditors and/or commission additional work from the external auditors on all or specific aspects of the framework, subject to any barriers to them providing non-audit services.

Other issues to be considered would be whether under the Code or legislation (depending on which is chosen) companies should be required to use a specified internal control standard or one of a range approved by the regulator, or whether companies could choose the standard and explain why. The White Paper includes an illustrative list of factors for the board to consider when determining their approach.

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

Under Option B, the auditors' report would be required to say more about the work that they already undertake to understand the company's internal control systems and how that work has influenced the approach taken to the audit, but without requiring a formal attestation of their effectiveness. This option could be reinforced by placing a specific positive duty on the board (or the CEO and CFO) to disclose to the auditor and the audit committee any significant deficiencies and weaknesses in the internal controls of which they are aware.

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

Option C assumes that a directors' statement about the effectiveness of the internal controls (Option A) is required. It would involve the auditor in undertaking additional audit and assurance work to be able to express a formal opinion on the directors' assessment. Under Option A, the directors' statement could be a statement in respect of all aspects of the company's internal control and risk management procedures or only in respect of financial reporting. The auditor's attestation requirement would match the scope of the directors' statement.

The Government's initial preferred option

The White Paper sets out a potential model which focuses on internal controls over financial reporting and comprises the following:

- Directors' responsibility statement: Directors should be required to acknowledge their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
- Annual review of internal control effectiveness and new disclosures: Directors should be required to carry out an annual review of the effectiveness of the company's internal controls over financial reporting; explain, as part of the annual report and accounts, the outcome of the annual review, and make a statement as to whether they consider the systems to have operated effectively; disclose the benchmark system that has been used to make the assessment; and explain how they have assured themselves that it is appropriate to

make the statement. If deficiencies have been identified, these should be disclosed and the directors should set out the remedial action that is being taken and over what timeframe.

- Principles and guidance: In deciding on the approach to be taken to the internal control effectiveness statement, directors should be guided by principles and guidance developed or endorsed by the regulator, reflecting audit committee best practice.
- External audit and assurance: Decisions about whether the internal control effectiveness statement should be subject to external audit and assurance should usually be a matter for audit committees and shareholders. Decisions should be based on judgements about the strength of companies' systems and controls and whether extra assurance would be proportionate and considered as part of the proposed Audit and Assurance Policy (see further below). Companies should be required to have their internal controls assured by an external auditor in limited circumstances (for example, where there has been a serious and demonstrable failure of internal controls or where material control weaknesses have persisted over several years).
- Enforcement: The regulator should 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. There should be effective powers to sanction directors where they have failed to establish and maintain an adequate internal control structure and procedures for financial reporting.
- Scope: The requirements should be set out in legislation and phased in over a period of time. They should apply initially to premium listed companies who are already familiar with the concept of an annual review (with possible temporary exemptions for newly listed companies where gross revenues remain below a specified threshold) and be extended to other PIEs after two years.

Directors' accountability for dividends and capital maintenance

The Government is seeking to strengthen the laws on dividends and capital maintenance, noting that issues have arisen from high profile examples of companies paying out significant dividends shortly before profit warnings and, in some cases, insolvency.

These have called into question the robustness of the UK's legal framework in this area and the extent to which the dividend and capital maintenance rules are being respected and enforced.

The White Paper highlights three issues with the current legal framework:

- There is no fixed definition of realised profits and losses and companies need clear guidance on how to separate out the profits and losses shown in the accounts into what are and are not distributable profits.
- Although dividends can only be paid out of profits available for distribution (accumulated realised profits less accumulated realised losses), there is no legal requirement for companies to disclose these figures. The profits shown in the annual accounts do not necessarily equate to the realised profits (cash or close to cash) that are available to be distributed so there is a transparency issue.
- The law's focus on capital maintenance and realised profits and distributable reserves is backward looking, reflecting a company's past performance. These figures represent a snapshot in time but, on their own, do not provide any guide to the future performance of the company or its future financial requirements.

The White Paper sets out a number of proposals to deal with these issues:

Give responsibility for defining realised profits and losses to ARGA and enhance the legal status and enforceability of the definition

Two alternative reform options for this are proposed:

- ARGA, as the regulator of the accountancy profession, rather than the ICAEW as currently, should have a duty to prepare guidance on what should be treated as realised profits and losses in accordance with generally accepted principles prevailing at the time. This guidance would be given authoritative status by providing in the Companies Act 2006 (CA 2006) that, in interpreting what are realised profits and losses according to generally accepted principles, regard should be had to the guidance produced by the regulator; or
- ARGA should have powers to make binding rules (established by reference to the prevailing generally accepted principles) as to the meaning of realised profits and losses with which preparers would have to comply.

New requirements to disclose distributable reserves for listed and AIM companies

The following new statutory reporting requirements are proposed for listed and AIM companies:

- Disclosure of the distributable reserves in the financial statements: This proposal would involve individual companies (or, in the case of a group, the parent company only) within the agreed scope disclosing, in their annual report, the total amount of reserves that are distributable. The aim of this is to help identify the headroom between a proposed dividend and the distributable reserves, provide some insights into the company's ability to pay dividends in the future and help with assessments of the legality of proposed dividends. Including the distributable reserves figure in the financial statements would also mean that it would be subject to audit, providing further reassurances about compliance with the rules on dividends. Where it is impossible to calculate the figure exactly, for example where a company's profit history goes back many years, companies could report a "not less than" figure for its distributable reserves. Any proposed dividend payment would not be allowed to exceed the known figure.
- Disclosure of estimates of a group's dividend-paying capacity: Since in some group situations, the disclosure of the parent company's own distributable profits would understate the potential overall capacity to pay future dividends (for example, when significant profits are earned by subsidiaries and that profit has not yet been passed to the parent company and is therefore not yet available for distribution by the parent), the Government proposes also requiring a parent company to estimate and disclose the amount of potential distributable profits across the group that could, in principle, be passed to the parent company for the purpose of paying future dividends to shareholders. Narrative disclosures would be provided to explain any major constraints on the ability of a subsidiary to pay its distributable reserves to the parent. These disclosures would also be a part of the financial statements and so be subject to audit.

New directors' statement about the legality of proposed dividends and the effects on the future solvency of the company

To address criticisms of the current framework that it is too backward looking, and to increase directors' accountability in this area, the Government proposes that directors should, in proposing a dividend, whether interim or final, make a statement covering the following:

- Confirmation that in proposing the dividend, the directors have both satisfied themselves that the dividend is within known distributable reserves, and have had regard to their general duties under section 172(1) CA 2006 (including the need to have regard to the likely consequences of any decision in the long term) and their wider common law and fiduciary duties; and
- Confirmation that it is the directors' reasonable expectation that payment of the dividend will not threaten the solvency of the company over the next two years in the light of the risk analysis undertaken and the directors' knowledge of the company's position at the date the dividend is proposed. Where relevant, directors should also confirm that the dividend is consistent with the Resilience Statement (see further below).

Views are sought on whether this requirement for a directors' statement should be extended beyond listed and AIM companies, to apply to all PIEs or even all large companies, or whether this would not be appropriate as it would be inconsistent with the proposed scope of the new distributable profit reporting requirements.

Improved information for investors about company distribution policies

While the Government is aware that investors are interested in companies' dividend policies, including the frequency, timing and description of how the amount of payments is determined, it believes that the introduction of mandatory disclosures on distributable reserves and the requirement for a directors' statement about dividends will encourage companies to provide a fuller narrative for shareholders about dividend decisions and capital allocation strategies. It also considers that companies should have discretion to develop their own narrative approaches in line with investor needs, so considers that a new reporting requirement for this is not needed, but seeks views on this.

New corporate reporting requirements

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 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 sets out proposals for implementing both these recommendations.

Resilience Statement

PIEs would be required to publish an annual Resilience Statement, consolidating and building on the existing going concern and viability statement. It is suggested that the Resilience Statement should be required initially of premium listed companies, in view of their existing experience of producing viability statements (and subject to the possible exclusion of recently listed companies for a period), and should extend to other PIEs two years later.

The requirement for a Resilience Statement would be introduced, via legislation, as a new section of the Strategic Report, supported by non-statutory guidance to be maintained by ARGA. It is noted that consequential changes may be needed to the Code and the Listing Rules to ensure that there is no duplication across the Strategic Report, the Code and the Listing Rules, and the Government will also consider whether there is scope for companies to report existing statutory disclosures on risk within the Resilience Statement.

The short-term section of the Resilience Statement would incorporate a company's existing going concern statement, including disclosure of any material uncertainties considered by management during their going concern assessment, which were subsequently determined not to be material after the use of significant judgement and/or the introduction of mitigating action.

The medium-term section would incorporate the existing viability statement requirements to provide an assessment of the company's prospects and resilience, and to address matters which may threaten the company's ability to continue in operation and meet its financial liabilities as they fall due. However, the mandatory assessment period should be five years, rather than the three year period currently chosen by most companies who produce viability statements and viability reporting over the medium-term should do more to evidence scenario planning by companies. Views are invited on how this could best be achieved in practice. The Government intends, at this stage, to require companies to include at least two reverse stress testing scenarios in their Resilience Statement.

Further specific disclosures in both the short and medium-term sections of the Resilience Statement would be required since the Government believes there are resilience issues common to many, if not all, businesses, and it could be helpful to shareholders and other users to have these addressed specifically. These could include issues such as: threats to liquidity, solvency and business continuity in response to a major disruptive event (such as a pandemic) which disrupts normal trading conditions; supply chain resilience and any other areas of significant business dependency; digital security risks (both including external cyber security threats, and the risk of major data breaches arising from internal lapses); the business investment needs of the company to remain productive and viable; the sustainability of the company's dividend and wider distribution policy; and climate change risk.

The content in the long-term section of the Resilience Statement would not generally be prescribed but should set out what the directors consider to be the main long-term challenges to the company and its business model, and how these are being addressed. These might include the impact of long-term changes in demographics, technology, consumer preferences and other identified trends on the company's long-term business model.

Views are sought on whether the Resilience Statement as a whole, including the long-term section, should specifically address the impact of climate change on the company's business model and financial planning, and whether the Resilience Statement could provide a means for companies in future to provide disclosures consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), in whole or part.

The Government also agrees with the Brydon Review that companies should consider, as part of their Audit and Assurance Policy, whether any independent assurance is required of the Resilience Statement, as well as outlining the company's internal assurance of its content. Any such independent assurance would be in addition to that required by the statutory audit.

Audit and Assurance Policy

The introduction of a statutory requirement on PIEs to publish an annual Audit and Assurance Policy that describes the company's approach to seeking assurance of its reported information over the next three years 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 Government suggests that initially only premium listed companies would be required to produce an Audit and Assurance Policy, given their existing experience of reporting on internal and external auditing matters through the work of their audit committees. They would have at least a year from the entry into force of the reporting requirement to prepare and publish their Audit and Assurance Policy and to put it to a shareholder vote. Other listed and unlisted PIEs would have a further two years to prepare and publish their Audit and Assurance Policy.

The Government invites views on whether the Audit and Assurance Policy should include the following new disclosures at a minimum:

- 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 that required by statutory audit. The Government proposes that this should include an explanation of what independent assurance, if any, the company plans to obtain in relation to both the company's Resilience Statement in whole or part, and other disclosures related to risk; and to the effectiveness of the company's internal controls framework.
- A description of the company's internal auditing and assurance processes. This might include how management conclusions and judgements in the annual report and accounts can be challenged and verified internally, and whether, and if so how, the company is proposing to strengthen its internal audit and assurance capabilities over the next three years.
- A description of what policies the company may have in relation to the tendering of external audit services (for example, whether the company is prepared to allow the external company auditor to provide permitted non-audit services).
- An explanation of whether, and if so how, shareholder and employee views have been taken into account in the formulation of the Audit and Assurance Policy.

The Government also invites views on how possible additional assurance on Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs), as well as the directors' statement for the purposes of section 172(1) CA 2006, might be considered through the Audit and Assurance Policy.

While the Brydon Review proposed that the Audit and Assurance Policy should be published annually, providing a three year rolling forward look on a company's approach to the audit and assurance of its reporting, and be subject to an annual advisory shareholder vote in the case of listed companies, the Government seeks views on whether it should be published at least once every three years, rather than annually. It considers that this would give companies more time to gather shareholder and other views in advance of a new Audit and Assurance Policy being published, with those views being informed by the experience of the previous Audit and Assurance Policy operating over more than one reporting year.

The Government believes that the Audit and Assurance Policy and the corresponding shareholder vote are best implemented as new statutory requirements under the CA 2006. It will consider with the FRC whether supplementary guidance can be provided through additions to existing guidance under the Code covering risk, internal controls and the work of audit committees.

It is worth noting that, following publication of the White Paper, the ICAEW published a report setting out a number of recommendations for companies that may be required to produce and publish an Audit and Assurance Policy. In "Developing a meaningful Audit and Assurance Policy", the ICAEW report urges companies to "seize the moment" and develop such a Policy but, as part of the report, the ICAEW examines the challenges companies may face when creating a meaningful Audit and Assurance Policy and outlines how they might be overcome. Its nine recommendations are aimed at helping an Audit and Assurance Policy fulfil its potential.

Reporting on payment practices

The White Paper seeks 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).

A specific option being considered is to require the annual reports of PIEs to provide a summary of how the company (or group in the case of a parent 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.

This new requirement could apply either to all PIEs that are large companies and which therefore already meet the large company criteria for reporting under the PPRD, or only to PIEs with more than 500 employees, being the companies currently required to include a non-financial information statement in their Strategic Report. The Government welcomes views on these options, and also on what minimum content could be required of supplier payment summaries in annual reports.

Public interest statement

The Brydon Review also recommended the introduction of a public interest statement, but the Government will keep the case for this under review and is not proposing to introduce it as a new statutory requirement at this stage. The FRC's October 2020 discussion paper, "The Future of Corporate Reporting", included ideas for how a public interest report might be designed and comments received in response to the consultation on the White Paper and in response to that FRC discussion paper will help inform the Government's and the FRC's further consideration of the issue.

Supervision of corporate reporting

The Government wants 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 the regulator are proposed.

Power of regulator to direct changes to company accounts

The regulator's current power to seek a court order to amend company reports will be replaced with a power to direct changes to reports and accounts, and an appropriate mechanism to ensure fairness to the companies and enable them to challenge the regulator's decision is being developed. The Government recognises the challenge associated with directing changes to matters involving significant judgements such as accounting for long term contracts and impairment reviews, so a further new power for the regulator to commission an expert review (see further below) should allow the regulator to instigate a review into the underlying reasons for an accounting application and assess what changes might be required. The power to direct will extend to instances where an expert review has indicated that the report or accounts need to be amended.

Power to publish CRR correspondence and summary findings

To increase transparency over the regulator's CRR work, the regulator will have powers allowing it to publish correspondence entered into during the course of a CRR review, as well as summary findings (although there will be safeguards regarding the publication of information which a company regards as commercially confidential). However, first the Government wants the regulator to test whether a "summary of findings" will provide sufficient transparency for investors and other stakeholders about the nature of the issues raised in the course of a review and the eventual outcome.

Extension of CRR powers to the entire annual report

It is proposed that the entire content of the annual report should be brought within the scope of the CRR process so legislation will 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, both the legally required and voluntary elements of the report such as the CEO and chair's reports (but not disclosures required by overseas regulators, such as US SEC requirements for dual-listed entities).

The Government has already asked the FRC to extend its CRR scrutiny to all elements of the annual report. Where it has further questions or concerns about any aspects, for example about the consistency of the chair's statement with the rest of the report, these concerns will be included in an "issues letters" as a separate section. Although the regulator will not initially have formal enforcement powers for these aspects of the annual report, it is expected that companies will be willing to engage with the regulator on a voluntary basis and, where necessary, to make revisions.

Power to offer a pre-clearance service

The FRC Review recommended that the regulator should be able to offer companies a pre-clearance service for novel and contentious matters connected with the interpretation of accounting standards in advance of the publication of the annual accounts. While ARGA will be given the necessary powers to provide a pre-clearance service, including a statutory exemption from liability where it offers this service, the decision on whether and when to offer a pre-clearance service, and whether it should be preceded by a pilot, will be a matter for ARGA.

Measures to strengthen corporate reporting review activity

The FRC Review recommended that the Government, 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. This would include preliminary results and investor presentations. While the Government has decided not to extend the FRC's work into this area into this area, it has asked the FRC to undertake a pilot study of preliminary results and investor presentations, working with the FCA, to establish the extent of any inconsistencies between this information and the subsequent annual report and accounts. Where it finds inconsistencies, the FRC will engage with companies via an "issues letter". It will also liaise with the FCA where there is evidence of non-compliance with the FCA's rules, and the FCA's formal powers will be engaged where necessary.

The FRC, FCA and the Government will review outcomes from the pilot study once it is complete. If they conclude that applying the CRR process to a wider range of investor information could increase its quality and reliability and help strengthen the existing market supervisory regime, it will become a permanent feature of the regulator's work and the regulator will be given the additional powers needed to undertake this work effectively.

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 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.

The Government proposes 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. These powers would work in tandem with those already held by the FCA, as well as those held by other agencies including the Serious Fraud Office, and overlap or duplications between ARGA and the FCA would be avoided wherever possible. However, where it has been decided that it is not appropriate for a case concerning a director's conduct to be addressed by the FCA, ARGA will be able to take action for corporate reporting and audit related failings in relation to PIE directors, including those of listed companies and financial services firms.

Directors in scope of new enforcement powers

While the FRC Review proposed that a new directors' regime for PIEs should cover four key director roles (the CEO, CFO, Chair and Chair of the audit committee), the Government believes that all directors of PIEs ought to be in scope due to the principles of collective responsibility and a unitary board. The Government also intends to ensure that, where appropriate, the scope of the regulator's enforcement powers apply to PIEs which are not companies, such as limited liability partnerships.

Duties in scope of new enforcement powers

The regulator's new enforcement powers would apply to breaches by PIE directors of the existing statutory duties relating to corporate reporting and company audits but any new statutory directors' duties should also be capable of being enforced by the regulator if introduced into the regulatory regime for which the regulator is responsible. The Government also proposes giving the regulator the power to impose more detailed requirements as to how certain statutory duties relating to corporate reporting and audit are to be met by directors.

The Government is also considering whether PIE directors ought to be required more specifically to meet certain behavioural standards in the way they carry out their duties relating to corporate reporting and audit. For example, directors could be required to act with honesty and integrity when carrying out these duties so the regulator could take action against a director who, for example, failed to act with honesty and integrity when deciding what information should be revealed to the auditor.

Strengthening clawback and malus provisions in directors' remuneration arrangements

Malus and clawback provisions in directors' remuneration arrangements are to be strengthened 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.

The regulator is to be asked to consult on changes to the Code to include provisions which recommend that certain minimum clawback conditions or "trigger points" are included in directors' remuneration arrangements and that these have a minimum period of application of at least two years after an award is made. While initially applying to directors of premium listed companies, following a review, the Government will consider whether there is a need to further extend this to all listed companies, potentially through the Listing Rules.

It is stated that companies should be able to and should actively consider adding to these minimum conditions to reflect company-specific circumstances. The following are proposed as minimum conditions within which clawback provisions can be triggered: material misstatement of results or an error in performance calculations; material failure of risk management and internal controls; misconduct; conduct leading to financial loss; reputational damage; and unreasonable failure to protect the interests of employees and customers.

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 Government's has a number of proposals in this area.

The purpose of audit

For audit to do better, the Brydon Review argued, *"the concept of audit needs to be rethought and redefined… rooted in a widely accepted clarification of its purpose".* The Government agrees that audit needs to change along the broad lines proposed by the Brydon Review and is proposing to give auditors a specific responsibility to consider relevant director conduct and wider financial or other information in reaching their judgements. This would be a statutory requirement of auditors and the Brydon Review refers to wider audit as "corporate auditing". The actions taken by auditors to meet this new statutory requirement would not constitute a non-audit service, and so could be undertaken by the statutory auditor.

The Government is also considering whether value would be added by the adoption of a new statement of audit purpose. It is considering adopting the Brydon Review's proposed purpose of audit as a broad ambition for its own programme of reforms. This is *"To help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements."*

Scope of audit

The Brydon Review identified that if businesses were to have a wider range of information audited then this could enhance confidence in those businesses and so improve the availability and cost of capital for them. The Government proposes that the Audit and Assurance Policy should set out what additional information has been subject to audit. A regulatory framework to cover both audits of financial statements ("statutory audit") and other types of information which companies decide to have audited via the Audit and Assurance Policy process ("wider audit") could be introduced. The scope of the wider auditing services which will be overseen by the regulator would be limited to auditing that companies choose to obtain, as set out in their published Audit and Assurance Policy.

To support the approach to wider audit, the Government proposes giving the regulator some functions in relation to all corporate auditors (i.e. statutory auditors and those providing wider audit services via the Audit and Assurance Policy), including setting and enforcing standards applicable to corporate auditing as a whole.

Principles of corporate auditing

The Brydon Review envisaged a single set of principles developed by the regulator that auditors would be obliged to follow and, as well as statutory auditors, these principles would cover those carrying out wider audit. The Brydon Review refers to those in scope collectively as "corporate auditors".

The Government is considering introducing a new legal framework to empower the regulator to set and enforce new principles of corporate auditing that would apply to both statutory auditors and those appointed to provide auditing services via the Audit and Assurance Policy. These are likely to incorporate the principles suggested by the Brydon Review, along with responses to the White Paper consultation.

Tackling fraud - Directors' responsibilities and related reporting

The Government proposes to legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud. The Government believes this will reinforce directors' primary responsibility for fraud prevention and detection and may also, in some cases, enhance their focus on the risks relating to fraudulent financial reporting. The need for supporting guidance for directors to be developed and issued will be discussed with the FRC and others (for example, for premium listed companies, this could be supplied through the Code).

This proposal ties in with the proposed move to a "failure to prevent" corporate offence for fraud and other economic crime (in line with the failure to prevent bribery offence under the UK Bribery Act 2010). The Law Commission is due to report back on options to reform corporate criminal liability by late 2021.

Tackling fraud: Auditors' responsibilities

The Government also intends to legislate to require auditors of PIEs, as part of their statutory audit, to report on the work they performed to conclude whether the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually accurate. This will enable users to understand the nature and extent of the work performed and the evidence obtained by the auditors relating to the actions which the directors state they have taken. The Brydon Review also recommended that auditors be required to report on the steps they took to detect any material fraud and assess the effectiveness of relevant controls. The Government supports this recommendation which complements the proposed obligation for directors to report on the actions they have taken. It will therefore discuss with the FRC the changes to company law and/or the auditor reporting standards which will be needed to give effect to it.

Auditor reporting of new information

The Brydon Review recommended that auditors should be free to report new information materially useful to a wide range of users, in their audit report and at the AGM, rather than be confined to commenting solely on the information reported on by the directors. This was linked to a suggestion that the proposed principles of corporate auditing (referred to above) could require auditors to ask the directors to report any material information that may legitimately be disclosed to assist users' understanding and, should the directors decline to do so, disclose it themselves. The White Paper notes that the FRC's review of its auditor reporting standards will examine the need to address any ambiguity regarding auditors' ability to disclose new information about the company.

If auditors are to be required to disclose in their report certain information meeting a materiality test in terms of its likely value to users, but the directors decline to do so, this gives rise to issues regarding its consistency and compatibility with requirements under the UK Market Abuse Regulation (MAR) for the handling and disclosure of inside information. Issuers would breach their obligations under MAR if they did not disclose inside information as soon as possible to the public or if their decision to delay the disclosure of inside information did not meet the relevant conditions in MAR. Accordingly, it is noted that the complex interaction of the Brydon Review's proposal and the current law on market abuse needs to be explored further and if the FRC decides to take this proposal forward, it will need to discuss it with the FCA (before deciding whether to consult, in due course, on introducing any such requirement).

True and fair view requirement

Directors must only approve a company's annual accounts if they are satisfied that they *"give a true and fair view of the assets, liabilities, financial position and profit or loss"* for the company and/or the group. Statutory auditors are in turn required to report on whether, in their opinion, the annual accounts give a true and fair view of the company and/or group's financial position and the profit or loss for the financial year.

The Brydon Review recommended replacing the *"true and fair view"* wording in the CA 2006 with *"present fairly, in all material respects",* the latter being the alternative form of wording recognised internationally and used in some other major jurisdictions. It considered that the *"present fairly"* wording better reflected the purpose now served by financial statements, which typically reflect a number of forward-looking accounting estimates and judgements and therefore cannot be "true" in a literal sense.

The Brydon Review also recommended that a new user guide to audit be developed by the regulator, with input from the Plain English Campaign, to explain clearly the meaning of the different elements of an audit report, and that it should be signposted in every annual report. The Government supports developing a new user guide to audit and the FRC has agreed to take this forward. This is considered 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 of APMs and KPIs linked to executive remuneration

A survey of investors commissioned for the Brydon Review identified APMs and any KPIs reported which are linked to executive remuneration as areas in which there was support for extending the scope of the statutory audit, and the Brydon Review recommended that companies be required to have both of these audited.

The Government does not propose to introduce any further audit requirement here as it believes that the proposed Audit and Assurance Policy process will enable investors to ask companies to obtain specific assurance on APMs and KPIs linked to remuneration, beyond any arising from the statutory audit of the financial statements, should they wish to do so. The part of the Directors' Remuneration Report which details the performance measures used to determine executive pay is already within the scope of the statutory audit in any event, but views are sought as to the effectiveness of this audit requirement and whether it could be improved to promote better disclosure of financial metrics.

The Brydon Review also recommended that auditors be required to read and consider material outside the annual report used in investor presentations and Regulatory News Service announcements and report if they consider it to be materially misstated. The Government believes that the Audit and Assurance Policy process will enable companies and investors to seek specific assurance on such material, as well as on information within the 'front half' of the annual report, if they wish and this should provide the necessary clarity for users as to whether the auditor is providing any level of assurance regarding this material.

Auditor liability

The Brydon Review noted that very few, if any, auditor liability limitation agreements (LLA) have been entered into since the provisions permitting them were enacted in the CA 2006, with some directors believing they would be in breach of their general duties if they recommended that shareholders authorise such an agreement. To address this, the Brydon Review recommended that the CA 2006 make clear that directors will not be in breach of their duties if they recommend, in good faith, that the company's members authorise an LLA. However, since the Government considers it already to be the case that directors who recommend an LLA to shareholders in good faith will not be in breach of their duties, it is interested in views from directors themselves, investors and auditors as to why LLAs have not generally been agreed and whether the relevant statutory provisions are serving a useful purpose.

The Brydon Review identified that a barrier to audit becoming more useful and informative may be perceptions that audit innovation, beyond what is currently mandated in law or standards, may increase auditors' exposure to litigation. It therefore recommended discussion begin between investors and auditors regarding an auditor liability regime that will facilitate a more informative audit, and suggested this should also cover other liability issues arising, for example, from the CMA's proposals to promote competition in the audit market. The Government agrees that such a dialogue is likely to be helpful but considers that the views of directors and other users of audit reports should also be sought.

The current statutory regime which limits the extent to which companies and auditors can agree to exclude or limit an auditor's liability applies only in relation to the audit of the financial statements. As set out above, the Brydon Review recommended only limited extensions to the scope of statutory audit, proposing instead a new process (the Audit and Assurance Policy) for companies and shareholders to decide on any wider assurance they wish to obtain from auditors. It also proposed that, while auditors should recognise that non-shareholders will make use of their report, their legal liability should not be extended beyond that owed to the shareholders as a body. The Government intends that company directors and auditors should remain free to agree whatever liability arrangements they consider appropriate for all non-statutory engagements to "assure and inform" the users of corporate information.

New professional body for corporate auditors

There is currently no separate professional body for external auditors, with statutory auditors being required to be members of one of a number of professional accountancy bodies, reflecting their traditional focus on financial statement audits.

The White Paper notes that corporate auditing, with a new ethos and wider scope, will require tomorrow's auditors to include individuals with different skillsets and a new professional body for auditors of all corporate information could help to elevate the status of auditors and reinforce their ethical and public interest obligations. As a result, the Government proposes to put an appropriate framework in place to facilitate this.

Audit Committee oversight and engagement with shareholders

The Government proposes to give 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.

Audit committee role and oversight

Proposed new requirements on audit committees to be developed by ARGA in relation to the appointment and oversight of auditors will cover the need for audit committees to continuously monitor audit quality, and consistently demand challenge and scepticism from auditors. ARGA will consider how these new requirements will fit alongside the existing obligations which apply to audit committees, and ARGA will continue to issue guidance to assist companies and those serving on audit committees which could include appropriate examples of good practice to allow companies to build on the experience and expertise of others.

The Government considers that any new requirements imposed by ARGA should allow for audit committees to exercise discretion and professional judgement and for innovative best practice to develop. The requirements set by the regulator will set minimum standards which audit committees will be free to exceed as they wish.

It is proposed that the new additional requirements should initially apply to audit committees of FTSE 350 companies and could then be extended to other PIEs in due course.

ARGA will have a duty to monitor compliance with the new audit committee requirements, including through a power to require information and/or reports from audit committees, to meet audit committee chairs to discuss issues and a power to place an observer on audit committees if necessary. It will have appropriate powers to take action in relation to breaches of the new requirements against the company directors and/or the audit committee. The audit committee will have the opportunity to address any issues of regulatory concern before ARGA takes remedial steps publicly. Further steps could include issuing public notices detailing ARGA's findings, or making direct statements to shareholders in circumstances where it is unsatisfied with an audit committee's response.

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, while the Government recognises that there are potential benefits to giving the regulator powers to appoint auditors in these limited circumstances, it has seen little evidence to suggest that even in these circumstances (or in others which the FRC has encountered in recent years) the powers would be useful in practice. It points out that if there were no willing appointees, the powers would only work if accompanied by the ability to compel auditors to take on the audit engagement in question. This would be a significant step, as it would give the regulator the power to override an auditor's freedom to choose their audit engagements.

In light of this, it is not considered appropriate to give ARGA independent powers of appointment at the moment but the Government is considering, and consulting on whether to legislate to provide flexibility for ARGA to be given such powers in the future.

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 Government agrees that a formal mechanism should be established to enable audit committees to gather shareholder views on the audit plan and that, in practice, shareholders might also benefit from a summary version of the audit plan provided to the audit committee (subject to the necessary safeguards on the publication of commercially sensitive information), setting out key audit matters, information on materiality and the proposed areas of focus for the audit. However, it believes that shareholder views should be purely advisory in nature and supplemental to the auditor's to ensure that the auditor retains autonomy for the way the audit is conducted. While a wide range of risks affecting the audited entity will be of interest to shareholders, the auditor should not be required to consider proposals which fall outside of the scope of the company audit as set out in the CA 2006.

While it also agrees that shareholders would benefit from having access to the latest risk assessment, the Government considers that the audit committee should only be expected to make an additional disclosure if there has been a material change to the principal risks facing the company since those already disclosed in the last annual or interim report. Where suggestions from shareholders go wider than issues that can be considered as part of the company audit (for example business or strategic risks), these could be considered as part of the proposed Audit and Assurance Policy.

ARGA will need to consider how this engagement would work in practice in liaison with audit committees, auditors and shareholder bodies, but it is suggested that the following would need to be considered: the timing and methods of engagement with shareholders; how a summary version of the audit plan will be communicated to shareholders; how the updated risks statement will be communicated to shareholders; and the types of shareholder request which should require formal consideration. The Brydon Review suggested this could be related to the size of shareholdings or a materiality test.

The Government considers that these proposals should initially apply only to the audit committees of premium listed companies and be addressed through a change to the Code (and/or associated guidance on audit committees).

The Brydon Review also recommended 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. The Government agrees with this recommendation but to help maintain auditor independence, it has concluded that it would be more appropriate for the audit committee to communicate this feedback. The obligation on auditors to consider suggestions put forward by shareholders and to provide feedback to the audit committee on the extent to which these have been adopted could be achieved through contractual provisions in the auditor's 'terms of engagement.' In recognising the iterative nature of the audit plan, any such disclosure in the audit committee report should also highlight material changes in the summary audit plan communicated to shareholders, including the impact on areas of focus proposed by shareholders.

Shareholder engagement on audits at general meetings

The Brydon Review highlighted that it is the exception rather than the rule for a company's auditor to attend and take questions from shareholders at a company's AGM and recommended that a standing item be added to AGMs at which the audit committee chair and auditor would take shareholder questions. The Brydon Review also suggested adding a standing item to AGM agendas for questions to be put to the auditor and the audit committee chair.

The Government agrees that shareholders should have better opportunities to ask questions about the audit but does not believe that a standing AGM agenda item is necessary or sufficient to achieve greater shareholder engagement. Instead, the Government wants to encourage better engagement with the auditor by inviting the regulator to revise its guidance to audit committees to encourage questions from shareholders about the company audit. The Government also invites the regulator to consider revisions to its guidance on the recently revised UK Stewardship Code to promote greater engagement from investors on matters relating to audit quality.

In addition, the Brydon Review suggested that the senior company auditor be required to attend the AGM and be prepared to answer questions. The Government does not think that such a requirement would be proportionate as the senior auditor's presence may not be necessary or justifiable in all cases. However, the Government believes that better attendance from both the audit committee chair and senior auditor at the AGM should be encouraged, and suggests that this could be implemented through updating the regulator's existing guidance to audit committees. It would also be open to audit committees to require as part of an auditor's contractual 'terms of engagement' that they attend the AGM and answer questions if asked to do so.

Shareholder engagement on auditor removal or resignation

The Brydon Review was concerned that auditors who resign, choose not to retender or are dismissed from PIEs do not, in general, provide meaningful reasons for their departure from the company, despite the CA 2006 requiring a statement of reasons for the departure to be provided to the company, shareholders and the regulator. It recommended that the statement given by departing auditors should, at a minimum, state whether certain matters led to their departure, and that a general meeting be held subsequently at which shareholders can ask the audit committee chair and the auditor about the departure.

The Government agrees the existing CA 2006 provisions which apply when an auditor ceases to hold office are generally failing to provide meaningful information to shareholders and the regulator as to the reasons for an auditor's departure but it recognises that the unexpected resignation or dismissal of an auditor may already be perceived by shareholders and others as a sign that a company has questions to answer about its financial reporting, regardless of whether the precise reasons are set out in the auditor's departing statement. The Government also recognises that audit firms may have concerns over potential liability issues arising from being obliged to state whether certain factors contributed to an auditor ceasing to hold office, both in their departing statement and at the proposed general meeting.

The Government will reach a final view on whether and how to implement these two Brydon Review recommendations, in whole or part, after taking account of responses to the White paper consultation.

Audit fee disclosures in audit committee reports

The Brydon Review believed that the accounting treatment of audit fees should reflect more clearly the fact that this is a cost borne by the company's shareholders.

The Government is not proposing to amend company law to require a different accounting treatment for audit fees to that currently applied under both IFRS and UK GAAP, but it would like to see improved audit committees' disclosures relating to audit fees and notes that the FRC is reviewing its guidance for audit committees in this area.

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. Having already consulted on the CMA's recommendations, the Government considers that the most effective and efficient way to increase choice, competition and resilience in the audit market is through a number of reforms, as set out below. It is envisaged that these measures will be delivered through a combination of primary and secondary legislation, as well as by giving ARGA rule-making powers that will give it the autonomy to refine and adjust elements of detail over time as the market adjusts.

Market opening measures – managed share audits for UK FTSE 350 companies

The Government agrees with the CMA's assessment that the FTSE 350 audit market is not working effectively and needs greater choice and resilience in order to deliver the desired improvements in quality. However, significant barriers to implementing the remedies identified by the CMA are the ability of Challenger audit firms to grow and increase capability in order to undertake larger more complex audits and the joint and several liability risks associated with the CMA's preferred solution of joint audit.

The core of the Government's proposal is a managed shared audit requirement for UK-registered FTSE 350 companies with limited exceptions (discussed below). This form of shared audit would see an audit firm appointed to lead the group audit, for which it bears the overall liability. When tendering the statutory audits of entities within the group, companies would be required to appoint a Challenger audit firm to conduct a meaningful proportion of the statutory audits. The requirement would apply across the FTSE 350, giving audit firms the opportunity to gain exposure to the statutory audit engagements and audit committees of the largest and most complex companies, and giving those companies greater choice of auditor.

The managed shared audit requirement would be phased-in by requiring FTSE 350 companies, acting through their audit committees, to adopt managed shared audit when their audit contract is re-tendered, rather than at an annual reappointment. Managed shared audit would require the companies to identify a meaningful proportion of the audits of statutory entities within the group for bids from Challenger firms only, unless they select a Challenger firm as the group auditor or receive an exemption. The Government's definition of a Challenger firm for these purposes is a firm that provides statutory audits to PIEs and whose audit revenues did not represent more than 15 per cent of the FTSE 350 statutory audit market by fees in either of the prior two years but it is seeking views on the appropriate threshold.

Detailed and binding requirements for managed shared audit would be issued, supported by guidance, and it is currently proposed that requirements would include the following:

- A Challenger firm to be appointed to carry out a meaningful proportion of the group's statutory audits (for example, a subsidiary or collection of subsidiaries). 'Meaningful' would be defined and calculated with reference to one or more of the total audit fee (in the prior year), group revenues, profits and assets of the company, with the Challenger's proportion to be no less than 10 per cent of these criteria and preferably closer to 30 per cent. It is recognised that the Challenger's proportion is likely to be at the lower end of this range for the largest and most complex FTSE 350 companies, at least at the outset.
- The company's audit committee would identify through its audit tender planning the subsidiary or subsidiaries that could be audited by a Challenger. The tender process would see the audit committee appoint the group and other (Challenger) auditor independently, with no joint bidding permitted. It is expected that the group and other audit engagements would be tendered at the same time.
- There would be merit in the Challenger subsidiaries being rotated during the term of the audit contract, to provide the Challenger with greater exposure to the company. The regulator would encourage this but not require it. The subsidiaries would, as a minimum, be subject to the same mandatory periodic rotation requirements as the group audit.
- The Challenger would be liable for its audit of the relevant subsidiaries but would not bear joint and several liability for the group audit. Any work performed by the Challenger would fall within the scope of the regulator's audit quality review regime. This addresses the CMA's concern that the smaller firm would be less motivated by audit quality under shared audit.

- The Challenger firm would have access to, and engagement with, the FTSE 350 company's main (group) audit committee. This aims to mitigate the CMA's concern that the audit committee would only engage meaningfully with the group auditor.

Managed shared audit requirements will not apply to companies that either appoint a Challenger firm as their sole audit firm or have not been a FTSE 350 company for at least half of the annual accounting period prior to the auditor appointment and are not a FTSE 350 company when the audit tender process begins.

There will be no blanket exemption for the largest and most complex FTSE 100 companies as a positive feature of managed shared audit is considered to be the fact that the selection of the subsidiary allows for greater flexibility in the division of work to ensure the subsidiary is appropriate for a Challenger, so they can engage across the FTSE 350 from the outset. However, the Government intends to provide for exemptions for companies from the managed shared audit requirements in exceptional circumstances and give the regulator the power to assess when such circumstances have been met. The use of this power would be subject to further consultation and limited by criteria to ensure that its use was exceptional. The Government proposes exceptional circumstances could also cover companies who do not receive bids or bids of sufficient quality.

The CMA proposed an exemption for investment trusts and individual entities that do not prepare consolidated accounts. While the Government agrees that it may not be proportionate or practical for these companies to implement a shared audit, since it believes many Challengers have the capacity to carry out these less complex engagements as sole auditor, the Government would expect their audit committees to carry out an audit tender that encouraged the appointment of a Challenger firm. As a result, instead of an automatic exemption for these entities, the Government intends to work with the regulator to develop a modified approach for these entities to follow, which will be set out in regulations.

The regulator would monitor companies' compliance with the managed shared audit requirements, so would have powers to request information from, and engagement with, FTSE 350 companies and audit firms. This would include details of upcoming and current audit tenders, the split of work between the group and subsidiary audit firms, details of the how the tender would be run and the outcomes of the tenders, as well as the audit firms' growth plans. It is expected that the regulator would issue guidance on the details of this information gathering. It is also proposed that the regulator would have enforcement and sanctioning powers against companies that do not comply with the requirements,

Market share cap

If in due course a review of managed shared audits concludes that they are not making sufficient progress in supporting Challenger firms to become sole auditors of FTSE 350 companies, then the Government would engage a reserve power (to be taken forward as part of the audit reform legislative package) to introduce a market share cap.

While the Government would undertake further consultation on the detailed design of the market share cap before the measure was introduced, the White Paper sets out a number of principles that it considers would feature. For example, there would not be a single numerical or percentage market share cap applied to any single audit firm, or group of audit firms. Instead, the regulator would review the pipeline of FTSE 350 audit tenders for an upcoming period and reserve a proportion of them for Challengers ("Restricted Tenders"). The market share cap would not remove the FTSE 350 company's obligation to run a competitive tender process or to hold a shareholder vote on the auditor appointment and the market share cap would not restrict FTSE 350 companies from appointing a Big Four firm to carry out a proportion of the subsidiary audits, as long as a Challenger firm was appointed as the group auditor.

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, has 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 the firm. The proposals to be implemented include requiring the strengthening of governance within audit practices through the creation of independent Audit Boards within firms and the publication of a separate profit and loss account for the audit practice, accounting for cross-subsidies between the audit practice and the rest of the firm through arm's-length transfer pricing. These proposals will be implemented through a combination of primary and secondary legislation and by the new regulator, which will be given an appropriate statutory framework to ensure effective delivery and to make regulatory rules.

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 is proposing to enhance the range of statutory powers available to the regulator so that it has a more powerful role in monitoring the resilience of individual audit firms and the PIE audit market. For example, ARGA will be required to monitor and regularly report on competition and developments in the broader statutory audit market and have appropriate information gathering powers to carry out that role effectively. It will also have powers to conduct market studies and powers to take enforcement action to address anti-competitive practices and an abuse of dominant position within the statutory audit market, under the Competition Act 1998.

Regulatory approach in the event of an audit firm failure

The CMA Study recommended that if a 'Big Four' firm was likely to fail, the regulator should have the power to take executive control of the distressed firm to limit the movement of clients to the remaining 'Big Three' firms. The Government does not agree with this proposal as it does not believe that the regulator intervening to take over the running of an audit firm, albeit on a temporary basis, would be proportionate or effective.

However, given that one major concern of a firm failure is that clients and employees will automatically migrate to one of the remaining large audit firms, leading to further concentration of the market, the Government proposes that the regulator's reserve power to introduce a market share cap could be activated if an acute firm collapse were under way. The power could be used to limit the proportion of audit clients which could be taken on by the remaining large audit firms and would create further opportunities for Challenger firms.

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 are set out in the White Paper.

Approval and registration of statutory auditors of PIEs

Recognised Supervisory Bodies (RSBs), professional accountancy bodies recognised by the FRC, currently determine whether individuals and firms are eligible for appointment as a statutory auditor and register those who have been approved as eligible for appointment. The FRC Review recommended that the approval and registration of audit firms carrying out PIE audits should instead be carried out by the regulator, and that the regulator should have the power to impose an appropriate range of sanctions less severe than audit firm deregistration in support of this role.

The Government agrees with this recommendation, with RSBs continuing to determine whether individuals and firms are eligible to be appointed as statutory auditors of non-PIE entities. The White Paper notes that the FRC is working with the Government to develop proposals on how it would carry out the function of approving individuals and firms as eligible to carry out statutory audits of PIEs, and will consult with the affected audit firms and RSBs.

Monitoring of audit quality

The FRC is required to carry out inspections of statutory auditors of PIEs. The FRC also has responsibility for carrying out inspections of statutory auditors of certain other entities. These inspections, Audit Quality Reviews (AQRs), are required to 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 intends to legislate 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. The regulator will be free to decide whether this is publication "in full" or in summary form. The Government will put in place safeguards to prohibit the publication of sensitive information about audited entities.

Shareholder ability to raise concerns on individual audits

The Brydon Review was concerned that shareholders lacked a confidential channel through which to raise concerns about individual audits, and called for a mechanism to be established to facilitate shareholder engagement with the regulator. Since there is currently a mechanism for this to happen via the FRC's complaints process, or informally via the FRC's Stakeholder Engagement team, the Government expects the regulator to publicise these existing channels and publicise the confidentiality of the complaints procedure.

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 intends 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

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

The FRC has identified that its inspections and investigations of statutory audit risk are being hampered because certain documents that may be crucial to the auditor's work are in some cases inaccessible to the regulator, since they are covered by the audited entity's legal professional privilege. The Government is seeking views on this as it considers whether a proportionate and effective solution is possible.

While the Government is concerned that it may be difficult or impossible for the FRC properly to inspect or investigate the audits of those companies without accessing all the information, including the audited entity's privileged information, which the auditor has relied upon in reaching their opinion, it recognises that it is essential to preserve the principle that lawyers and their clients should be able to communicate freely and without fear of those communications being disclosed to the client's prejudice.

As a result, the Government wants to ensure that any solution does not impact adversely the willingness of audited entities to seek legal advice, or undermine the relationship between companies and their auditors. Measures to address the problem would need to be targeted only at documents belonging to the audited entity that had already been shared with the auditor and, if the regulator were able to see privileged information, it would need to be strictly limited in circulation and purpose, with appropriate safeguards.

A strengthened regulator

The FRC Review concluded that the FRC should be replaced with a new statutory regulator with clear statutory powers and objectives. The Government proposes to establish the new regulator, ARGA, by bringing forward the necessary legislation when Parliamentary time allows. ARGA's general objective, which will apply when it is carrying out its policy-making functions, will be *"to protect and promote the interests of investors, other users of corporate reporting and the wider public interest."* This will be accompanied by two operational objectives, a quality objective (to promote high quality audit, corporate reporting, corporate governance, accounting and actuarial work) and a competition objective (to promote effective competition in the market for statutory audit work), which will be supplemented by a number of regulatory principles, to which the regulator will be expected to have regard.

ARGA's functions will consist of existing functions which are performed by the FRC and new functions. So, for example, ARGA will have responsibility for the Code, the UK Stewardship Code and auditing standards. It will also continue to set UK accounting standards and periodically review compliance with corporate reporting requirements. A new duty will be to determine whether individuals and firms can be auditors of PIEs, as mentioned above.

Additional changes in the regulator's responsibilities

Other responsibilities and powers will complement ARGA's role, including powers to act on serious concerns relating to corporate reporting and audit. These include 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

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. It also suggested that the Government should consider whether any further powers are needed to assess and promote compliance with the Stewardship Code.

The Government expects the FRC and FCA, working with the Department of Work and Pensions (DWP) and The Pensions Regulator (TPR) to launch a review of the regulatory framework for effective stewardship including the operation of the Stewardship Code in 2023, to establish if it is delivering expected outcomes. The Government will work with these bodies to determine the criteria by which the success of the Code will be measured. It will then consider whether further powers are needed to assess and promote compliance with the Stewardship Code following the outcomes of that review.

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

The Government agrees 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. PIE auditors already have such a duty. Views are sought as to whether there are there other matters which PIE auditors should have to report to the regulator and whether this duty could otherwise be improved to ensure that viability and other serious concerns are disclosed to the regulator in a timely way.

The White Paper notes that auditors of FCA or Prudential Regulation Authority (PRA) authorised firms benefit from statutory protection when making certain disclosures to a regulator. In particular, an auditor is not in breach of any duty owed to their client merely because they communicate information on a matter of which they have become aware in their capacity as an auditor. They must however have acted in good faith and reasonably believe that the information or opinion is relevant to the regulator's activities. Views are sought as to whether putting in place equivalent statutory protection for all auditors of PIEs might enable or encourage them to disclose viability and other serious concerns to the regulator in circumstances where they might otherwise be concerned about being subject to a breach of contract or breach of confidence action.

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 is concerned that giving new powers to the regulator to intervene in governance matters could undermine the principle that it is for shareholders to ensure that appropriate governance arrangements are in place. It could also lead to investors becoming less engaged in their oversight of governance arrangements or even becoming over-confident in a company's governance arrangements, based purely on the fact that no action had been taken by the regulator. As a result, the Government believes that new powers to address serious concerns in PIEs should be limited to the areas where the regulator has existing enforcement powers, that is corporate reporting and audit.

To achieve this, the following is proposed:

- Power to require rapid explanations: The regulator will have the power to require rapid explanations from PIEs where it has concerns relating to a PIE's compliance with its corporate reporting or audit obligations. The Government will consider how this power will fit with the regulator's existing information gathering powers in relation to corporate reporting and audits by PIEs.
- Power to require an expert review: The regulator will have the power to require an expert review where it has identified concerns as to whether a PIE's corporate reporting and audits comply with any requirements which are enforced by the regulator. The Government's view is that the regulator's costs of commissioning an expert review should fall to the inspected company, as is the case with FCA and PRA expert reviews in the financial services sector.
- Power to publish the expert review: The Government intends to legislate to include a power to publish a summary of the report from the expert review where it is considered by the regulator to be in the public interest. It expects this power to be used only exceptionally. The Government believes that this strikes the right balance between giving shareholders and other stakeholders appropriate information about the findings of the review, while making it easier to ensure that publication does not result in the disclosure of commercially sensitive information.

Conclusion

The three reviews that resulted in most of the White Paper's proposals were conducted in 2018 and 2019 and, with initial consultations on some of their recommendations having already been conducted, the White Paper has taken longer to emerge than many expected. Reportedly this has been due in part to concerns raised by some business leaders and others that certain of the proposals could make the UK less competitive, and adversely impact its reputation as a good place to do business, at a time when investment in the UK is needed and businesses are already facing multiple challenges.

While there is general agreement about the need to maintain high audit standards, questions have been raised as to 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. In the same vein, while shareholders and investors are likely to appreciate the opportunity to engage with companies over their Audit and Assurance Policy and audit plan more generally, it will be interesting to see how many shareholders take up these opportunities given that some companies, particularly smaller listed companies, have not always found it easy to get their shareholders to engage with them.

Directors of PIEs will be relieved that the Government is not proposing to go as far as the Sarbanes-Oxley requirements in relation to their assessment of the company's internal controls systems but the White Paper does impose a number of additional reporting requirements on such directors. These include not only the proposed new Resilience Statement and Audit and Assurance Policy, but also the need for a statement concerning the legality of any interim or final dividend the directors propose to pay, as well as confirmation that this will not threaten the company's insolvency over the next two years. Whether these increased responsibilities will deter some from becoming a PIE director remains to be seen.

As far as corporate reporting and audits are concerned, companies will have to incur extra costs in relation to the assurance of a wider range of information going forward, and the proposals around managed share audits will give audit committees plenty to consider.

As ever, the "devil will be in the detail" and that will not be available for some time yet.

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