Understanding the BEIS consultation

‘Restoring trust in audit and corporate governance’

Non-Executive Director (NEDs) focus group: Strengthened internal controls regime

Strengthened internal controls regime – NEDs support enhancing the UK’s internal controls regime but are concerned about the proportionality and cost of the Government's proposals

On 18 March 2021, the Government (BEIS) published its long-awaited consultation on reforms aimed at ‘restoring trust in audit and corporate governance’. It is a significant consultation with 98 consultation questions covering almost all 155 recommendations from the Kingman, CMA and Brydon reviews. The deadline for responses to the consultation was 8 July 2021.

PwC focus groups

During the consultation period PwC convened a series of focus groups to serve as an open forum for NEDs to discuss the Government’s proposals. On 27 May 2021, three groups met to talk about the proposal for a strengthened internal controls regime for the UK.

These focus groups were conducted under the Chatham House Rule so quotations in this article are unattributed.

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Some of the key questions around the introduction of a strengthened internal controls regime discussed were:

Do you believe the proposals to strengthen the internal controls regime would benefit the UK?

A number of participants with experience of the Sarbanes-Oxley (SOx) internal controls regime in the US were supportive of the benefits of stronger requirements in this area. In particular, they noted the possibility of the regime resulting in an increase in the quality of financial reporting, although they remained conscious of the potentially high implementation costs.

"In the US, SOx was a big cost but it really added value. It strengthened internal controls, helped document judgements, helped a bit with fraud, and increased accuracy and accountability overall. Having people personally sign-off really matters."

Several participants, however, were uncertain as to whether the proposals to strengthen the internal controls regime in the UK would address the root cause of concerns relating to financial reporting and corporate failure.

"The current case for reform is not based on issues with the accuracy of data, but the quality of judgements in the financial reports."

There was also a discussion about whether the adoption of a US style system would make a significant difference to the detection of fraud, as some participants believed it to be too formulaic and not sufficiently risk based.

"If you wanted to do more to detect fraud then a risk-based analysis of the internal controls framework would be most effective. I'm not sure I see a US SOx style system picking up the risks they're seeking to identify."

What considerations should be given to the development of a UK reporting regime for internal controls?

Participants agreed that one of the biggest challenges of implementing the proposed UK regime would be ensuring there is consistency in how organisations apply the new rules. The need for a common framework was widely supported.

"In my experience of implementing SOx in the US, consistency of application is key. Without a framework you're doomed."

There was agreement that if the UK were to implement a strengthened regime in line with what's currently proposed in the consultation, then this would likely lead to the adoption of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework for reporting on internal controls - currently the only internationally recognised standard.

Do you think the proposals for a strengthened regime in the UK are proportionate?

A number of participants believed that attempting to recreate a US style regime in the UK might not be the most appropriate solution. There were views that the UK is starting from a very different place, and that there are more suitable international examples we could look to emulate.

"We need to be careful not to refer to 'UK SOx', otherwise we may end up with a system that is similar to US SOx. In my experience the Spanish version is less onerous than in the US and more proportionate than what is currently being proposed for the UK."

While the need for consistency of reporting and testing was widely accepted, concerns were raised by a number of participants about the likely adoption of the COSO framework in the UK. Specifically, given the expansion of the PIE definition in the proposals, this would lead to a wide range of different organisations having to apply the framework.

"Consistency is important, but so is proportionality. Given the range of businesses that could be covered by this regime we should avoid trying to squeeze a square peg into a round hole."

There was widespread support for the alternative internal controls regime proposals developed by the Audit Committee Chairs Independent Forum (ACCIF), which build on the current listing rules requirements for directors to have controls and processes in place to enable them to make proper judgements, on an ongoing basis, as to the financial position and prospects of the company and group.

"It needs those on the ground, such as the ACCIF, to input to ensure a crass system will not be imposed on companies."

There was debate over whether a rules-based or principles-based regime would be most proportionate. Some participants argued that a rules-based regime meant directors would have a clearer understanding of the requirements, while others believed that, given the range of organisations that could eventually have to report under the new regime, a principles-based approach in line with the ACCIF proposals, would provide greater flexibility. This was deemed especially important for both AIM listed and large private companies who could struggle to implement a US style SOx approach.

"You need to strike the right balance - one size does not fit all. These proposals appear to be a sledgehammer to crack a nut."

The potential cost of implementing the proposed regime was also highlighted by a number of participants as an area of concern. There was agreement that the estimated annual compliance cost of £60k for an average company, included in the Government's impact assessment, is likely to be a significant understatement. The prospect of large charities having to apply the proposed regime was also described as “worrying”, linking to questions raised in previous focus groups about whether the public would want their donations to fund these additional costs.

“Different organisations can accept different costs, but for private companies for example these proposals are disproportionate.”

There was also discussion about the impact increased costs might have on the attractiveness of the UK as a listing destination.

“The approach adopted when the US introduced SOx was for the parent company to delist in the US, taking it out of the SOx regime and therefore saving costs...This was applauded by investors, especially from the cost saving perspective.”

What role would external assurance likely play in the proposed regime for the UK?

There was agreement that the proposed regime would lead to a large number of companies seeking external assurance on their internal controls. Several participants believed this would predominantly be driven by the board looking for comfort before signing their attestations, as well as peer and investor pressure.

“If directors want to have confidence in their attestation then they’ll need their controls to be audited.”

Others felt that even with external assurance over internal controls, boards would still be motivated to get closer to their organisations in order to “validate and direct interventions,” although this did raise questions about whether NEDs could do so without breaking their independence requirements.

External assurance was viewed by a number of participants as important to ensure “an even application of the requirements". Those with experience of the internal controls regime in South Africa, which introduced a discretionary approach to assurance, highlighted how this led to an inconsistency of implementation.

Participants who had experienced the implementation of the internal controls regime in the US also highlighted that, at the time, companies relied heavily on extensive training from their auditors on how to comply with the new requirements.

However, concern was expressed by a number of participants about the additional cost external assurance would add to the proposed regime. There was support for using the new Audit and Assurance Policy, proposed in the consultation, to test investor appetite, but participants questioned whether all shareholders would have the sufficient experience or skill set to understand the existing interplay between the financial audit and internal controls - e.g. the ability to perform a comprehensive audit without reliance on internal controls.

“We will be using the Audit and Assurance Policy to get the investors involved. If 70% say they want the auditors involved then we will do that but it will be expensive. It will add about £350k to a £1m audit.”

Participants also questioned whether the larger firms could meet all of the demand for additional assurance over internal controls the proposals would likely create, and suggested that the reforms might instead provide an opportunity to bring in smaller, or more boutique providers, which could help boost capacity in the assurance market.

Conclusion

There was strong support for strengthening the UK’s internal controls regime, but concern that, unless properly designed, the Government’s proposals could significantly increase costs without necessarily addressing the underlying issues that have caused concern after recent high-profile corporate failures.

While a desire to ensure consistency of implementation of the proposed regime was evident, there was support for adopting a more proportionate, principles-based approach aligned with the proposals developed by the ACCIF, which build on the current premium listing rules.

Though the value of external assurance on internal controls was widely recognised, participants expressed concerns over the additional cost this would add to the regime.

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