# Understanding the BEIS consultation

## 'Restoring trust in audit and corporate governance'

## Summary briefing

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.

### Who would be impacted by the reforms?

The consultation sets out a broad programme of reform for auditors, companies, directors, audit committees, investors, other stakeholders and the regulator. We strongly support this 'system-wide' approach to reform and believe it's essential if sustainable quality improvements in corporate governance, reporting and audit are to be achieved.

A significant focus of the consultation was on companies with a significant public interest, i.e. Public Interest Entities (PIEs), with this definition potentially set to expand (see below). This goes beyond just large listed companies, although there are some recommendations targeted at premium listed companies with a smaller number (albeit quite significant) for just the FTSE 350. In all cases, application could broaden in the period after implementation.

### When will changes actually be implemented?

It's important to remember that all of the proposals were subject to consultation and therefore could be refined or even abandoned following the consultation process.
The implementation date for changes that are agreed will depend upon whether legislative change is needed, or if change can be made through regulation. In some cases, the FRC may seek to implement change on a voluntary basis in order to accelerate the timetable.

BEIS is keen to balance the urgency of reform with the additional requirements which will be placed on businesses. They're proposing to implement measures that don't directly impact businesses (such as establishing the Audit, Reporting and Governance Authority (ARGA) to replace the FRC) more quickly. Measures that impact the audit profession may also be pushed forward quickly but there is likely to be a longer transition period. Measures that directly impact businesses (like the new internal controls regime, and managed shared audits) will most likely commence later, again with a transition period.

For the majority of the changes, we don't expect implementation until 2023 at the earliest, with transition periods and phased implementation approaches thereafter.

## What are the headlines?

1 All directors of PIEs to be held accountable for their reporting responsibilities and subject to increased regulatory scrutiny and enforcement powers, a new regime for internal controls over financial reporting (‘UK SOx’) and new disclosure requirements around resilience and capital maintenance

2 Strengthening of the role and responsibilities of audit committees, and also subjecting them to more regulatory scrutiny and potential inspection and observation of their activities

3 Requirement for an Audit and Assurance Policy that sets out what assurance is being commissioned (or not) over the whole annual report and other corporate information subject to shareholder comment and advisory vote

4 Requirement for a managed shared audit regime for FTSE 350 companies that have a big-four firm as lead auditor

5 Requirement for operational separation of the largest audit firms – through a combination of legislation and a statutory framework for the regulator

6 A new corporate auditor profession to be established, effectively separate from accounting profession

7 Expansion of the definition of PIE to cover large AIM and large private companies

In the rest of this document we’ve set out a summary briefing on the recommendations as they impact companies, audit committees and the audit profession.

We’d be delighted to discuss any of these areas further with you.

Please ask your usual PwC contact, or alternatively you can contact:


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## What are the key changes for directors and companies?

BEIS has concluded that the current regulatory framework is inadequate in holding directors to account for high quality corporate reporting. The Secretary of State for Business, Energy and Industrial Strategy, Kwasi Kwarteng MP has said that there is a need to ensure 'that those who prepare and assure reports are held to the highest standards, including the directors who sign off the reports of the largest companies.'[1] The package of proposed reforms responds to this through suggesting increased regulatory scrutiny and enforcement powers over directors, new disclosure requirements and a new regime for internal controls over financial reporting (ICFR).

- **Increased regulatory scrutiny and enforcement powers over directors**

  The consultation proposes that all directors of PIEs should be within the scope of potential regulatory action from the FRC/ARGA; this is a significant change from today's regime, which only permits the FRC to take enforcement action against directors who are members of professional bodies, e.g. chartered accountants.

- **A new regime for internal controls over financial reporting**

  As has been heavily trailed, the consultation includes a proposal that the UK should adopt a version of the US Sarbanes-Oxley rules which require directors to attest to the effectiveness of internal controls over financial reporting. This proposal would initially apply to premium listed companies and be extended to all PIEs after two years.

  BEIS explores a number of different options for the new regime, with varying degrees of auditor involvement. Their preferred option (although they are open to considering other possibilities) was that directors make an explicit statement about the effectiveness of ICFR. As part of this statement, directors would also need to explain how they had carried out their assessment, details of the outcome (with any deficiencies), the benchmark system used to make the assessment and how they had assured themselves it is appropriate to make the statement. Any decisions about whether the directors' attestation should be subject to external audit would be explained in the company's Audit and Assurance Policy (see below), although external audit of the statement would not be mandated.

  This proposal, if implemented, could be a major change for impacted companies. Our experience in the US is that the workload for directors and management teams in implementing the SOx rules was significant, but that the regime also drove substantial improvement in the quality of financial reporting and control.

- **New capital maintenance disclosures**

  This is an area of focus in the consultation as there have been high profile examples of companies paying out significant dividends shortly before profit warnings and, in some cases, insolvency. As a result, there is a recommendation that listed companies (with a possible future extension to all PIEs) disclose their distributable reserves and the group's dividend paying capacity (these disclosures would be subject to audit). There was also a recommendation that the directors make a statement about the legality of proposed dividends and the effects on future solvency.

- **More transparency around resilience planning**

  There's a recommendation for premium listed entities (extending to all PIEs after two years) that the existing going concern statement and viability statement be combined into a new 'resilience statement'. The resilience statement would address business resilience:

  - over the short term (incorporating the company's existing going concern statement);
  - the medium term (incorporating the current viability statement requirements, albeit with better scenario planning disclosures and over a longer period of 5 years); and
  - the long term.

Notably there is a recommendation that material uncertainties be disclosed in the short-term part of the statement, even if mitigated (effectively a gross and net disclosure) and that at least two reverse stress tests[2] should be included within the medium-term part of the statement to improve the usefulness of the disclosure.

Other key recommendations impacting directors/companies are:

- Directors of PIEs must meet certain behavioural standards when fulfilling their statutory duties, for example, acting with honesty and integrity.
- The implementation of all of the Brydon review recommendations in relation to fraud, including that directors of PIEs report on the steps they have taken to prevent and detect material fraud.

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[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970676/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf

[2] Stress testing is a forward-looking analysis technique that many entities are carrying out to some degree, if not in name. An entity identifies an appropriate range of adverse scenarios of varying nature, severity and duration relevant to its business, and considers its exposure to those scenarios. A reverse stress test is a stress test that starts from the opposite end – with the identification of a pre-defined outcome. This might be the point at which an entity can be considered as failing, or the entity's business model becomes unviable. Severe, but plausible, scenarios that might result in this outcome are then explored.

## What are the key changes for audit committees?

The consultation recognises that the audit committee's role includes being an important safeguard in protecting the interests of a company's shareholders in relation to the company's external audit. There were a number of proposals aimed at strengthening the role and responsibilities of audit committees, and also subjecting them to more regulatory scrutiny.

- There's a focus on audit committees of FTSE 350 companies (with a possible extension to all PIEs in the future), with proposals for a new regulatory framework and explicit minimum standards for monitoring of audit quality and audit tender processes. ARGA would have the power to require information and/or reports from audit committees and a power to place an observer on the committee if necessary. ARGA would also have the power to take action against the audit committee if they are deemed to have breached the new requirements.
- A statutory requirement for audit committees/boards, initially of premium listed companies (but with a possible extension to all PIEs in the future), to develop an Audit and Assurance Policy to be put to shareholder advisory vote. The Audit and Assurance Policy would explain what independent assurance the company intends to obtain in the next three years in relation to the annual report and other company disclosures; much of this information is not currently covered by the audit of the financial statements. The policy would explicitly describe what, if any, independent assurance is planned in relation to the new resilience statement, and the directors' attestation on internal controls over financial reporting. We think that this proposal could create a new incentive for shareholders and audit committees to discuss proactively the scope of assurance, increasing engagement with the audit process. Reporting and assurance of non-financial metrics in areas such as climate impact will be a particularly important area of the new policy.
- A recommendation that a formal mechanism be established for audit committees of premium listed companies to gather shareholder views on the auditor's overall strategy and plan for the audit; shareholders would be able to suggest specific areas of focus for the annual audit. Guidance would be issued from the regulator to ask audit committees to encourage questions from shareholders about the company's audit.

## What are the key changes for auditors?

As we've covered above, the consultation included some significant proposals for companies and their directors. But of course, there remains a focus on reform for the audit profession. Proposals covered the introduction of a managed shared audit regime for the FTSE 350, specific new responsibilities for auditors as well as the suggestion that there should be a new profession of corporate auditing – to include those who give assurance over non-financial areas as well as financial statement auditors. BEIS hopes to drive a new auditor mindset, as well as strengthening the resilience of the audit market.

- A lot has already been reported about operational separation of the largest audit firms from their non-audit businesses and we've been working with the FRC to respond to their voluntary principles. The consultation proposed that the voluntary steps that we – and the other larger firms – are already taking, should be required through a combination of legislation and a statutory framework for the regulator.
- The initial market study by the CMA proposed joint audits as a means of increasing choice in the FTSE 350 audit market. This is no longer being considered as an option. Instead, BEIS is proposing a 'managed shared audit' regime. This would require all FTSE 350 companies, at their next retender date, to either:
  - Select a 'challenger' audit firm as their auditor; or
  - To outsource a 'meaningful proportion' (10-30% of either total audit fees, group revenues, profits or assets) of their subsidiary statutory audits to a challenger audit firm.

  The consultation was clear that BEIS expects there would be few, if any, exemptions granted. The proposal went on to say that if after a period (probably between five and nine years), choice of auditor in the FTSE 350 market has not sufficiently increased, then ARGA would be given powers to consult on the introduction of a market share cap.

  We believe that there would be many practical challenges with the design and implementation of this type of regime.
- BEIS recommended the creation of a new corporate auditing profession. This would effectively separate the audit profession from the accountancy profession, and would also create an opportunity for an 'auditor' to be broader than 'just' a financial statement auditor.
- Similar to the requirement that directors disclose the steps they have taken to address the risk for fraud, there was a proposal that the auditor should disclose how the audit has addressed the risk of fraud, including how the auditor has concluded on the effectiveness of internal controls around fraud.
- There was a recommendation that the auditor should consider 'wider financial and other information' when making judgements. It's not clear what would be considered 'wider information' but it's suggested that ARGA should write a standard for auditors to follow in this regard. Examples of 'wider information' could include director behaviours and perhaps external risk indicators, such as short selling.

## Changes to the PIE definition

Following a period of political disquiet after a number of high profile failures of large private companies, there was a recommendation in the consultation that the PIE definition should be extended to include more organisations where there could be a significant public interest.

PIEs are currently defined as: entities whose transferable securities are admitted to trading on a UK regulated market (informally – companies listed on the main market); credit institutions (informally – banks); or insurance undertakings. PIEs are subject to increased regulatory and disclosure requirements and their audits also come under more scrutiny. Suggestions for the PIE definition extension include:

- Large AIM companies (market capitalisation > €200m); and
- Some large private companies.

Large private companies would either be defined with reference to the 'Wates principles criteria' (companies with EITHER more than 2000 employees OR both a turnover of more than £200million and a balance sheet of more than £2billion) or with reference to the threshold for certain non-financial reporting requirements (companies with over 500 employees AND a turnover of more than £500million). Some large 'third sector' organisations could also be included.

New PIEs would fall within the regulatory scope of ARGA and would be subject to most of the proposals in the consultation. Depending on the measure used, there could be between 1000-2000 new PIEs.

## What does the consultation say about the impact of climate change?

The consultation didn't directly deal with the impact of climate change on corporate governance, reporting or audit. However, the consultation questions did ask whether the newly proposed resilience statement should be a vehicle for climate change reporting (specifically reporting arising from the Task Force on Climate-related Financial Disclosures (TCFD)), in whole or in part. It's also likely, although not specifically referenced, that the risk and reporting associated with climate change would be considered as part of the Audit and Assurance Policy.

## Next steps

- This consultation comes at an important time as the UK seeks to attract foreign investment and maintain its status as a leading place to do business.
- While the response period is now closed, we expect there will continue to be a lot of debate, and potential change, before any implementation happens.
- We would therefore like to encourage stakeholders to continue engaging and sharing their views on this topic as it evolves.



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