Restoring trust in audit and corporate governance

The BEIS reforms – FAQs

July 2022

pwc

Introduction

Purpose of this document

This is a list of frequently asked questions (FAQs) that are intended to help you navigate the Government's response to its consultation and to understand the implications of the most key proposals in more detail.

These FAQs are not definitive, but rather we are seeking to provide practical support to companies whilst we await more details on the reforms from the Government and / or the regulator. Our answers are based on our interpretation of the Government's proposals and Response Statement, as well as the FRC's Position Paper on the reforms. It is also not an exhaustive list, and we're sure there will be plenty of questions we've not yet thought about.

There's still a lot of uncertainty about what the final reforms will look like, and a number of the proposals will be subject to further consultation, but the thoughts we've set out below are designed to help you start to think through the implications for your organisation. The FAQs will be updated as and when we have substantial details to reflect.

Introduction to the reforms

On 31 May 2022, the Government (BEIS) published its Response Statement (the Statement) following its consultation (the Consultation) on reforms for "Restoring trust in audit and corporate governance". This was a significant consultation with 98 questions covering almost all 155 recommendations from the Kingman, CMA and Brydon reviews. The Government received over 600 responses to the consultation from stakeholders in all parts of the financial system and beyond. The Statement summarises the themes from the responses received, and outlines the proposals the Government intends to take forward through primary legislation, as stated in the Queen's Speech on 10 May, secondary legislation (potentially using existing powers that the Secretary of State has under the Companies Act 2006), or by other means, such as new or enhanced regulation. It also describes the proposals that will no longer be pursued. The majority of the proposals will be focused on Public Interest Entities (PIEs) over a certain size, with some just for premium listed companies and a couple of reforms aimed just at the FTSE 350. We have provided more details on this in the FAQs. See here for our summary of the key proposals in the Response Statement. We also have our Restoring Trust Series that provides practical guidance on how a number of the proposals could be implemented.

On 12 July 2022, the FRC issued a Position Paper on restoring trust in audit and corporate governance (the Position Paper). In the Position Paper, the regulator outlines its plans for supporting the Government's reforms that fall within its remit as it transitions into the Audit, Reporting and Governance Authority (ARGA). It outlines where there will need to be revisions and additions to the existing suite of Codes, Standards and Guidance to implement some of the reforms. Where relevant, we have included details of the FRC's plans in the specific questions within these FAQs.

In Appendix 1 we have provided a summary of the likely mechanisms through which the proposals will be implemented.

Potential timing

Primary and secondary legislation are dependent upon the Parliamentary timetable. If we assume that the Audit Reform Bill that includes the reforms being implemented through primary legislation is introduced following the Queen's Speech in May 2023, those reforms could become effective, following due legislative process, at some point in 2024 (for example, our understanding is that the target date for establishing ARGA is April 2024).

For reforms to be introduced through secondary legislation (for example the Audit and Assurance Policy), whilst technically these could be introduced more quickly if covered by existing powers that the Secretary of State has under Companies Act 2006, they will need implementation guidance from the regulator, which we expect will be subject to consultation. So the effective date for reforms through secondary legislation is also likely to be 2024 at the earliest.

Changes to the UK Corporate Governance Code (the Code), for example the strengthening of internal control requirements, are expected to be effective for periods commencing on or after 1 January, 2024, following consultation in Q1 2023. Changes to the Ethical Standard are also expected to be consulted on in Q1 of 2023, and be effective for periods commencing on or after 15 December, 2024.

If you would like to discuss any of these points further, please ask your usual PwC contact, or alternatively you can contact: Jayne Kerr (Director, UK Public Policy) at jayne.l.kerr@pwc.com, Sotiris Kroustis (Partner, UK Head of Public Policy) at sotiris.kroustis@pwc.com, or Flora Hogg (Senior Manager, UK Public Policy) at flora.v.hogg@pwc.com.

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Definition of a UK PIE

1. What is the current definition of a UK PIE and what regimes do today's PIEs have to follow?

Public Interest Entities or "PIEs" are currently defined as:

- entities whose transferable securities are admitted to trading on a UK regulated market (informally – companies with listed equity or debt on the London Stock Exchange);
- credit institutions (informally – banks); or
- insurance undertakings.

PIEs are subject to a number of legal and regulatory requirements over and above those that apply to non-PIE companies. These cover corporate reporting, audit and governance requirements. There are also some requirements that apply only to listed PIEs but we have not covered these in this paper as we are focused on the changes private companies will face if they become PIEs.

The key requirements that apply to today's PIEs are detailed in the Appendix 2, but in summary they are as follows.

Governance requirements

- PIEs must have an audit committee with a majority of independent members and at least one member with competence in accounting or auditing.

Corporate reporting requirements

- PIEs with over 500 employees must include a non-financial information statement in their strategic report.

Audit requirements

- PIEs must re-tender their audit appointment every ten years, and rotate the audit firm every 20 years.
- There are extensive restrictions on the non-audit services that auditors of PIEs can provide. Only those services on a short permissible list (included in the FRC's Ethical Standard[1]) can be provided, with a cap on the level of fees that can be earned from non-audit services.
- The Ethical Standard also imposes strict rules on the tenure of audit partners and senior audit staff, and requirements for cooling off periods between employment by the audit firm and employment by the audited entity.
- A number of UK Auditing Standards contain specific requirements in relation to PIEs which increase the level of review and reporting required from the auditor. Notably, PIE auditors are required to issue a public "extended audit report", setting out the details of the key audit matters considered, amongst other areas.

Note that some large private and AIM companies are considered "Other Entities of Public Interest" (OEPIs) because, although they don't meet the current definition of a PIE, they could be of significant interest to wider stakeholders. OEPIs already have to apply certain PIE restrictions – this is covered in more detail below.

2. How will the definition of a UK PIE be expanded?

As we've described above, only entities listed on the London Stock Exchange, banks and insurers are considered PIEs under the current PIE definition.

Through primary legislation, the Government intends to expand the definition of a PIE to include large private companies with both:

- 750 or more employees, and
- annual turnover of £750m or more.

In the remainder of the FAQs we will refer to this as the "750 / 750" threshold.

[1] https://www.frc.org.uk/getattachment/601c8b09-2c0a-4a6c-8080-30f63e50b4a2/Revised-Ethical-Standard-2019-With-Covers.pdf

The Government is clear in the Statement that the 750 or more employee threshold would include all global employees of the UK entity, so we are also assuming that the annual turnover measure would include turnover earned by the UK entity anywhere in the world. It is not yet clear how "turnover" would be defined, but we expect that the Government will try, where possible, to use existing definitions, for example in the Companies Act. Clarity will also be needed from the Government whether turnover should include intercompany revenue, or just that arising from third parties. For both the employee number and the turnover amount, we expect, in the interests of transparency, that already disclosed numbers would be used.

The FRC will also consult on revisions to the Ethical Standard to take account of the expanded PIE definition.

3. Will the expanded PIE definition apply at the individual company level or at the group level?

Companies will need to consider both individual entities and the group position when determining if the expanded PIE definition is met.

Private UK companies and UK groups

A stand alone private UK company will become a PIE if it meets the 750 / 750 threshold. From a group perspective, the situation is a little more complicated. From our interpretation of the Statement:

- Where there is a group in the UK, individual subsidiaries within that group will become a PIE if they meet the 750 / 750 threshold. The parent company will also become a PIE if one or more subsidiaries are PIEs by virtue of meeting the threshold.
- In situations where a subsidiary in the group is already a PIE, e.g. because it has listed debt or is an insurer, it is not yet clear whether, if that subsidiary meets the threshold, the parent will also become a PIE.
- Even if there are no individual subsidiaries in the group that meet the 750 / 750 threshold, if consolidated accounts are prepared in the UK and the consolidated group meets the threshold, the parent company will become a PIE.

It is our understanding that by "prepares", the Government means "files" consolidated accounts.

In these scenarios, we assume the parent in question would be the top UK parent only, i.e. not referring to any intermediate parent companies, although we know the Government is keen to ensure there is appropriate accountability of directors at the right levels within a group.

Note that these scenarios apply even if the UK group is ultimately headed by an overseas parent (listed or not listed).

UK groups with a listed UK parent

For a number of UK groups the parent company is already a PIE because it is the listed entity. In this situation, which we expect could be relatively common, any subsidiaries that become PIEs because they meet the threshold may already have been indirectly impacted by some existing PIE requirements, for example restrictions on non-audit services, but would need to also apply the new reporting requirements outlined in these FAQs.

Potential for duplication

As we outline above, the expansion of the PIE definition means it is feasible that there will be multiple PIEs in a group. It is not yet clear whether, in this situation, the new requirements will be applied at the group level or the individual PIE level (particularly in the scenario outlined above where the parent and one or more subsidiaries are PIEs but group accounts are not prepared). We expect this level of detail to be addressed as legislation is developed. The Government appears to be sympathetic to the issue of having multiple PIEs within a group and the risk of duplication, and has said it will consider a mechanism to help reduce this risk before introducing the legislation (for example, an option of either reporting at subsidiary level or reporting on a consolidated group basis).

PIE requirements

4. How will the PIE requirements be applied?

The Government has attempted to introduce proportionality into the application of not just new, but also existing, PIE requirements. All PIEs will be subject to regulatory scrutiny and the additional audit procedures that are required for a PIE, as outlined above. However, there will be some differences in application of other requirements, including the new corporate reporting requirements set out in the Statement and outlined in these FAQs, depending on the size of the PIE. This segmented approach will result in three levels of impact as follows:

1. **PIEs under the existing definition that do not meet the 750 / 750 size threshold** – these entities will not have to meet the new reporting requirements set out in the Statement, with the exception of premium listed companies, which will have to meet new requirements that are implemented through changes to the UK Corporate Governance Code (the Code), i.e. strengthening of internal controls.
2. **PIEs under the existing definition that do meet the 750 / 750 size threshold** – these entities will have to meet the new reporting requirements set out in the Statement, i.e. the Resilience Statement, Audit and Assurance Policy, directors' statement on fraud measures, and new disclosures about capital maintenance. They will also have to implement the changes to the Code around internal controls if they are required to apply the Code.

3. **New PIEs as a result of meeting the 750 / 750 size threshold** – these entities will have to meet the new reporting requirements set out in the Statement (as outlined above) and requirements that already apply to existing PIEs, excluding the requirements to have an audit committee, to retender the audit every ten years, and to rotate auditor every 20 years. They will also not have to apply the changes to the Code around internal controls, as they will not have to comply with the Code.

In the table below, we have mapped key PIE requirements highlighted in the Statement to the different tiers in more detail. Note this is based on our interpretation of the Statement and could be subject to change as the final legislation is developed.

Table of PIE requirements

Key PIE requirements	**Tier 1 – PIEs under the existing regime that do not meet the new size threshold.**		**Tier 2 – PIEs under the existing regime that do meet the size threshold.**		**Tier 3 – New PIEs as a result of meeting the size threshold (including existing OEPIs that meet the size threshold)**
	Not premium listed	Premium listed	Not premium listed	Premium listed	N/A
Regulatory scrutiny, enhanced director accountability and a PIE audit	✓	✓	✓	✓	✓
Mandatory firm retendering and rotation and requirement to have an audit committee	✓	✓	✓	✓	✗
Subject to list of permissible non-audit services	✓	✓	✓	✓	✓
Subject to 70% cap on fees for permissible non-audit services	✓	✓	✓	✓	✓
Strengthened internal controls	✗	✓	✗	✓	✗
Resilience Statement	✗	✗	✓	✓	✓*
Dividend and capital maintenance disclosures	✗	✗	✓	✓	✓*
Audit and Assurance Policy	✗	✗	✓	✓	✓*
Steps taken to prevent and detect material fraud	✗	✗	✓	✓	✓*
Minimum standards for audit committees	✗	✓ – if a FTSE350	✗	✓ – if a FTSE350	✗
Managed shared audits	✗	✓ – if a FTSE350	✗	✓ – if a FTSE350	✗

* As further explained below, it is our understanding that new or existing PIEs that are not companies will not be subject to these new reporting requirements

5. Over what period or periods would the 750 / 750 threshold be applied when determining if a company becomes or ceases to be a PIE?

If the company qualifies as a PIE because it is newly listed, the Government is clear that, as it is assumed that it should have complied with the vast majority of the requirements when preparing for listing, it does not intend to provide temporary exemptions from PIE requirements. Notwithstanding this, if the newly listed company does not meet the 750 / 750 threshold, we are assuming it will not have to apply all of the PIE requirements, as described above.

If the company is private and becomes a PIE by virtue of meeting the 750 / 750 threshold, to ensure that the company and its auditors have sufficient time to prepare for complying with PIE requirements (for example, ensuring the auditor does not provide excessive or prohibited non-audit services), the Government will allow an adequate period between an entity exceeding the new 750 / 750 threshold and being subject to any new requirements. The Government will set out the details in legislation, but it will be a full annual reporting period as a minimum. Our interpretation of this is that the entity will not officially become a PIE until the beginning of its next financial year, at the earliest.

The Government intends to introduce a smoothing mechanism which will mean that entities will have to continue meeting the PIE requirements for a set period after they qualify as a PIE, even if they drop below the 750 / 750 threshold. Details of this mechanism will be included in legislation.

6. What about the restrictions on provision of non-audit services? If I'm a director of a UK PIE (existing or new), do these restrictions impact other companies in the group?

Assuming that the current approach set out in the Ethical Standard is followed, the restrictions on provision of non-audit services would continue to apply to the PIE itself (new or existing), to a UK parent of the PIE, and to all subsidiaries of the PIE (whether they are in the UK or elsewhere in the world). However one thing to consider is that, should the parent of a PIE become a PIE itself by virtue of a subsidiary or the consolidated group meeting the 750 / 750 thresholds described above, it would appear that the non-audit services restrictions could then apply to all companies that sit under that parent, so there would be a bigger impact on the ability to provide these services within a UK group.

As noted above, in its Position Paper, the FRC has said that, following consultation, the Ethical Standard will be revised to take account of the new proposed framework for PIEs.

7. Companies with listed debt are already PIEs under the current definition. Are there any changes impacting these companies?

We are assuming that the changes outlined above will be the same for both equity and debt-listed PIEs and will similarly depend on whether the entity meets the 750 / 750 threshold.

Other Entities of Public Interest (OEPIs)

9. What will happen to the OEPIs under the new proposal?

The FRC Ethical Standard 2019 introduced a new category of UK companies – "Other Entities of Public Interest (OEPIs)". The only restriction for OEPIs is that they have to apply the same restrictions on non-audit services provided by their auditor as those applicable to PIEs, with the exception of the 70% fee cap.

The Ethical Standard's definition of an OEPI includes larger private companies with either 2,000 employees OR £200m+ in turnover and £2bn+ in assets. The 750 / 750 threshold that the Government intends to use to bring private companies under the PIE definition would capture some of these existing OEPIs. As noted above, these companies will already be applying the non-audit services restrictions that come with being a PIE (although they will become subject to the 70% cap) and, as we note above, private companies that become PIEs by virtue of meeting the threshold will not be subject to mandatory audit firm rotation, which is the same for current OEPIs. So, most likely, the biggest change for these companies of being a PIE, rather than an OEPI, will be that they fall under the regulatory scope of the FRC / ARGA, will be subject to PIE audit requirements, and will have to apply the new corporate reporting requirements. So, if you're a director of a current OEPI, and your company is likely to become a new PIE, there will be plenty of new requirements for you to consider and take action.

There may be some OEPIs that won't be captured by the new PIE definition (for example if they don't have £750m in turnover). We don't yet know whether the FRC will continue to identify certain companies as OEPIs, over and above the new definition of PIE. However, in its Position Paper, the FRC does say it will consult on whether to maintain the OEPI definition.

AIM companies

10. What will be the impact on AIM companies that qualify to be PIEs?

AIM companies that meet the 750 / 750 threshold would qualify as PIEs under the expanded definition. Some AIM companies are already considered to be OEPIs and so for these companies, as we explain above, the restrictions on non-audit services will not be new (although they will now be subject to the 70% fee cap). In addition, AIM companies also have to apply and report against a recognised governance code under AIM Rule 26; this means that some will already have an audit committee that would comply with the requirements for PIE audit committees. AIM companies are also already subject to the FRC's Corporate Reporting Review process and their auditors are already subject to both the FRC's Audit Quality Review process and Audit Enforcement Procedure, as well as to certain auditing standard requirements, including having an extended audit report.

However, the new PIE reporting requirements will create new demands for AIM companies that are designated as PIEs because they meet the 750 / 750 threshold.

Other entities

11. Which other entities will be considered as PIEs under the extended definition?

Third sector entities (including charities) and LLPs that meet the 750 / 750 threshold will also be considered PIEs. However, although these entities will be PIEs with the regulatory scrutiny that comes from being a PIE and have a PIE audit, only PIEs that are companies will have to undertake the new reporting requirements.

Lloyd's syndicates, local authorities and other public sector bodies that are not already considered to be PIEs,(for example because they have listed debt) are not intended to be included as PIEs based on size, even if they exceed the size threshold.

Increased director and audit committee accountability and scrutiny

Increased director and audit committee accountability and scrutiny

Background

1. Why does the Government think directors need to be held more accountable?

In the Consultation the Government stressed that it is vital that directors of the largest companies are held to account, both to protect the interests of shareholders and because a loss of trust in directors and companies could have far-reaching adverse effects across the UK. As described below, today there's a rather complex picture when it comes to holding directors accountable; the Government believes one of the consequences of this complexity is that if there are instances of poor or misleading corporate reporting – or weak internal controls that lead to errors in reporting – it's actually quite hard for directors to be held to account. That was the conclusion reached by Sir John Kingman when he undertook his independent review of the FRC, and he recommended to the Government that there needed to be a clearer and simpler accountability regime for directors in respect of their corporate reporting and audit responsibilities.

2. What is the current regime for directors' accountability as it applies to corporate reporting and audit?

Today directors face a patchwork of responsibility and accountability regimes in relation to corporate reporting and audit. There are directors' duties under the Companies Act 2006, duties under the Listing Rules and other FCA regulations, and of course the current regulator, the FRC, is responsible for the UK Corporate Governance Code (the Code) that sets out principles to be followed by directors of premium listed companies. Here is a summary of the various elements.

Companies Act 2006

The Companies Act 2006 includes directors' duties in respect of:

- **Company accounts and reports:** Directors have a duty to keep adequate accounting records and to prepare reports (e.g. strategic, remuneration and directors' report) which need to be approved by the board of directors and signed off by a director on behalf of the company.
- **Audit:** Directors have the duty to appoint an auditor and provide information or explanations at the request of the auditor.

Listing rules

Directors of companies that are listed in the UK (whether incorporated in the UK or elsewhere) must follow minimum requirements for the admission of securities to listing, the content, scrutiny and publication of listing particulars, and continuing obligations of companies after admission. For example, directors of a company that is seeking a premium listing of its shares on the Main Market of the London Stock Exchange, have to be satisfied that there are established procedures that provide a reasonable basis for them to make proper judgements on an ongoing basis as to the financial position and prospects (FPP) of the applicant and its group (Listing Rule 8.4.2(4)).

UK Corporate Governance Code

The Code applies to companies that have a premium listing in the UK (whether incorporated in the UK or elsewhere), and contains Principles, Provisions and guidance. Whilst the Principles must be adopted, the Provisions apply on a "comply or explain" basis.

Section 4 of the Code sets out the requirements relating to audit, risk and internal control and sets out both Principles and Provisions that relate to accounting and financial reporting. Principle M provides that "The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements" and Principle N provides that "The board should present a fair, balanced and understandable assessment of the company's position and prospects". The Provisions include requirements for the board relating to: establishing an audit committee and setting out its main roles and responsibilities; stating in annual and half yearly statements whether it considers it appropriate to adopt the going concern basis of accounting and to identify any material uncertainties to the company's ability to do so over at least the next 12 month period. Directors should also explain their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position, performance, business model and strategy. The board should also confirm that it has assessed the prospects of the company and whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities.

The Listing Rules require that companies report on how they have complied with the Code in their annual report; clear explanations are expected if a company has departed from any of the Provisions. The Code does not create any additional director duties in itself.

FCA

Of course, directors of financial services companies face additional responsibilities, for example, those set out by the FCA:

- **FCA Handbook:** Companies (and company directors) in the financial services industry are subject to the Principles and Code of Conduct set out in the FCA Handbook. There are 11 Principles which include requirements to: conduct business with integrity, due skill, care and diligence; observing proper standards of market conduct; take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- **Senior Managers and Certification Regime (SMCR):** Individuals who perform a senior management function in a FCA/PRA regulated firm, must be approved by the FCA and produce a statement of responsibilities that sets out what they are responsible and accountable for, there are also prescribed responsibilities set out in the FCA Handbook that will apply. Each senior manager is subject to a statutory "duty of responsibility" which means if something goes wrong in an area that they are responsible for, the FCA will consider whether they took reasonable steps to stop this from happening and can take action if a breach has occurred. This regime is applicable to directors performing a senior management function, regardless of whether they are UK based or overseas.

3. In what ways are directors held accountable today if they breach their duties / responsibilities?

In theory, shareholders could bring an action for breach of duty under the Companies Act 2006 against a director; in fact they have to get the Court's permission to do that, and then the company itself would have to take action against the director. This means it is a complex process and rarely happens.

The FCA can pursue directors for breaches of FCA regulations, including the Listing Rules, – but in practice (at least outside of financial services) that's very rare, and typically only happens for truly egregious offences like insider trading.

The Code has no enforcement mechanism attached to it at all; the theory is that the company's shareholders should exert pressure on the directors to change their behaviour in the event of non-compliance.

If there's an error in the accounts, the FRC has rights of enforcement, but the FRC can only pursue a director if s / he is a member of a professional accounting or actuarial body. In addition, the FRC's current regulatory locus extends only over the financial statements and certain sections of the "front half" of the annual report and not over the whole annual report.

The Insolvency Service has powers to investigate directors – and ultimately could order that a director be disqualified. That is a power that's used, but the Insolvency Service has limited resources and so it tends to use this power only in very high profile situations.

Increased accountability of directors

4. How does the Government intend to hold directors more accountable and will it apply to all directors?

Through legislation, the Government will give the new regulator, the Audit, Reporting and Governance Authority (ARGA) the power to investigate and sanction breaches of corporate reporting and audit-related duties and responsibilities by directors of Public Interest Entities (PIEs).

There's a few critical elements of this proposal:

- Firstly, it will apply to directors of PIEs. Currently PIEs comprise companies with listed debt or equity on the Main Market of the London Stock Exchange, banks and insurance companies. But, as outlined above, the Government intends to expand this definition to include private companies, AIM companies, LLPs and third sector organisations over a certain threshold.
- Secondly, it will apply to ALL directors. This moves beyond today's position where only directors who are members of professional accountancy bodies can be held to account by the FRC and puts all directors, whether executive or non-executive directors, at risk of enforcement.
- Thirdly, the powers of the regulator are concerned with breaches of corporate reporting and audit related duties and responsibilities. This moves the bar for enforcement action to what could be quite a detailed level; potentially it's a lot easier to breach a corporate reporting duty than it is to be negligent in following directors' duties. It's important to note also that this will include the new corporate reporting responsibilities, such as those around fraud and capital maintenance and internal controls (where applicable), that we discuss elsewhere in this paper.

This new enforcement regime will not replace existing arrangements for taking action against company directors outlined above.

5. How will the regulator exercise these powers?

The Government intends to ask ARGA to set out what it reasonably expects of PIE directors by way of compliance with their legal duties in relation to corporate reporting and audit, as well as how directors are expected to demonstrate they have complied with these duties. This would appear to signal a significant change for directors and a significant responsibility for the regulator, first of all in setting standards for directors that are clear and proportionate, and then in exercising its ability to supervise the application of those standards, and to enforce where there are breaches, in a fair and transparent manner.

The Government is also keen that the new enforcement regime be targeted and proportionate, taking account of an individual director's role and experience, so that they are only accountable for what could be reasonably expected of a person in their position.

6. Will this result in overlap and / or duplication between the role of ARGA and existing scope or powers of the FCA and other regulators?

The Government acknowledges that there could be a degree of overlap in powers, but is clear that companies and directors should not face any unfairness as a consequence of parallel or competing investigations by two different regulators into essentially the same circumstances. It intends to manage this through effective coordination and cooperation, as well as by a Memorandum of Understanding that sets out the respective roles and responsibilities of ARGA and the FCA and how they will manage any overlap in their powers.

7. Are there any changes to the conditions for malus and clawback of remuneration?

The Government continues to believe that companies that follow the Code should explain more clearly to shareholders and other interested parties what malus and clawback conditions they have in place and be encouraged to consider a range of possible conditions. It will ask the FRC to consult on how the existing malus and clawback provisions in the Code can be developed to deliver greater transparency, and to encourage consideration and adoption of a broader range of conditions in which executive remuneration could be withheld or recovered, beyond that of "gross misconduct" or "material misstatements" (which account for the majority of malus and clawback conditions currently).

Increased scrutiny of audit committees

8. There will be new requirements for increased scrutiny of audit committees of FTSE 350 companies over audit tendering and monitoring of the audit. Why is the Government making this recommendation?

Both the review of the audit sector by the Competition and Markets Authority (CMA) and Sir John Kingman's review of the FRC raised concerns that the commercial relationship between a company's audit committee and its chosen auditor could result in a lack of scepticism being exercised by both parties. The CMA also commented that "cultural fit" and "chemistry" played a part in the selection of auditors by audit committees. As a result, the CMA recommended that audit committees of FTSE 350 companies should be required to meet minimum standards, and come under greater scrutiny by ARGA in relation to audit tender processes and the ongoing monitoring of the audit.

In our experience, many audit committees already function to a high standard. However, an enhanced regulatory framework and increased reporting and oversight could be useful in bringing greater consistency between audit committees.

9. What are the current requirements of audit committees when it comes to the audit tender process and the audit?

Most PIEs are required to establish an audit committee (or body performing equivalent functions). The audit committee is there to act as a safeguard in protecting the interests of shareholders in relation to the company's external audit. In choosing an audit firm, the audit committee must carry out a prescribed selection process under the Companies Act 2006, after which it must make a recommendation to the board of its first and second choice candidates for auditors, together with reasons for those choices. The tender documents must contain non-discriminatory clauses and the audit committee must make a statement confirming that the recommendation is free from third party influence and that there are no contracts restricting the choice of auditors. The audit committee also has a number of other ongoing functions in relation to the audit, including: reviewing and monitoring the auditor's independence and objectivity; reviewing the effectiveness of the audit; and informing the board as to the outcome of the audit.

10. What will the new requirements be and who are they for?

Exact details of the new requirements are not covered by the Statement, but the Consultation indicated that they would cover the need for audit committees to monitor audit quality continuously, and consistently demand challenge and scepticism from auditors. The Position Paper also says that the standards will address how audit committees can support greater market resilience and diversity when tendering for audit services.

The scope of the requirements will be set out in legislation and will initially apply to FTSE 350 companies. ARGA will then set the actual minimum requirements / standards. They plan to issue these in "shadow" form initially, so companies can adopt them voluntarily if they choose. The standards are expected to be available for use in 2023, with supervision of companies' compliance beginning in 2024. It appears application of the new requirements will not be through the Code as that would only be on a comply or explain basis. Instead, we assume it will be through a more enforceable regime / mechanism within the powers of ARGA.

Once the requirements have been implemented, ARGA will monitor their impact and the Government will consider whether they should be extended to a wider community of PIEs.

11. How will compliance with the new requirements be monitored?

As noted above, the Government will empower ARGA to monitor compliance with the new requirements on audit committees. Monitoring will be conducted through reviews of publicly available information as well as new powers to obtain information and reports. In cases of failures of compliance, ARGA will also be able to impose sanctions by means of accompanying enforcement powers. Note that the Government has decided not to proceed with the original proposal of placing an independent observer on the audit committee, except in extremely limited circumstances, such as when a company has parted with their auditor outside the normal rotation cycle or the audit committee is implicated by audit failings.

While not set out in detail in the Statement, in the Impact Assessment that accompanied the Consultation, the Government assumed that each year ARGA would perform targeted monitoring of five audit tenders and of the ongoing activities of 50 audit committees.

Stronger internal controls

Stronger internal controls

1. What will be required and who will it apply to?

The Government has invited the FRC to consult on strengthening the internal controls provisions in the UK Corporate Governance Code (the Code) to provide for an explicit statement from the board on its view of the effectiveness of the internal control systems (financial, operational and compliance systems) and the basis for that assessment. It is expected that the regulator will provide guidance underpinning this requirement, covering the identification of acceptable standards, benchmarks or principles and address definitional issues and the circumstances in which external assurance might be considered appropriate.

In its Position Paper, the FRC confirmed that it would make revisions to the parts of the Code that deal with the need for a framework of prudent and effective controls to provide a stronger basis for reporting on and evidencing the effectiveness of internal control around the year end reporting process. It will also update its "Guidance on Risk Management, Internal Control and Related Financial and Business Reporting" to take account of changes to the Code around internal control.

As the requirements will be in the Code, they will apply to companies that adopt the Code, which, today, is premium listed companies.

2. What are the requirements today and how is this different?

UK law and regulation already includes various responsibilities in respect of internal control for companies and their directors. Key elements include the following:

- The Companies Act 2006 requires all companies to keep adequate accounting records (although there is no recent guidance on what this means in practice).
- The Listing Rules require premium listed companies to report against the Code, which itself requires boards to establish a framework of prudent and effective controls, which enable risk to be assessed and managed.
- To address these responsibilities under the Code, boards must also monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review, although there is no actual requirement for Boards to make a positive statement on the conclusion of the review. Guidance on performing the review is set out in the FRC's "Guidance on Risk Management, Internal Control and Financial and Business Reporting", mentioned above. This recommends that companies applying the Code "explain what actions have been taken or are being taken to remedy any significant failings or weaknesses".
- Directors of a company that is seeking a premium listing of its shares on the Main Market of the London Stock Exchange, have to be satisfied that there are established procedures that provide a reasonable basis for them to make proper judgements on an ongoing basis as to the financial position and prospects (FPP) of the applicant and its group (Listing Rule 8.4.2(4)). There is guidance from the ICAEW on what these procedures should entail, which includes assessing the IT environment, although there is little mention of transactional level controls.
- Most existing listed Public Interest Entities (PIEs) must, under the FCA Disclosure Guidance and Transparency Rules, provide a description of the main features of their systems of internal control and risk management specifically in relation to the financial reporting process.

These existing requirements do not require an explicit public statement on the effectiveness of internal control to be made by directors, so it is expected that the new requirement for directors to make such a statement on the effectiveness of internal control goes further than the requirements outlined above. Also, although it's unclear exactly how prescriptive the enhancements to the Code will be, the proposals already suggest more structure than currently exists.

Further, the Government proposals to strengthen the enforcement powers of the regulator, described above, would enable the regulator to sanction directors where they have failed in their corporate reporting duties, presumably including reporting on internal controls.

3. How does this compare to US SOx reporting requirements?

At this stage, without an understanding of the framework that would underpin the new requirement, it is impossible to be definitive. We do know that, while these proposals are viewed by some as a lesser version of the US SOx requirements, because they will not be enshrined in legislation, the Government believes that proceeding through changes to the Code is more practical and proportionate. Additionally, per the Statement, this is a way of testing and refining an approach before potentially making it a stronger legal requirement and expanding it to a broader range of companies in the future if needed. Most significantly perhaps, although provisions in the Code are on a comply or explain basis and only apply to premium listed companies, the strengthening of internal controls requirements over financial and operational and compliance controls, which the Government suggests, is broader than the US SOx focus on controls relating to financial reporting.

4. Does this mean there will be even stronger requirements in the future and for more companies?

As mentioned above, the Government believes the Code is a way to test and refine an approach before making it a stronger legal requirement if needed. That is not to say the Government will definitely make this a stronger requirement in the future, but we know that the Government and the regulator will review the effectiveness of the envisaged Code changes, presumably including those that make reporting on controls more informative, as part of a Post-Implementation Review of the full reform package. At that point, we assume the Government will consider if further measures are needed and also if the requirements should be expanded to other PIEs. Also, as noted below, there are other ways the Government is intending to increase the focus on controls.

5. What are the other ways in which the Government intends to increase the focus on internal controls?

In addition to the enhanced Code requirements, the Government intends to increase the focus on internal controls by:

- requiring PIEs above the 750 / 750 threshold as part of their Audit and Assurance Policy (see below) to describe whether or not they plan to seek external assurance of the company's reporting on internal controls; and
- asking the regulator to explore with investors and other stakeholders whether, and how, the content of auditors' reports could be improved to provide more information about the work auditors have undertaken on the internal controls over financial reporting as part of the audit.

5. What if I am compliant with a SOx regime, with the UK rules be an additional requirement?

There is no specific mention in the Statement of equivalence between the strengthened UK requirements and other regimes. In the Impact Assessment that accompanied the Consultation, companies that already complied with the US SOx regime were excluded from the number of companies expected to be impacted by a strengthened UK regime. From this it can be inferred that, for internal controls around financial reporting at least, there is an assumed equivalence between US SOx and the UK proposals.

There was no indication of whether other SOx-style regimes (such as those in Japan, South Africa or India) would be considered equivalent.

It is important to note, however, that in the Statement, as noted above, the Government proposes to make the UK requirements cover not just financial controls (the focus of US SOx) but also operational and compliance controls systems, which means even companies that are already compliant with US SOx may have additional work to do around this broader spectrum of controls.

7. Although assurance over the directors statement is not being mandated, do you think the market will drive the demand for assurance?

By strengthening the requirements through the Code rather than new legislation, the Government believes that it will avoid companies defaulting to seeking external assurance from their auditors as the safest way to avoid challenge of their statement.

Instead, the Government suggests that as part of the proposed Audit and Assurance Policy (see below), the directors would be required to explicitly state whether independent assurance has been commissioned over the company's internal control framework. Although the Government has therefore stopped short of mandating independent assurance, there appears to be an expectation that boards would consider the need for it carefully. In its Position Paper, the FRC said it intends to consult on proposed guidance in the form of performance standards to support a consistent approach to assuring internal controls reporting (as well as the new Resilience Statement – see below), which also points towards the expectation that there could be more demand for assurance over internal controls.

Even if the directors' statement is not to be audited or assured, we think it is important that the supporting work is performed to an 'auditable' standard. This would drive quality and consistency in performance and, in the event that directors are challenged on the basis for their statement, provide an evidence base for their conclusions. Based on our experience of US SOx, where assurance on the directors' attestation is mandatory in most cases, the directors' statement and the related assurance meaningfully contribute to the reliability of financial statements.

8. What framework do you think companies will end up using? COSO?

As noted above, as part of the explicit statement on effectiveness that the board will be required to make, there will be an expectation that companies also disclose the benchmark used. This suggests that there could be multiple frameworks considered suitable for this purpose, and we expect that the FRC will provide more guidance on this when it consults on changes to the requirements of the Code. Two potential frameworks referenced in the Consultation are:

- the COSO framework – a well known framework setting out an approach to establishing governance processes and controls. It is commonly used by (although not mandated for) companies complying with the US SOx requirements; and
- the FPP approach prescribed by the UK Listing Rules. Following the Brydon Review, the Audit Committee Chairs' Independent Forum (ACCIF) drafted a set of principles which could be used to support the directors' statement. These principles used the FPP approach as a basis.

We will need more detail from the regulator on what the ultimate framework might look like, but neither of these frameworks specify how to assess and test effectiveness of controls, so that will need to be considered if they are used as a basis.

For practical advice on how to get started with the strengthened requirements and the benefits they will bring, please see our Restoring Trust guide on "Restoring trust through stronger internal controls".

New reporting responsibilities for directors

New reporting responsibilities for directors

Background

1. What are the new reporting responsibilities for directors and which companies would these apply to?

The Government plans to increase the reporting responsibilities of directors by requiring new statements and disclosures in the financial statements, or the 'front half' of annual reports. These are:

- dividend and capital maintenance disclosures;
- the Resilience Statement; and
- the steps taken to prevent and detect material fraud.

Each of these new disclosures will only apply to PIEs that meet the 750 / 750 threshold described above (i.e. with both 750 or more employees and £750m or more annual turnover – also refer to the section above for more details on group situations).

In its Position Paper, the FRC confirmed that it will develop guidance for companies on each of these new disclosures.

Below, we've answered some of the frequently asked questions about these new reporting responsibilities.

Dividend and capital maintenance disclosures

2. What will be required?

Following a number of high profile examples of companies paying significant dividends shortly before profit warnings and, in some cases, insolvency, the Government intends to introduce a number of new disclosures around dividends and capital maintenance as follows:

- companies, or in the case of a UK group, the parent company only, will be required to disclose their distributable reserves at the balance sheet date, or a "not less than" figure if determining an exact figure would be impracticable or involve disproportionate effort;
- a narrative explanation of the board's long-term approach to the amount and timing of returns to shareholders (including dividends, share buybacks and other capital distributions) and how this distribution policy has been applied in the reporting year; and
- an explicit statement confirming the legality of proposed dividends and any dividends paid in the year.

3. Where in the annual report would the new disclosures be presented and will they be subject to audit?

The company's (or in the case of a UK group the parent company's) disclosure of distributable reserves (and we assume the narrative explanation around the policy) at the balance sheet date will be included, as at the balance sheet date, in the audited financial statements, so will be subject to audit.

Our understanding is that the legality of dividend statement will be in the directors' report, which would mean that it would not be audited; instead the statement would be covered by the requirement for the auditor to read the disclosures and consider whether there are any material inconsistencies with the financial statements or their knowledge from the audit. If the company were to decide that further assurance over the statement was desirable, this could be considered as part of the Audit and Assurance Policy described below.

4. What if it is not possible to determine the exact amount of my company's distributable reserves?

The Statement acknowledges that there may be situations where it is impossible to calculate the distributable reserves figure exactly, for example when a company's profit history goes back many years. In this situation, companies would be permitted to report a "not less than" figure for distributable reserves. This would act as a 'dividend cap' and any proposed dividend would not be allowed to exceed this known figure.

5. Will there be guidance on what is considered to be distributable reserves and the new disclosures?

Guidance on distributable reserves currently exists and is published by ICAEW and ICAS. As part of the reforms, the Government will give ARGA the formal responsibility to issue guidance to companies on what should be treated as "realised" profits and losses for this purpose. It is also expected that the regulator will issue guidance on the format of the new disclosures and also the new narrative reporting requirements.

Per its Position Paper, the FRC states that the FRC Lab will carry out a series of projects to assist in the development of the new reporting requirements, including capital maintenance disclosures.

6. It was proposed in the Consultation that the group dividend-paying capacity be disclosed and that there should be directors' assurance that a dividend wouldn't jeopardise the future solvency of a company. Are these no longer going to be required?

In response to the concerns expressed by many of the respondents to the Consultation about the group-wide disclosure, namely that it would be costly, complex and potentially misleading, the Government has decided not to make this a legislative requirement, rather companies will be encouraged to make the disclosure. That said, as part of the narrative explanation of the company's long-term approach to making returns to shareholders, companies will be expected to explain the availability of distributable reserves and cash within the wider group and any significant barriers to subsidiary companies paying up dividends to the parent.

The Government has also decided not to proceed with the proposal that directors provide assurance that a dividend wouldn't impact company solvency and, instead, it is expected this will be taken into account in the Resilience Statement described below.

The Resilience Statement

7. What will be required?

Companies will be required to produce an annual Resilience Statement, where the directors will report on matters they consider a material challenge to resilience over the short and medium term, together with an explanation of how they have arrived at this judgement of materiality and their approach to managing and developing resilience. In doing so, companies will be required to have regard to (as opposed to being required to address each risk as was originally proposed), the following **risks**:

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

Companies will be required to report for each of the relevant risks above and any material risks to resilience not in this list:

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

Guidance will be developed by the regulator that sets out more detail on how the potential materiality of these matters should be considered as well as on the Resilience Statement as a whole.

Term – There will not be a minimum five year mandatory minimum assessment period for the combined short and medium term parts of the Resilience Statement, as was originally proposed. Instead, companies will be obliged to choose and explain the length of the assessment period for the medium-term part of the Resilience Statement and describe how resilience planning over that period aligns with the company's strategy and business investment cycle.

There will still be a long-term element to the Resilience Statement, although legislation won't be prescriptive over its term or contents, beyond asking that it goes beyond the medium term section and covers long-term challenges to the company's business model and strategic planning to address these challenges.

Reverse stress tests – Companies will be required to provide a minimum of one reverse stress test (see below).

Material uncertainties – Companies will be required to disclose material uncertainties to going concern that existed prior to taking mitigating action or the use of significant judgement, which the directors consider are necessary for shareholders and other users of the Resilience Statement to understand the current position and prospects of the business (effectively "gross" materialities). This does not change existing requirements for disclosing material uncertainties relating to going concern under accounting standards.

8. What are reverse stress tests the Goverment proposes would be required?

Stress testing is a forward–looking analysis technique that many entities already carry out to some degree, even if they don't describe it as such. 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.

The Government will require companies to disclose at least one reverse stress test in which a company would:

- identify a combination of adverse circumstances annually, which would cause its business plan to become unviable;
- assess the likelihood of such a combination of circumstances occurring; and
- summarise within the Resilience Statement the results of this assessment and any mitigating action put in place by management as a result. The summary would not be required to include any information which, in the opinion of the directors, would be seriously prejudicial to the commercial interests of the company

The process behind this disclosure will need to be documented, and that documentation available to the regulator to review on request.

9. Will this overlap the reverse stress testing banks and other financial services companies already have to carry out?

In the Statement the Government recognises the need for consistency between this new requirement and existing requirements for banks and other financial services companies, and not replicating existing obligations to test solvency and capital adequacy in the financial system. It intends to address in the design and implementation of the legislation how these entities might rely on existing reverse stress testing activity.

10. How might climate-related risks be considered as part of the Resilience Statement?

When implementing and developing supporting guidance for the Resilience Statement, the Government, along with the regulator, will consider how it can effectively reference, make links to, and provide a coherent framework with wider sustainability disclosures. In the Consultation, it was suggested that the long-term part of the Resilience Statement could be a means for companies to provide disclosures consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

11. Where will the Resilience Statement be in the annual report and what will happen to existing requirements around going concern and viability?

It is expected that the Resilience Statement will be in the Strategic Report. Companies will be given the flexibility to report the existing principal risks and uncertainties facing the business that are already in the strategic report within the short and / or medium term sections of the Resilience Statement, noting that different kinds of risk or uncertainty may crystallise or resolve over different time periods.

Subject to consultation, the Government intends that the existing viability statement provision in the UK Corporate Governance Code (the Code) will be incorporated into statutory requirements for a Resilience Statement, and the existing Code provision will then cease to apply. The Government also plans to consult on removing Provision 30, covering the going concern statement, from the Code as this will also be incorporated into the Resilience Statement, and companies will continue to provide a going concern statement as required by accounting standards and company law. This means that premium listed entities that do not meet the 750 / 750 threshold, and so do not have to have a Resilience Statement, will no longer need to do a viability statement or going concern statement under the Code once it is amended (but will continue to be required to make a going concern statement in the financial statements under accounting standards).

12. Will the Resilience Statement be assured?

As noted above, the Resilience Statement will not sit in the financial statements, and so will not be subject to audit (although the going concern element will be subject to audit as it is also required under accounting standards to be in the financial statements). The Resilience Statement will be covered by the consistency check an auditor is required to perform between disclosures in the front half of an annual report, the financial statements and their knowledge from the audit.

Companies will be required to explain in the Audit and Assurance Policy (see below), their approach to seeking independent (external) assurance over any part of the Resilience Statement. Further, in its Position Paper, the FRC states that it intends to consult on proposed guidance in the form of performance standards to support a consistent approach to assuring the Resilience Statement (and internal controls, see above). Both of which suggest there is some expectation that the market may demand assurance.

For practical advice on how to get started with the Resilience Statement, please see our Restoring Trust guide on "Restoring trust through the Resilience Statement".

The steps taken to prevent and detect material fraud

13. What will be required?

The Government intends to legislate to require directors to report on the steps they have taken to prevent and detect material fraud.

14. Is there any indication in the Statement as to what this disclosure would look like and where it would sit?

There's not a lot of detail in the Statement about what the directors' disclosure will look like in practice. However, there was an indication in the Impact Assessment that accompanied the Consultation, that the directors would be required to report on the actions they have taken to fulfil their obligation to prevent and detect material fraud. It went on to say that such actions may include undertaking an appropriate fraud risk assessment and responding appropriately to identified risks; promoting an appropriate corporate culture and corporate values; and ensuring appropriate controls are in place and operating effectively.

For many companies, being able to support such a disclosure could involve quite a significant change in terms of the formalisation of their approach to fraud risk management. In our experience, there is much variability in the rigour of companies' existing fraud risk management programmes and in particular their fraud risk assessments, with many companies not yet having a formal process in place. Based on this additional detail in the Impact Assessment, we would assume at a minimum, companies would need to prepare a fraud risk assessment to support their disclosure and it would seem sensible for directors to put additional focus on the design and operating effectiveness of their internal controls relating to fraud.

As described below, the directors' reporting would be covered by the auditor's work on the consistency between the front half of the annual report and their knowledge from the audit, which implies that the disclosure will be part of the front half of the annual report (rather than in the financial statements), but we expect the location to be confirmed as the requirement is developed.

15. Will the auditor have increased responsibilities for reporting about the risk of fraud?

The Government originally proposed that auditors would report on the work they have performed to conclude whether the directors' statement is 'factually accurate'. Separately, it was proposed that auditors would then report on the steps they themselves had taken to detect material fraud and assess the effectiveness of "relevant controls" – which we assumed refers to the controls the company has in place to prevent and detect material fraud.

However, in the Statement, the Government has decided that existing requirements to identify and report on material inconsistencies in directors' reporting will be sufficient in reporting on the directors' fraud statement. Also, the Government intends to wait and see if the recently revised auditing standard over fraud (ISA (UK) 240), has the anticipated effect in clarifying what is expected of auditors in explaining the work they have done to detect fraud and to assess the effectiveness of relevant fraud controls.

We've created a guide to developing a fraud risk management framework, including a fraud risk assessment as part of our Restoring Trust document "Restoring trust through enhanced fraud risk management". This guide also provides our view on what might be included in the directors' disclosure.

The Audit and Assurance Policy

The Audit and Assurance Policy

1. What will be required?

The Government intends to require companies to produce a triennial Audit and Assurance Policy (AAP) that sets out the company's approach to assuring the quality of the information it reports to shareholders beyond the financial statements. The primary purpose of the AAP is to require companies to demonstrate to their shareholders and others with a direct interest in a company's reporting and prospects, how they are assuring their reported information, whether internally or externally, and how they are considering where any additional internal or external assurance may be needed going forward.

As part of the spectrum of reported information, directors must set out whether, and if so how, they intend to seek independent (external) assurance over any part of the Resilience Statement (see above) and their internal control framework.

In addition, the AAP must describe:

- the company's internal auditing and assurance processes, including how management judgements are challenged and verified internally; and
- the company's policy in relation to tendering of external audit services, including whether a company is prepared to commission non-audit services from its statutory auditor.

In its Position Paper, the FRC confirmed that it will develop guidance for companies on the AAP and related disclosure requirements. Also in the Position Paper, the FRC states that it intends to consult on changes to the UK Corporate Governance Code (the Code) and Ethical Standard to reflect the wider company reporting responsibilities around sustainability and ESG information, and, where commissioned by the company, appropriate assurance in accordance with the AAP.

2. How will companies determine what reported information should go into the AAP?

There will be more guidance on the content and process for approaching an AAP as the requirement is developed. However, we expect that an "assurance mapping" process will be important for mapping the reported information to the levels of assurance provided and identifying any gaps. The first stage in creating this "Assurance Map" is determining what information, from the volume of information a company reports, should be included in the mapping process. This will depend on the individual facts and circumstances of the company, and it will be key to have a sensible and transparent way to determine what reported information should be included. The following could be considered:

- **Principal risk disclosures –** The principal risk disclosures in the annual report are, by their very nature, important reported information so could be considered for inclusion in the Assurance Map.
- **KPIs linked to principal risks –** There are a number of important disclosures a company makes which are not usually subject to external audit, such as key performance indicators (KPIs) and alternative performance measures (APMs), that could be considered for inclusion in the Assurance Map. The principal risks are often a good signpost to these important measures.
- **Information important to stakeholders and reputation –** Reported information that might not link to a principal risk but is important to stakeholders or to the reputation of the company could also be considered. For example, ESG disclosures such as climate risk (although we are increasingly seeing this be included as a principal risk) or diversity data; KPIs that underpin executive remuneration.
- **Minimum content as required by the Government –** As noted above, there are certain pieces of reported information where the Government will require that a company explain its approach to obtaining independent assurance, so would be included, i.e. the Resilience Statement and the reporting over the internal control framework.

When describing the assurance provided, the AAP will need to state whether this is "limited" or "reasonable" assurance as defined in the FRC's Glossary of Terms (Auditing and Ethics)[2] or whether an alternative form of engagement or review has been / will be undertaken and whether any independent assurance has been carried out to a recognised professional standard.

3. Will there be a shareholder vote on the AAP?

In the Consultation, the Government proposed having a non-binding shareholder vote on the AAP but has decided not to proceed with this proposal as it was felt it would not be essential in promoting engagement with shareholders.

However, there will be a requirement that companies state in the AAP how they have taken account of shareholder views in its development. Companies will also be required to state whether, and if so how, they have taken account of employee views.

[2]https://www.frc.org.uk/getattachment/d4968a74-15d1-47ce-8fc4-220ae3536b06/Glossary-of-Terms-(Auditing-and-Ethics)-With-Covers.pdf

4. How often will the AAP be published and where will it be disclosed?

As noted above, the AAP will be required to be published every three years (although companies will be free to update more frequently should they judge this to be necessary, for example, to highlight any significant change in assurance activity). However, there will be a requirement that the directors (typically through the audit committee) provide an "annual implementation report" that will summarise how the assurance activity outlined in the AAP is working in practice.

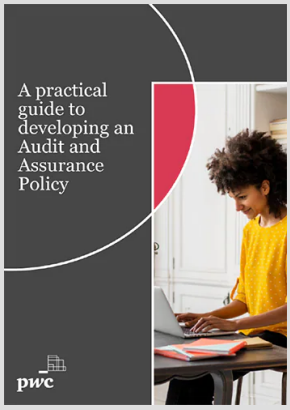
For companies that are required to produce an audit committee report, the AAP and annual implementation report on the AAP will most likely be published in the same section of the annual report. For companies that don't have to produce an audit committee report, the Government is still considering whether this reporting should be in the strategic report or elsewhere in the annual report.

5. Will the annual audit plan for the statutory audit be shared externally?

Although not yet at the stage of making this a formal requirement, in addition to the AAP, the Government intends to give the regulator powers to establish a formal mechanism for audit committees to gather shareholder views on the statutory auditor's annual audit plan. However, the Government was clear in the Consultation that any shareholder views on the plan should be purely advisory in nature to ensure that the auditor retains autonomy for the way the audit is conducted. It was also noted that 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 statutory audit.

This is expected to be part of the audit committee requirements that ARGA will have the power to put in place described above. We don't have any more detail at the moment on how the plan would be shared and when, but in the Consultation it was suggested it would be shared at the start of every audit cycle and would be based on the information an auditor normally communicates to the audit committee in the audit plan, including the auditor's consideration of key risks and their scoping and materiality decisions.

It was suggested in the Consultation, that the audit committee's annual report would then set out which shareholder suggestions put forward for consideration had been accepted or rejected by the auditor.



As part of our Restoring Trust Series, we have looked at "Restoring trust through an Audit and Assurance Policy" and provided detailed and summary guides on developing an AAP that go into the the Policy and, in particular, assurance mapping process, in much more detail and includes an illustrative example of what this element of the AAP might look like.

Managed shared audit

Managed shared audit

Background

1. Why is the Government proposing a managed shared audit regime?

The Government continues to believe that FTSE 350 companies face limited choice when appointing an auditor and that "challenger firms" (see below for definition) face significant barriers to entering this market. It has therefore decided to put in place a requirement for a managed shared audit regime, which it believes will provide a strong foundation to build capacity and increase choice in the audit market, when coupled with the alternative for FTSE 350 companies to appoint a challenger firm as sole auditor.

It is worth acknowledging up front that it is very early in the process of developing this regime and we expect there will be changes and further developments as the detail is worked out, which we think will take some time. What we have provided here is based on the limited information we have to date.

2. What are 'shared' audits and are they different from "joint" audits?

A shared audit is where one audit firm (the lead auditor) takes overall control, responsibility and liability for the audit but another audit firm supports the lead auditor on certain aspects of the audit (potentially auditing a number of subsidiaries in a group situation). It is only the lead auditor who signs the audit opinion. This means that the lead auditor has to take responsibility for the direction, supervision and review of the whole audit and is responsible for all material audit judgements – but the lead auditor will rely to some extent on detailed work performed by the other audit firm in reaching those judgements.

Shared audits are different from joint audits. In a joint audit, two audit firms take joint responsibility for the entire audit, and both firms sign the audit opinion. Both audit firms have to take responsibility for all material audit judgements and both could be held accountable if something goes wrong.

3. Don't we have shared audits today?

Yes. The concept of a shared audit is not new. Today, there are plenty of examples of group audits where one firm signs the group accounts, but another audit firm performs the audit work over one or more subsidiaries (or components) of the group. Circumstances where this might happen include:

- where the group auditor does not have a presence in a particular territory;
- where the component is an associate or joint venture and so has a degree of independence from the parent entity, meaning that the component has chosen to appoint a different audit firm;
- where there is a different cycle of audit firm rotation in the subsidiary's territory, meaning that the subsidiary has been required to change audit firm; or
- in a post merger / acquisition situation where two legacy groups have had different auditors.

Often a subsidiary / component auditor will audit all or parts of the financial information of a specific subsidiary / component. They may also be requested to perform "specified procedures" on financial information; this would not be considered a full audit of the information, but would contribute to the group auditor's consolidated work over that information. UK auditing standards set out requirements for the oversight that a group auditor must exercise over a subsidiary / component auditor.

UK auditing standards don't specify a maximum amount of an overall group audit that can be performed by another audit firm. At PwC currently it would be extremely unusual for us to accept a group audit appointment where a significant proportion of the group was to be audited by a non- PwC network firm.

4. How will the managed shared audit regime work?

Shared audits, as described above, exist today but are not mandatory, and when they are carried out, there is no requirement for a set proportion to be shared or for the other auditor to be a challenger firm.

A managed shared audit would be mandatory for UK-incorporated FTSE 350 companies that do not appoint a challenger firm as the sole auditor. Exact details will develop over time, but from the Statement and from what was included in the Consultation, we understand the following may apply:

- The regime will be based on the normal tender cycle once the requirement becomes effective.

- As part of the regime, companies will be required to allocate a "meaningful proportion" of their audit to the challenger firm. In the Consultation, "meaningful proportion" was calculated with reference to 10-30% of one or more of the total audit fee (in the prior year), group revenues, profits and assets of the company, and it was clear that it had to be a portion that carried some risk and enabled exposure to the audit committee. However, in the Statement, the Government plans to give ARGA the powers to set this percentage, and to amend it and or increase it over time as challenger firms grow in capacity and capability, so it will be a phased approach. The regulator will also have the ability to determine the percentage in terms or revenues, profits, assets or audit fees.
- If a company appoints a challenger firm as sole auditor, there will be no requirement to have a shared audit (although we expect that it would not be prohibited).

As well as the legislated managed shared audit regime, in its Position Paper, the FRC states that the minimum standards for audit committees that it will develop will address how audit committees can support greater market resilience and diversity when tendering for audit services. Furthermore, the FRC plans to consult on a policy paper setting out their approach in respect of the Government's proposed market resilience / competition objective for ARGA.

5. Who is considered to be a "challenger firm"?

The Government's working definition of a challenger firm in this context was outlined in the Consultation as an audit firm that provides statutory audits to Public Interest Entities (PIEs) and whose audit revenues did not represent more than 15% of the FTSE 350 statutory audit market by fees in either of the prior two years.

6. Does the Government believe the challenger firms will have the capacity and appetite to participate in this regime?

The Statement indicates that the regime will be phased in over time to allow the regulator to learn more about the effectiveness of the regime, and to amend the proportion of the audit allocated to the challenger firm based on changes in their capacity and capabilities.

7. How would I split the audit work between the two firms?

As noted above, under a managed shared audit regime, the challenger firm would be given a meaningful proportion of the audit, where the meaningful proportion is determined by the regulator. The Government is still of the view that legal subsidiaries should be used as a basis for the meaningful proportion, except in exceptional circumstances. However, in a change from the Consultation, international subsidiaries could be included in the percentage as it is thought this will help develop a challenger firm's international network. That said, we would still expect that the international subsidiary would need to be able to provide the challenger firm with sufficient exposure to the riskier aspects of the audit and the audit committee.

We foresee a number of practical challenges in splitting the audit work this way as outlined below.

8. Is this expected to be a permanent requirement? Are any other measures being considered?

The Government intends to make powers available to introduce a market share cap in the future if it becomes clear that choice in the FTSE 350 audit market has not significantly improved as a result of the managed shared audit regime. Although this might not be the final format, in the Consultation, the Government proposed that the principal features of a market share cap would be that:

- it would apply to all UK-registered FTSE 350 companies (although in reality it may only impact a proportion until the cap was reached); and
- the cap would not be set at a specific percentage applied to an audit firm or group of audit firms, rather it would be at the discretion of the regulator as they examined the pipeline of upcoming tenders taking into account the capacity and capabilities of a cohort of challenger firms.

In reality, should it evolve this way, we think this would mean that ARGA could identify a number of upcoming FTSE 350 audit tenders and require that the audit mandates be awarded to the companies' choices of challenger firm.

Scope of a managed shared audit regime

9. You say this would apply to all FTSE 350 companies. Would there be any exemptions?

The Government acknowledges that circumstances might arise where challenger firms may not be able to act as sole auditor, or may not wish to bid for a meaningful proportion of the audit and where a lack of experience or capacity may significantly compromise audit quality. The Government also acknowledges that the minimum meaningful proportion threshold may represent a very large quantity of audit work in absolute terms for the very largest FTSE 350 companies.

So, the Government and regulator will develop an exemptions framework that addresses practical considerations so that exemptions could be granted by the regulator in limited circumstances.

It's interesting to note that, in the Impact Assessment that accompanied the Consultation, the Government acknowledged there is a risk that companies may not have suitable subsidiaries for audit by a challenger firm, and that it believes the proposal will work most successfully on FTSE 350 groups where there are 'material UK subsidiaries that a challenger firm could comfortably audit'. It considered these groups to be those that have UK-incorporated subsidiaries that individually account for 20-60% of group turnover or group total assets. The Impact Assessment estimates this could be just 149 of the FTSE 350 companies. Allowing international subsidiaries to be part of the meaningful proportion, as described above, might help with this challenge, as will having some flexibility in the percentage, but we still believe there will be practical difficulties in applying this regime for a number of companies.

10. Will this only apply to companies listed in the UK or could it also apply to UK subsidiaries of overseas listed companies?

Managed shared audits will only apply to UK-incorporated companies that are in the FTSE 350. So our interpretation is that if a company is listed overseas rather than in the UK, it should not be captured by this regime, and neither would any of its non-listed UK-registered subsidiaries. Similarly it doesn't appear that FTSE 350 companies incorporated overseas will be included. As described above, overseas subsidiaries of UK-incorporated FTSE 350 companies might be impacted if it is determined they are the part of the audit that is to be shared with a challenger firm.

11. I already use a challenger firm to audit a number of my overseas subsidiaries, will this count as a managed shared audit?

As discussed above, the Government's focus appears to be on the audits of UK-incorporated subsidiaries being shared as part of the regime. However, we understand that the Government will be willing to consider the inclusion of overseas subsidiaries in the meaningful proportion percentage, presumably only if they truly represent a meaningful proportion of the audit.

12. How would this work for investment trusts and companies that do not prepare group accounts? It seems like it wouldn't be possible to share these audits by dividing up subsidiary statutory audits.

In the Consultation, it was suggested that there should be no reason why a challenger firm shouldn't be appointed as sole auditor for less complex entities, and that audit committees of these types of entities would be expected to carry out an audit tender that encouraged the appointment of a challenger firm. The Statement appears to hold firm in this view as, despite the introduction of an exemptions framework, as described above, this appears to be available only on limited circumstances.

13. Are there any allowances for companies moving in and out of the FTSE 350?

This is not specifically mentioned in the Statement, but the Consultation proposed that the managed shared audit regime would not apply to a company which has not been a FTSE 350 company for at least half of the annual accounting period prior to the auditor appointment, and which is not a FTSE 350 company when the audit tender process begins.

The Consultation also suggested that if a company that has already implemented a managed shared audit subsequently leaves the FTSE 350 index, it would be expected that the shared audit arrangements would remain in place until the audit engagement is next retendered. The only exceptions to this would be if the company were to cease trading in its current form, were to be delisted from the London Stock Exchange Main Market,or were to be acquired by an overseas entity that was not subject to the managed shared audit requirements.

The Statement does not contradict this, so we are assuming it would be part of the final requirement although, as we mention above, we believe there is a long way to go and a lot of details that will need to be thought through in developing a managed shared audit regime.

Possible scenarios and practical challenges of a managed share audit regime

We don't yet know what a managed shared audit regime will look like and how it will evolve. However, we have given some thought to a number of situations where managed shared audits might not work as intended and the practical challenges that would need to be overcome.

14. I have one UK subsidiary that generates 90% of my group revenue, does this mean that a managed shared audit regime won't work for me?

As we explain above, the Consultation suggested that under a managed shared audit regime, audit work would be shared by allocating the audit of particular legal entities in a group to a challenger firm. However, this approach could be problematic for a group where a subsidiary represents a very large proportion of the whole; if the subsidiary audit were to be awarded to a challenger firm, then there could be insufficient audit work remaining for another audit firm to feel able to sign off on the group accounts. As we note above, it would be extremely unusual for PwC to accept a group audit appointment where a significant amount of the group was to be audited by a non-PwC network firm. In this case, a managed shared audit might not be achievable.

Arguably, an alternative might be to split the audit work in a different way, perhaps with a challenger audit firm taking responsibility for auditing a particular process or cycle (for example, the purchases and payables cycle). However, our experience suggests that the complex interplay between financial statement balances and transactions, and financial systems and processes, could mean that such an approach would be complex to implement and could result in significant duplication of audit effort.

15. At my company, we have a material UK subsidiary but the financial processes at this subsidiary are fully integrated with the rest of the group. We have one finance team, one system and one set of processes. How will this regime work for me?

It's clear that there could be challenges in sharing a meaningful proportion of the audit work efficiently in companies where the subsidiaries are highly integrated with the parent company or other parts of the group. In particular, it could be difficult to avoid substantial duplication of audit work.

16. How would a managed shared audit regime work where my company has significant shared service centres or where my auditors test certain controls centrally and share the audit evidence with others in their network (an approach often used in respect of IT general controls)?

As noted above, the managed shared audit regime contemplates that the audits of whole legal entities would be allocated to a challenger firm. As this question demonstrates, the operations of a large group do not always follow a legal entity structure – often systems and processes are shared between entities. Where a single audit firm is responsible for the audit of such a group, audit work can be planned so that it is performed once, with the results shared throughout the team to facilitate the completion of audits of statutory entities.

In theory, the same approach could be used if more than one audit firm is involved. For example, the group auditor could take responsibility for the audit of a shared service centre and then share the results of that work with a challenger firm responsible for the audit of a subsidiary. However, we anticipate that this process of sharing audit evidence could be significantly more complex if operating between different audit firms.

17. It seems inevitable that there will be some duplication of efforts, perhaps a lot. What are the additional audit costs to the company estimated to be?

The Impact Assessment that accompanied the Consultation assumed that, where a managed shared audit is undertaken, the additional effort would be in the planning, cross-review and completion phases of the audit, and that no additional effort would be required during the execution phase of the audit. Overall, the Impact Assessment estimates that the additional audit effort would result in an increase in audit fees of between 5% and 15%. However, we believe that the complexities of this regime mean that the uplift in audit fees could be higher than the Government has estimated. It's also important to note that it's likely there would be considerable additional time and effort for management teams in dealing with two audit firms.

Appendix 1 – Implementation mechanisms

Below are the key proposals discussed in this paper and the mechanisms by which the Government and the regulator indicate they will be implemented. This represents our current interpretation of the Statement and the Position Paper, and we expect it will become clearer over time.

Implementation mechanism				
	Government		FRC / ARGA	
Reform	**Primary legislation**	**Secondary legislation**	**Revisions to the UK Corporate Governance Code (the Code)**	**Revisions to the Ethical Standard**
Establish ARGA	X			
Increased regulatory scrutiny / enforcement of directors	X			
Expansion of the PIE definition	X			X
Managed shared audit regime	X			
Resilience Statement[1]		X		
Audit and Assurance Policy[1, 4]		X		
Enhanced fraud requirements[1]		X		
Capital maintenance disclosures[1]		X		
Strengthened internal controls[2]			X	
Minimum standards for audit committees[3]	Scope to be set in legislation but not clear yet if primary or secondary legislation			

[1] Per the Position Paper the FRC intends to issue implementation guidance for these proposals
[2] As well as updating the Code, the FRC intends to revise its existing "Guidance on Risk Management, Internal Control and Related Financial and Business Reporting" as part of the implementation of this proposal
[3] Scope to be set in legislation then the FRC will develop the new standards, initially in shadow form for voluntary adoption ahead of legislation. It also intends to revise its "Guidance on Audit Committees" and "Guidance on Board Effectiveness" as part of this proposal
[4] Also, the Code could potentially reflect the responsibilities of the board and audit committee to obtain appropriate assurance over sustainability and ESG reporting where it has been commissioned in accordance with the company's Audit and Assurance Policy

Appendix 2 – Existing requirements for PIEs

Public Interest Entities (PIEs) face a number of legal and regulatory requirements over and above those faced by other companies. These cover corporate reporting, audit and governance requirements. The key requirements that apply currently to PIEs are outlined below. (There are also some requirements that apply only to listed PIEs but we have not covered these in this paper).

Governance requirements

- **The FCA Disclosure Guidance and Transparency Rules (DTR) and the PRA Rulebook** require that a PIE must have a body that carries out the role of an audit committee, including monitoring financial reporting and the arrangements for the statutory audit. At least a majority of the members (and in some cases all) must be independent and at least one member must have competence in accounting or auditing, or both. The members as a whole must have competence relevant to the sector in which the issuer is operating.

Corporate Reporting requirements

- **s414CA of the Companies Act 2006 –** PIEs with over 500 employees are required to include a non-financial information statement in their strategic report.

Requirements relating to the audit or auditor of a PIE

- **s494ZA of the Companies Act 2006 –** sets out tendering and audit firm rotation regulations for PIEs and provisions related to the conduct of an audit tender. Most significantly, there's a requirement to re-tender the PIE company's audit appointment every ten years and rotate the audit firm every 20 years.
- **Article 3 The Statutory Auditors and Third Country Auditors Regulations(SATCAR) 2016 –** includes a requirement for the regulator (currently the FRC) to take direct responsibility for inspecting, investigating and imposing sanctions in relation to all audits, including PIEs. This includes the Audit Quality Reviews (AQR) inspection programme that covers all auditors of PIEs at least once every three years.
- **The FRC's 2019 Ethical Standard –** the revised Standard became effective on 15 March 2020 and, for PIEs, introduced a list of permissible non-audit services that auditors of PIEs could provide (some are services required by law or regulation, some are not); auditors of PIEs are not permitted to provide any other non-audit services to that PIE or its related entities. All services require approval by the audit committee or equivalent body. The list of the permissible services that can be provided applies up and down the control chain to:
  - upstream entities of the PIE within the UK; and
  - downstream controlled entities of the PIE, wherever located in the world.

There is also a cap on how much, in terms of fees, the permissible services that are not required by law and regulation can be provided by the auditor (the cap is set at 70% of the audit fee, with some complex rules about how the cap should be calculated).

The FRC's Ethical Standard also includes stricter rules for PIEs on tenure of audit partners and staff and the period before which they can return to the audit; greater restrictions and requirements for cooling off periods between employment by the audit firm and employment by the audited entity; and a cap on fees for non-audit services when compared to audit services.

A number of UK Auditing Standards contain specific requirements in relation to PIEs, these include the following.

- **ISA (UK) 220 "Quality control for an audit of financial statements" –** requires additional consideration of the Engagement Quality Control Reviewer (in PwC, the Quality Review Partner) of areas, at both the group and component level, such as the independence of the auditor from the company, the nature and scope of corrected and uncorrected misstatements identified and the reasoning of the key audit partner with regard to materiality and significant risks.
- **ISA (UK) 260 "Communication with those charged with governance" –** requires that the PIE auditor submit an additional report to the audit committee, or those charged with governance, on matters including a declaration of independence, a description of the scope and timing of the audit, the audit methodology used, materiality used, any significant difficulties encountered in the course of the audit; any significant matters or deficiencies arising.
- **ISA (UK) 700 "Forming an opinion and reporting on financial statements" –** requires that the auditor's report for PIEs shall include certain additional information, including by whom the auditor was appointed, the date of appointment and uninterrupted tenure, a declaration that no prohibited non-audit services were provided and that the audit firm remained independent in conducting the audit, as well as setting out any services, in addition to the audit, which were provided by the firm but are not disclosed in the annual report or financial statements.
- **ISA 701 "Communicating key audit matters in the independent auditor's report" –** requires extended auditor reporting, where an auditor describes the key audit matters, materiality and scoping process in their public auditor's report. Although primarily intended by the auditing standard setters for listed entities, this requirement is also applicable to the current population of unlisted PIEs, i.e. the banks and insurers noted in the definition above.

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