

An aerial night photograph of a city, likely London, showing a dense cluster of illuminated buildings and streets. A large yellow rectangular box is positioned in the upper left quadrant, containing the main title and subtitle. The city lights create a warm, golden glow against the dark night sky.

Restoring trust in audit and corporate governance

Government consultation at
a glance

March 2021



Building a better
working world





Introduction

The UK Government has published its long-awaited consultation '*Restoring trust in audit and corporate governance*'. It sets out a comprehensive package of reforms to help build public trust in business, taking forward recommendations from earlier reviews¹. We encourage all stakeholders to engage with the consultation process and consider submitting a response by the deadline of 8 July 2021. Many of the developments proposed, when implemented in the next two to three years, will have a significant impact on a wide range of entities and individuals. Make sure you have your say!

The notes below provide a high-level summary of the key proposals in the consultation. They include excerpts and limited commentary, to give you a sense of its scale and the level of ambition that is driving this forward. To access the consultation, [click here](#).

¹ The Independent Review of the Financial Reporting Council, Sir John Kingman, 2018. The Competition and Market Authority (CMA) Statutory Audit Services Market Study, 2019. Assess, Assure and Inform: Improving Audit Quality and Effectiveness, Sir Donald Brydon, 2019.



The Government's approach to reform

The consultation proposes to amend the definition of Public Interest Entities (PIEs) and widen its scope to capture large companies, regardless of their ownership status and whether or not they are admitted to trading on a regulated market.

The Government is mindful of the impact the pandemic continues to have on the UK economy and wants to minimise the extent of changes required of businesses in corporate governance, reporting and auditing.

A number of reforms in the consultation will be introduced as soon as Parliament allows, whilst others will be phased in. Transition periods, following the coming-into-force of new legislation, will help to ease the timing and introduction of a new regulatory regime. Priority will be given to measures that are aimed at establishing the Audit Reporting and Governance Authority (ARGA)¹, a new regulator, with new requirements placed upon the entities and individuals that it regulates. Measures that could have a significant impact on a wider range of businesses will be introduced at a later stage.

The Government proposes that most of the new regulatory measures related to audit, corporate reporting and corporate governance should apply to the same pool of entities. The consultation therefore proposes to amend the definition of Public Interest Entities (PIEs) and widen its scope to capture large companies, regardless of their ownership status and whether or not they are admitted to trading on a regulated market. The two options of proposed size thresholds align to other existing corporate requirements.

¹ The Audit Reporting and Governance Authority (ARGA), to be formed from the current Financial Reporting Council (FRC).



Directors' accountability for internal controls, dividends and capital maintenance

Directors to carry out a review on the effectiveness of their company's internal controls over financial reporting (ICFR) each year, and to provide a statement to that effect.

Companies (the parent company in the case of a group) should 'disclose the total amount of reserves that are distributable, or – if this is not possible – disclose the 'known' distributable reserves, which must be greater than any proposed dividend.

The consultation acknowledges the findings from previous reviews, as well as responses to earlier consultations, around the introduction of internal control requirements. However, it clarifies that further consultation will be needed prior to developing any concrete proposals for change.

Views are sought on all aspects of an internal control framework, including the type of regulatory measures that should be introduced (whether through legislation or changes to the Corporate Governance Code), companies that should be in scope, and the extent of the requirements.

A number of options for consideration are suggested, as well as an indication of a 'preferred' approach as a starting point. This would require:

- ▶ Directors to carry out a review on the effectiveness of their company's internal controls over financial reporting (ICFR) each year and to provide a statement to that effect, including their conclusion on the effectiveness of the controls, details of the benchmark system they used to perform the assessment and how they assured themselves that it was appropriate to make the statement.

- ▶ If deficiencies have been identified, these should be disclosed and directors should set out the remedial action that is being taken and over what timeframe.
- ▶ Directors should provide the statement according to guidance endorsed or produced by the regulator.
- ▶ Decisions on whether the statement should be subject to external assurance should rest with audit committees and shareholders.
- ▶ In limited circumstances mandatory assurance by external auditor would be required (e.g., where serious and demonstrable failure of ICFRs or where material ICFR weaknesses have persisted over several years).
- ▶ Enforcement would be left to the regulator, in terms of investigations and sanctioning failures.
- ▶ Requirements would initially apply to premium listed companies and extended to other PIEs after two years.

In terms of accountability and reporting on dividends and capital maintenance, the Government proposes that companies (the parent company in the case of a group) should 'disclose the total amount of reserves that are distributable, or – if this is not possible – disclose the 'known' distributable reserves, which must be greater than any proposed dividend.' It adds that the distributable reserves in a group should be estimated by the parent and, regardless of whether the entity is a group or not, the directors should state that 'payment of the dividend will not, in the directors' reasonable expectation, threaten the solvency of the company over the next two years'.



New corporate reporting

The Government is considering whether companies should be required to produce an annual Resilience Statement (combining the going concern statement, and a medium and long-term risk outlook). Another new disclosure under consideration is for directors of PIEs to explain how they prevent and detect material fraud.

A requirement to produce an Audit and Assurance Policy is also under consideration. This would provide a holistic view (on a rolling three-year basis) of a company's audit and assurance requirements over its reported information.

As a follow-on from the Brydon report, the Government is considering whether companies should be required to produce an annual Resilience Statement (combining the going concern statement, and a medium- and long-term risk outlook). This would include uncertainties that the management team considered to be immaterial during their going concern assessment (e.g., due to mitigations), with a mandatory five-year risk horizon as the medium-term outlook.

Importantly, the consultation signals the Government's intention to ensure consistency between any new requirements proposed as part of this reform process, to the wider sustainability agenda. Whilst the consultation from the Department for Business, Energy & Industrial Strategy (BEIS) on the Taskforce on Climate-related Financial Disclosures (TCFD) reporting framework is expected imminently, this paper provides links between relevant measures and seeks views on additional integration.

A requirement for PIEs to produce an Audit and Assurance Policy is also under consideration. This would provide a holistic view (on a rolling three-year basis) of a company's audit and assurance requirements over its reported information. For quoted companies, it would be subject to an annual shareholder advisory vote. The Policy would also provide an opportunity for companies to explain their approach to internal audit and to their tendering policy for external audit services. At a minimum, the Government suggests that the Policy include details of independent assurance sought on the annual report and other company disclosures, outside the remit of the statutory audit. This would cover an explanation of any type/level of assurance on the Resilience Statement (in part or whole), and the directors' attestation on internal control effectiveness.

Another proposed disclosure for the directors of PIEs is a report 'on the steps they have taken to prevent and detect material fraud'. The intention behind this is to 'reinforce the directors' primary responsibility for fraud prevention and detection'. The Government hopes this will also 'enhance their focus on the risks relating to fraudulent financial reporting'.

It is also proposed that listed companies disclose, in their strategic reports, how they manage payments to their suppliers. They would be required to provide a year-on-year comparison, to show whether (or to what extent) their performance in this regard has improved, worsened or remained constant. This could be subject to independent assurance under the Audit and Assurance Policy, if agreed by companies and their shareholders.

Whilst welcoming recommendations by Brydon, the Government has decided not to require companies to publish a Public Interest Statement. This was because of the work already started by the Financial Reporting Council (FRC), via their discussion paper on the future of corporate reporting¹, and the current Section 172 disclosure requirements (i.e., how the interests of various stakeholders and the environment are taken into consideration by companies, including an obligation to promote the success of the company for the benefit of shareholders as a whole).

¹ A Matter of Principles – The Future of Corporate Reporting, FRC, October 2020.



Supervision of corporate reporting

The Government would give the regulator powers, allowing it to publish correspondence during a review of corporate reports and the summary findings.

ARGA would be given powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors.

Proposals focus on the FRC's current activities when conducting Corporate Reporting Reviews (CRR). The regulator would extend CRR scrutiny to the entire annual report and expand the volume of CRR activity on reporting by PIEs. The Government would also give the regulator powers, allowing it to publish correspondence entered into during the course of a CRR review, as well as summary findings. Once the FRC has transitioned to ARGA, the new regulator would have the powers to 'order amendments to company reports directly, rather than requiring a court order'.

The Government also plans to 'ensure that ARGA has the necessary powers to provide a pre-clearance service, including a statutory exemption from liability where it offers this service'. This would apply in situations where a company is confronted with 'novel and contentious matters' when interpreting accounting standards. One condition of a company making a pre-clearance application may be that the auditor would have to confirm that it accepted the proposed accounting treatment. It will be for the regulator to decide whether it will offer such a pre-clearance service.

Company directors

ARGA would be given powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors. The Government is minded not to compromise the collective responsibility of the unitary board, and therefore it proposes that all directors should be in scope, regardless of their role and whether they hold an accountancy qualification.

ARGA's new powers would sit alongside and, in certain circumstances, overlap existing Financial Conduct Authority (FCA) powers. For example, similar powers already rest with the FCA in respect of various breaches e.g., FCA Listing Rules, FCA Transparency Rules or Market Abuse Regulation.

The Government stresses that it will avoid duplication with other regulatory activities when granting new powers to ARGA. It has therefore suggested that a Memorandum of Understanding (MOU) between FCA and ARGA should be required, to ensure there is a smooth coordination between the two.

The consultation is specific about which enforcement powers would be granted to ARGA.

These would apply to directors that breach the following duties to:

- ▶ Keep adequate accounting records.
- ▶ Approve accounts only if they give a true and fair view.
- ▶ Approve and sign the annual accounts.
- ▶ Approve the directors' report.
- ▶ Provide a statement on disclosure to auditors, and to provide information or explanations at the request of the auditor.
- ▶ Potential new duties (e.g., statements on ICFR).

The Government has considered the merit of introducing changes to the contractual arrangements in directors' remuneration to strengthen their accountability, and it calls upon ARGA to consult on relevant changes to the Corporate Governance Code. This consultation seeks views on a minimum list of 'malus and clawback' conditions.



Audit scope and purpose

The Government is keen to widen the scope of the auditor's role. This includes a statutory requirement for auditors to consider 'relevant director conduct and wider financial or other information in reaching their judgements'.

The Government believes that auditors should 'provide users with more meaningful and useful opinions and information.'

The Government is keen to widen the scope of the auditor's role. This includes a statutory requirement for auditors to consider 'relevant director conduct and wider financial or other information in reaching their judgements'. The Government believes that, in consequence, auditors may reach different judgements not only on whether a true and fair view is presented overall, but also on line items e.g., revenue, goodwill and other intangible assets.

Other notable developments would include a legislative requirement for auditors of PIEs (as part of the statutory audit) to 'report on the work they performed to conclude whether the proposed directors' statement, regarding actions taken to prevent and detect material fraud, is factually accurate.' The consultation refers to and acknowledges the work already undertaken by the FRC to augment ISA (UK) 240¹ on the auditor's duty in respect of the detection of fraud. It is made clear though, that more is expected from the auditor - in effect the auditor is being asked to provide assurance on the means deployed by the directors to prevent and detect material fraud.

The subject of graduated findings is also included in the consultation. The Government explains that the auditor's report includes 'a professional judgement on evidence'. It believes that the users of the auditor's report can 'therefore benefit from additional information about how that judgement was reached: how the audit was conducted and how certain risks have been factored into the auditor's judgement.' The Government believes that auditors should 'provide users with more meaningful and useful opinions and information' and, in this regard, the consultation refers to Brydon's recommendation for specific disclosure, three examples of which are listed below:

- ▶ An update on Key Audit Matters reported in the previous two years, along with how the company has responded to deficiencies identified in the prior year's audit.
- ▶ Any risks omitted from the Risk Report which the auditor considers to be significant.
- ▶ In the light of the auditor's knowledge of the company and its processes, whether the company's section 172 statement reflects 'observed reality'.

¹ ISA (UK) 240 is shorthand for the International Standard on Auditing (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements (Revised June 2021)).



Audit scope and purpose (cont'd)

The Government plans to ensure that ARGA has the power to 'set additional requirements as to the audit committee's role in the appointment and oversight of auditors to ensure the committee acts effectively as an independent body responsible for safeguarding the interests of shareholders and other users of accounts'.

The Government also expresses its support for enabling shareholders to offer their views on the Audit and Assurance Policy to audit committees, but cautions that, in this context, shareholder views should be purely advisory in nature.

Other areas to be audited should, according to the Government, be left to the company and shareholders to decide, e.g., the use of Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs), to be included in the Audit and Assurance Policy (subject to an advisory shareholder vote).

In addition to the proposed introduction of auditor principles and a new professional body, the consultation refers to auditor liability. It explores why Liability Limitation Agreements (LLA) have not been used and concludes that it was because directors raised concerns that seeking shareholder approval to introduce an LLA would be a breach of the directors' duties. The Government is very clear that this is incorrect and confirms that: 'directors who recommend an LLA to shareholders in good faith will not be in breach of their duties'. However, there is no proposal in the consultation to require mandatory LLAs (or an equivalent).

Audit committee oversight and engagement with shareholders

The Government plans to ensure that ARGA has the power to 'set additional requirements as to the audit committee's role in the appointment and oversight of auditors to ensure the committee acts effectively as an independent body responsible for safeguarding the interests of shareholders and other users of accounts'. It proposes to empower ARGA to monitor compliance with these requirements, 'including through a power to require information and/or reports from audit committees, and a power to place an observer on audit committees if necessary', and to enable ARGA to take remedial action 'against the company directors and/or the audit committee for breaching the requirements'.

It is likely that additional powers will be given to ARGA so it can e.g., intervene when 'an auditor resigns, when a PIE is unable to find an auditor, and when a persistent issue with audit quality is

identified'. However, for the time being, the Government has stopped short of proposing that ARGA should have the power to appoint auditors.

For premium listed companies, the Government also expresses its support for enabling shareholders to offer their views on the Audit and Assurance Policy to audit committees, but cautions that, in this context, 'shareholder views should be purely advisory in nature and supplemental to the auditor's to ensure that the auditor retains autonomy for the way the audit is conducted'. The Government further indicates that the audit committee's report should set out which shareholder suggestions put forward for consideration had been accepted or rejected by the auditor, and that greater visibility over risk assessments should be provided to shareholders.



Competition, choice and resilience in the audit market

The Government believes that competition, choice and resilience in the audit market all need to be improved and that this can be achieved with a combination of legislation and regulation.

In the event that mandatory managed shared audits do not bring about the desired change to the FTSE 350 market, the regulator would be empowered to implement a market share cap.

The Government believes that competition, choice and resilience in the audit market need to be improved and that this can be achieved with a combination of legislation and regulation. As an alternative to the recommendation of mandatory joint audits set out in the Competition Markets Authority's (CMA) statutory audit market study, the Government proposes the regulator be empowered to introduce mandatory managed shared audits for UK-registered FTSE 350 companies (with limited exceptions).

Under this regime, a non-Big Four auditor would carry out 10% to 30% of the company's statutory audit and their liability would be limited to the work on that component. The Big Four group auditor, by contrast, would bear overall liability. The requirement would be phased in for companies at the time an audit contract is re-tendered, with the tender process requiring audit committees to appoint the group and component auditor independently and concurrently. The regulator would have enforcement and sanctioning powers against companies that fail to comply.

In the event that mandatory managed shared audits do not bring about the desired change to the FTSE 350 market, the regulator would be empowered to implement a market share cap (i.e., a limitation on the number of FTSE 350 companies that any one of the Big Four firms can audit over a given period of time).

In addition to these measures, the consultation expresses the Government's support for requiring the operational separation of the audit and non-audit arms of the Big Four firms in the UK – a process that was voluntarily started by the Big Four last year. This is described by the Government as: 'separate governance, financial statements prepared on an arm's length basis, and regulatory oversight of audit partner remuneration and audit practice governance'. The Government does not support the CMA's proposal that operational separation also entails the introduction of audit-practice profit pools, but seeks to empower the regulator to require a full structural separation of the Big Four firms in the future, 'subject to consultation and Parliamentary scrutiny'.

Added to this would be a new statutory power for the regulator to 'proactively monitor the resilience of audit firms and the audit market, require audit firms to address concerns, and to act in the event of audit firm failure'.

Supervision of audit quality

A key proposal by the Government is that it plans to introduce legislation that will allow the publication of individual Audit Quality Review (AQR) reports. It emphasises that this would enable ARGAs to publish these reports: 'without the need for consent from the audit firm and the audited entity.' The regulator would also have full discretion to decide whether to publish an individual inspection report in full, or as a summary. The Government adds that it will 'place safeguards to prohibit the publication of sensitive information about audited entities', however it is not clear what would constitute sensitive information.



The Government intends to introduce the necessary legislation to allow the formation of ARGA at the earliest opportunity and subject to Parliamentary due process.

The Government proposes to give the regulator the power to establish a standardised code of ethics with which members of the chartered bodies (either individuals or firms) would be required to comply.

A strengthened regulator

The Government intends to introduce the necessary legislation to allow the formation of ARGA at the earliest opportunity and subject to Parliamentary due process. The overall objective of ARGA is proposed as: 'to protect and promote the interests of investors, other users of corporate reporting and the wider public interest'.

Key features of the new regulator:

- ▶ It will be established as a company limited by guarantee.
- ▶ It will have clear statutory objectives and functions.
- ▶ It will be governed by a new, smaller board to improve effectiveness and responsiveness.
- ▶ It will follow strategic direction set by the Government and will be accountable to Parliament.

The new regulator will be funded by a statutory levy on market participants, including preparers of accounts. The Government intends for ARGA to have the power to specify who pays the levy and the apportion of costs, similar to the FCA, but first there will be a public consultation on the design and methodology of the levy.

Additional changes in the regulator's responsibilities

The Government states that ARGA should have 'powers to act on serious concerns relating to corporate reporting and audit of PIEs. These include: to require rapid explanation about reasonable concerns identified by the regulator relating to a PIE's compliance with its corporate reporting or audit obligations; to commission an expert review at the company's expense, akin to the 'skilled person reviews' commissioned by the FCA and PRA, where it has concerns as to whether a PIE's corporate reporting and audits comply with requirements enforced by the regulator; and to publish a summary of the expert's report where it is considered by the regulator to be in the public interest.'

It is proposed that ARGA should be the regulator for the actuarial profession, and that it should set legally binding technical standards against which actuaries' work can be monitored and enforcement actions taken as necessary. The Government is also considering whether the regulator should have the power to bring disciplinary proceedings, in the public interest, against entities that undertake actuarial work, as is the case for the audit and accountancy professions.

Finally, the Government would like ARGA to focus on oversight of the chartered accountancy bodies, where 'those using the services of its members expect the highest standards and where failures are likely to have the biggest economic impact'. Chartered accountants are required to adhere to the ethical standards set by the professional accountancy body to which they belong. The Government proposes to give the regulator the power to establish a standardised code of ethics with which members of the chartered bodies (either individuals or firms) would be required to comply and which would be enforceable by the regulator using its new powers.

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