

Overhaul of UK audit regime

The Government is consulting on plans to modernise the country's audit and corporate governance regime, building on the recommendations of three recent independent reviews with the goal of restoring business confidence by implementing reforms to improve the quality of corporate reporting.

26 March 2021

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The consultation builds on the recommendations of three recent independent reviews with the goal of restoring business confidence by implementing reforms to improve the quality of corporate reporting with the aim of: 1. making directors of the country's biggest companies more accountable; 2. reinforcing investor and public confidence in the audit process; and 3. diluting the supremacy of the 'big four' accountants as auditors of FTSE350 companies.

The collapse of various big-name companies, such as Carillion, Thomas Cook and BHS, has had a serious impact on confidence in corporate governance and resentment from the British taxpayer. The proposed reforms aim to drive up quality and standards in the market by giving investors, employees and consumers a more accurate picture of the health of a company.

The Government intends to expand the definition of Public Interest Entities (PIEs) so that its proposals apply to large businesses of public importance regardless of whether they are admitted to trading on a regulated market. The government is consulting on alternative approaches to identify the companies which will be captured by the new definition and this is most likely to align to:

- (i) the test to identify those large companies that are already required to include a corporate governance statement in their directors' report; or
- (ii) the narrower test which incorporates the threshold for additional non-financial reporting requirements for existing PIEs and large companies with both: (a) over 500 employees; and (b) a turnover of more than £500 million.

The Government consultation includes proposals to:

- impose new reporting obligations on directors and auditors of PIEs including:
 - a duty to consider a wider range of information as part of an audit and to extend audits beyond just financial results (for example, by looking at wider performance against key climate targets);
 - the production of an annual 'resilience statement' that sets out how an organisation is mitigating short and long-term risks;
 - the publication of an annual audit and assurance policy that describes a company's approach to seeking assurance of its reported information;
 - to report on the steps taken to detect and prevent fraud; and
 - an obligation to report on the company's performance towards supplier payments together with a comparison with the previous year.
- strengthen the internal controls framework by enhancing the law relating to dividends and capital maintenance. These measures will include a new requirement to disclose distributable reserves and introduce a new directors' statement about the legality of proposed dividends and the effects on the future insolvency of the company. These measures will initially apply to most, if not all, AIM and listed companies before being extended to all PIEs;
- impose greater sanctions against directors of PIEs for non-compliance (including reprimands, fines, orders to mitigate a breach or to make declarations as to non-compliance and, in the most serious cases, temporary prohibition on acting as a director of a PIE) and enhance the clawback and malus provisions to target remuneration and bonuses paid to directors in the event of collapse or serious director failings up to, at least, 2 years following payment (this also has the potential of being extended to all listed companies, potentially through the Listing Rules);

- empower shareholders by enhancing their engagement with audit committees in order to improve oversight of auditors and audit quality;
- require companies to use a smaller “challenger” firm to conduct a meaningful portion of their annual audit. The “big four” could face a cap on their market share of FTSE 350 audits if competition in the sector does not improve;
- create a new regulator, the Audit, Reporting and Governance Authority (ARGA) (backed by legislation and funded by a mandatory levy on industry) to oversee compliance with a general objective “to protect and promote the interests of investors, other users of corporate reporting and the wider public interest.”

There is a clear political purpose behind these reforms; not just to save the public purse and ‘build back better’ but to help identify those companies that can differentiate themselves by being more accountable, transparent and, therefore, inherently more trustworthy. The proposals, in whatever form they are eventually enacted, will undoubtedly impact the companies to which they apply but the resulting ripples can also be expected to have an impact on customers, suppliers, investors and other stakeholders with an interest in the business affected.

The consultation will end on 8 July 2021 and primary legislation is expected to follow thereafter.

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