MORE TEETH FOR THE UK'S AUDIT AND GOVERNANCE REGIME

Briefing for Corporates

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50:50 THE EQUALITY PROJECT

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INTRODUCTION

In March 2021, the government released a much anticipated White Paper titled 'Restoring trust in audit and corporate governance' containing proposals to reform the UK's audit and corporate governance regime (the **Proposals**) including new enforcement powers against directors. This briefing focuses on the changes that will have most impact on corporates and their directors.

The White Paper imposes a host of audit and governance measures and new liabilities on directors. Many of these obligations will apply to a wider definition of Public Interest Entities which is proposed to include large private companies, as well as AIM-listed companies with a market capitalisation exceeding €200 million.

The regime will also have significant impacts on directors, shareholders, auditors, accountants and the newly established ARGA (the FRC's successor as the UK's audit and governance regulator). The timetable for implementation is uncertain though likely to be staggered with this initial consultation on the proposals closing on 8 July 2021.

We have picked out some hot topics for corporates from these Proposals:

1. New Director Personal Liability – New enforcement and Investigation Powers
2. Directors' Accountability for Internal Control
3. Regulatory Powers to address Serious Concerns
4. Clawback and Malus Provisions in Directors' Remuneration Packages
5. Audit Committee Oversight and Engagement with Stakeholders

NEW DIRECTOR DISCIPLINARY POWERS

The White Paper proposes to give ARGA powers to investigate and sanction directors of Public Interest Entities for breach of existing directors' duties in the Companies Act 2006 concerning corporate reporting and audit and for breach of any further rules ARGA may impose on them related to the preparation and reporting of accounts.

Which directors will enforcement apply to?

The powers will not be restricted to directors who are chartered accountants as is currently the case, and will not be limited to listed companies.

All directors of Public Interest Entities (**PIEs**) will be within scope. The definition of PIEs will be expanded to include:

- AIM listed companies over €200m capitalisation; and
- larger private companies, though the Government has not settled on the appropriate balance sheet or turnover threshold. Under its alternative proposals either 2000 or 900 more private companies will be brought within scope.

New conduct rules

Under the Proposals, ARGA will be able to supplement existing statutory directors' duties in relation to the preparation and reporting of accounts with new rules, including conduct rules. So not only will the regulator be able to exercise enforcement powers in respect of breaches by directors of existing rules in this space but, it could, to quote an example given in the White Paper, introduce a conduct standard to "act with honesty and integrity“ in respect of accounting and audit matters. This conduct standard would be similar to that currently imposed by the FCA on members of financial services firms but appears to be restricted to accounting and audit matters.

What is the impact of these new regulatory powers?

These powers will significantly expand the existing obligations on directors’ and empower the regulator to take action for breach of directors duties where previously only companies could do so.

What are ARGA’s powers?

The White Paper proposes that ARGA will be empowered to:

- gather information;
- conduct interviews to investigate suspected breaches; and
- impose sanctions on all directors of Public Interest Entities.

Regulatory sanctions will include:

- reprimands and fines;
- orders from ARGA to take specific actions; and
- temporary prohibition on acting as a director.

How will these powers sit vis-à-vis other regulatory powers?

ARGA will be able to exercise these powers where they do not already fall within the remit of the FCA (in respect of publicly traded companies' listing and market abuse obligations).

ARGA’s powers are proposed to work in tandem with those held by other regulators.

DIRECTORS' ACCOUNTABILITY FOR INTERNAL CONTROLS

Directors' statement on accounts

The White Paper proposes to require directors to acknowledge their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting in an annual published statement. The government is strongly in favour of this requirement, and in addition, seeks to require directors to:

a) carry out an annual review of the effectiveness of the company's internal controls over financial reporting;

b) outline the outcome of the review in the annual report and accounts;

c) disclose the benchmark system used; and

d) explain how they have got comfortable making the statement.

Unlike the equivalent US Sarbanes Oxley rule, where external auditors must assure that the company's internal controls are sufficient, the decision on whether the statement on internal controls should be assured by an external auditor will usually be a matter for the audit committee and shareholders. Decisions should be based on judgements about the strength of systems and controls and whether extra assurance would be proportionate and should be considered as part of the proposed new audit and assurance policy.

The proposals also acknowledge that external assurance should only be required in limited circumstances, for example, where there has been a serious failure of controls, or material weaknesses have persisted over several years.

Regulatory powers with respect to directors' disclosures

- The regulator will have powers to investigate the accuracy of disclosures and to order amendments or recommend an external audit of the internal controls.
- Directors of all PIEs could be investigated and sanctioned where they have failed to establish and maintain an adequate internal control structure and procedures for financial reporting.
- Unlike in the US these breaches are civil in nature not criminal, though the lower civil standard of proof is likely to make enforcement easier than in the US.

The Proposals indicate a willingness to hold directors collectively responsible for audit internal control rather than requiring the CEO or CFO to do so individually.

What are the likely impacts on companies and directors?

- The government's preference is for these requirements to be imposed on premium listed companies first, and extended to PIEs after two years.

- This enforcement risk, along with the wider investigation and enforcement powers described above, increase the personal risk for directors of premium listed companies.

- This increased risk profile for directors takes place against the backdrop of an already hardening D&O market (i.e. increased premiums and narrower cover), due in part to a wider trend of increased regulatory activity and resultant costs.

- Based on the experience in the US, the proposals could lead to an increase in costs for impacted firms as boards seek to obtain additional evidence to support their statement, whether in the form of internal or external assurance.

REGULATORY POWERS TO ADDRESS SERIOUS CONCERNS

ARGA will have new powers to address concerns relating to a company's corporate reporting and audit, including powers relating to the newly proposed requirements on companies' internal controls mentioned above (but not corporate governance more generally).

The proposed powers will allow the regulator to require a rapid explanation from a company about reasonable concerns and the White Paper invites industry views on whether additional powers should be conferred on the regulator where significant non-compliance has been identified.

ARGA powers to order expert review

The Proposals would empower ARGA to require that an expert review be carried out (at the company's expense) where it has identified concerns relating to a Public Interest Entity's corporate reporting and audit.

Exceptionally, a summary of the expert's report could be published if deemed to be in the public interest.

What are the likely impacts on companies and directors?

- The expert review proposal seeks to emulate the Skilled Persons reviews that can be compelled by the PRA and FCA. In practice, expert reviews are likely to present a similar risk for companies in that they may be used as a basis for enforcement investigations by the regulator, which will rely on the review report to build its case.
- In many cases, companies will need to approach these expert reviews with the same preparation and thought as an investigation.
- They will also result in an increase in costs.

CLAWBACK AND MALUS PROVISIONS IN DIRECTORS' REMUNERATION PACKAGES

Malus and clawback proposals

Although the vast majority of FTSE 350 listed companies have malus and clawback provisions in place, outside of the financial services sector there are no mandatory requirements in respect of these. As such, their scope varies as between companies.

The proposal is to strengthen malus and clawback arrangements by requiring minimum "trigger points" and a minimum two-year period of application after an award is made.

Overall, the Proposals are not particularly surprising and continue a trend towards greater accountability which started in the financial services sector following the financial crisis in 2008.

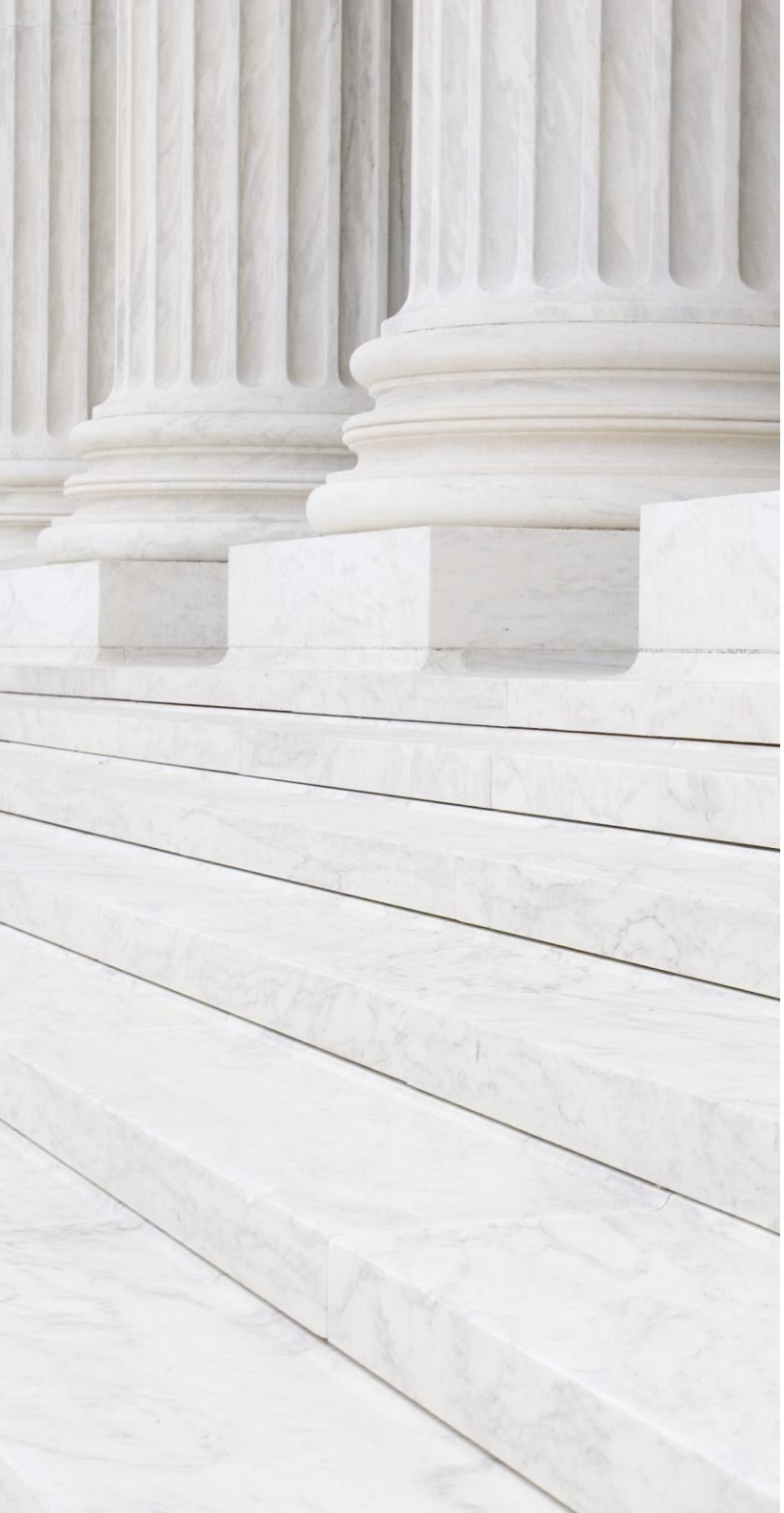
What are the "trigger points"?

The minimum trigger points proposed are:

- material misstatement of results or an error in performance calculations;
- material failure of risk management and internal controls;
- misconduct, conduct leading to financial loss or reputational damage; and
- unreasonable failure to protect the interests of employees and customers.

For many companies, these triggers will go beyond the arrangements they currently have in place, in particular the trigger of failing to protect the interests of employees and customers — which tracks a wider theme in corporate governance of taking varied stakeholder interests into account.

The Proposals also suggest that companies consider supplementing these minimum triggers with other tailored triggers to better reflect its particular circumstances. The White Paper invites further consideration as to whether there is a need to extend the regime to all listed companies.



AUDIT COMMITTEE OVERSIGHT AND ENGAGEMENT WITH STAKEHOLDERS

The regulator, ARGA, will have new powers to set and enforce additional requirements for audit committees of FTSE 350 companies in the appointment and oversight of auditors. These requirements will cover the need for audit committees to monitor audit quality on a continuous basis and demand challenge and scepticism from auditors. The regulator will be tasked with setting and monitoring compliance with the new audit committee requirements which will extend to requiring information/and or reports from audit committees and the power to place an observer on the audit committee, if necessary. Regulatory action could be taken against directors and/or the audit committee for breaches of the new requirements.

Continuing with the theme of greater stakeholder engagement, the Proposals introduce a formal mechanism by which shareholders of a premium listed company could suggest additional matters for emphasis within the scope of the company's external audit, as well as mechanisms for better communication to shareholders following the resignation or dismissal of the auditor.

What will the impact be on companies and directors?

- It will be interesting to see how the Proposals, when implemented, balance the need for auditor independence on the one hand, with the ability for shareholders to more effectively engage in the audit process on the other.

- Audit costs are likely to be increased.

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