

# Clients & Friends Memo

## The Government is Launching a Consultation on Reforming the UK's Audit and Corporate Governance Regime

13 April 2021

On 18 March 2021, the Department for Business, Energy & Industrial Strategy [launched](#) a [consultation](#) on its proposals for wide-ranging reforms to modernise the UK's audit and corporate governance regime. The reforms proposed in the consultation would implement the recommendations of three previous independent reviews<sup>1</sup> commissioned in the wake of a series of large-scale company failures, such as Carillion, Thomas Cook and BHS, which have been laid at the door of poor internal governance and external review at those companies.

The proposals espouse a holistic approach, setting out responsibilities of directors, auditors, shareholders and the audit regulator.

**The Regulator.** The previously published [Kingman review](#) on the Financial Reporting Council recommended a significant overhaul. That regulator is set to be replaced by a new regulator, the Audit, Reporting and Governance Authority ("**ARGA**"), with new statutory objectives and functions funded by a new statutory levy on industry. ARGA will have an improved corporate review function, including a remit to review the whole of the annual report and accounts (including areas not currently within scope, such as the corporate governance statements) and the power to require changes to company reports and accounts without needing to seek a court order first. ARGA will be responsible for overseeing audit committees, enforcing corporate reporting duties of directors and approving the statutory auditors of public interest entities. The definition of public interest entities is subject to consultation but will include publicly listed companies, large private companies and, potentially, third sector entities with a public benefit purpose.

**Auditors.** The proposed reforms seek to separate corporate auditing from other services (such as legal services) commonly provided by the major audit firms, create new overarching principles for auditors and subject auditors to a new duty to take into account a wider range of information (not just financial statements) in reaching audit judgements (in particular, whether financial statements give a "true and fair view"). This will be achieved in part by new regulatory measures, to be promulgated by ARGA, aimed at increasing competition by mandating opportunities for challenger audit firms to participate in audits of FTSE 350 companies, and new requirements for

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<sup>1</sup> i. The [Independent Review of the Financial Reporting Council \(FRC\)](#) led by Sir John Kingman (published on 18 December 2018); ii. The [Independent Review into the quality and effectiveness of audit](#), led by Sir Donald Brydon (published on 14 February 2019); and iii. The Competition and Markets Authority's [statutory audit services market study](#) (published on 9 October 2018).

audit firms to operationally separate their audit and non-audit practices, with separate governance and financial statements.

**Directors.** The consultation posits that directors' current reporting and accountability requirements are deficient in the following three areas:

- i. internal controls over financial reporting: the consultation suggests requiring directors make an annual statement by directors on the effectiveness of internal controls, which would allow the directors to determine whether the external auditor should assure that statement.
- ii. dividend and capital maintenance decisions: the consultation suggests that dividends must be made exclusively out of a company's distributable reserves. Guidance on how to calculate distributable reserves currently rests with professional accountancy bodies. This consultation proposes to give ARGAs powers to set legally enforceable guidance on calculating distributable reserves. It also proposes new requirements that companies disclose their total distributable reserves as part of the annual reporting process and that directors, when proposing any dividend, make a statement confirming it is in line with the requirements and is not reasonably expected to threaten the company's solvency in the next two years.
- iii. company resilience planning and attestation requirements: the proposals would require directors of public interest entities to publish an annual resilience statement (potentially including TCFD (Task Force on Climate-related Financial Disclosures) climate change disclosure) setting out how their organisation mitigates short and long-term risks and an audit and assurance policy describing external checks on the information they report to shareholders.

The consultation proposes an amendment to UK Corporate Governance Code (which applies on a comply-or-explain basis to all premium listed companies) so directors' remuneration would contain two-year clawback or malus provisions for serious misconduct, a material misstatement of results or error in performance calculations, failures of internal controls and risk management, reputational damage and unreasonable failure to protect the interests of employees and customers.

The new regulator, ARGAs, is proposed to have its own investigation and civil enforcement powers regarding breaches of duty related to corporate reporting and audit for directors of public interest entities.

**Shareholders.** The consultation reflects a concern that shareholders do not sufficiently prioritise audit or adequately steward their investments, which have partly been addressed by the most recent changes to the Stewardship Code (see our [memo](#) on this subject), a voluntary code to which investors may adhere as a kitemark of quality. This consultation proposes regulatory changes giving investors better tools to exercise stewardship through (i) an advisory shareholder vote on a company's audit and assurance policy and (ii) a right of shareholders to propose to the audit committee areas of emphasis to be considered within the auditor's annual audit plan.

The proposed changes are designed to increase directors' responsibility in performing their duties, shareholder engagement on audit matters and improve the quality and scope of external audits. Although it remains to be seen whether and in which form these proposals will be incorporated into legislation, they will undoubtedly produce a shake-up in the UK audit industry and significantly impact the corporate governance styles of large corporates.

The deadline for responses to the consultation is 8 July 2021.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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