

## UK GOVERNMENT PUBLISHES PROPOSALS ON AUDIT AND CORPORATE GOVERNANCE REFORM

On 18 March 2021, the Department for Business, Energy & Industrial Strategy (**BEIS**) published a [consultation paper](#) on its proposals for significant reform to UK audit and corporate governance. The proposals are centred on reforms to further the public interest in audit and corporate reporting and the establishment of the previously announced new regulator - the Audit, Reporting and Governance Authority (**ARGA**), replacing the Financial Reporting Council (**FRC**). The aim of the proposals includes to deliver more effective governance, reporting and audit of the UK's largest businesses in order to increase the reliability of the information on which investors base their decisions. The proposals would extend a range of new obligations to Public Interest Entities (**PIEs**) - the definition of which would be extended to cover large UK private companies and certain AIM listed companies. The proposals also envisage additional responsibilities and liabilities for directors of PIEs, including when declaring dividends, the potential for bonuses to be clawed-back in the event of serious director failings, and additional responsibilities for members of audit committees of FTSE 350 companies.

The proposals are part of wider efforts to strengthen the legal and corporate governance framework within which UK companies operate, so as to underpin fairness and transparency in UK markets. They follow on from, and respond to recommendations made in, Sir John Kingman's independent review of the FRC, the Competition and Markets Authority's market study on the audit of FTSE 350 companies and Sir Donald Brydon's independent review of the quality and effectiveness of audit. They also respond to the concerns raised about statutory audits following high profile, sudden and major corporate collapses, such as those of Carillion, BHS and Patisserie Valerie.

A summary of the key proposals in respect of companies, directors, audit committees, ARGA and auditors is set out on the following pages. The deadline for comments on the proposals is 8 July 2021.

### Key issues

- BEIS commences consultation on significant reform to UK audit and corporate governance, following the Kingman review, the CMA market study and the Brydon review
- Majority of proposals apply a range of new obligations to PIEs (as newly defined)
- Proposals contain increased corporate reporting requirements and additional director confirmations when declaring dividends
- Malus and clawback powers in contractual arrangements with directors to be strengthened in the event of serious failings
- A new regulator (ARGA) to be formed with statutory objectives and stronger powers
- Proposals to increase competition and resilience in the audit market

## Key proposals

In summary, the key proposals are:

- **Companies:**

- New requirement for a **directors' statement about the effectiveness of internal controls for financial reporting**. Unlike the mandatory nature of the US Sarbanes-Oxley approach, the directors, audit committee and shareholders would decide whether such statement should be subject to external audit and assurance.
- New requirement for an annual **resilience statement**, setting out a company's approach to exploring and mitigating risks and uncertainties over the short-term (1-2 years; replacing the current going concern statement), medium-term (5 years; replacing the current viability statement and extending the most used current time period of 3 years to 5 years) and long-term (an indefinite period to be determined by the company; to cover the main long-term challenges to the company and its business model and how these are being addressed). The resilience statement would be a new section of the existing strategic report.
- New requirement for annual disclosure of the **audit and assurance policy**, describing the directors' approach (over a rolling three-year forward look period) to seeking internal and external assurance of the information they report to shareholders, including any external assurance planned beyond the scope of the annual statutory audit. For quoted listed companies (i.e. companies with listed equity share capital), this policy would be subject to an advisory shareholder vote at the time of its publication.
- New requirement for the annual report (e.g., the strategic report) to provide a summary of how the company (or group in the case of a parent company) has performed with regard to supplier payments over the year being reported on and to comment on how this compares to the prior year.
- New requirement for companies (or, in the case of a group, the parent company only) to **report on the total amount of their distributable reserves** in their annual report. In addition, it is proposed that there be a new requirement for parent companies to disclose an estimate of the amount of potential distributable profits across the group that could in principle be passed to the parent company. These requirements would only apply to listed companies and AIM companies (not all PIEs).

- **Directors:**

- New requirement to make a **formal statement about the legality and affordability of proposed dividends** – see details of the proposed statements in the box opposite. BEIS is consulting on whether this requirement would extend to all PIEs despite the proposal that the new distributable reserves reporting requirements would only apply to listed companies and AIM companies (see under **Companies** above). The proposals on dividends seek to address the issues raised by high profile examples of companies paying significant dividends shortly before profit warnings or insolvency.
- New **power for ARGAs to take civil enforcement action** against PIE directors in relation to breaches of PIE directors' duties relating to

### **Proposed directors' statement when proposing a dividend:**

- Confirmation that in proposing the dividend, the directors have: (a) satisfied themselves that the dividend is within known distributable reserves; and (b) had regard to their general duties under section 172(1) of the Companies Act 2006 (including the need to have regard to the likely consequences of any decision in the long term) and their wider common law and fiduciary duties.
- Confirmation that it is the directors' reasonable expectation that payment of the dividend will not threaten the solvency of the company over the next two years in the light of the risk analysis undertaken and the directors' knowledge of the company's position at the date the dividend is proposed. Where relevant, directors should also confirm that the dividend is consistent with the resilience statement (see under **Companies** above).

corporate reporting and audit (see under **ARGA** below). The proposed sanctions include reprimands, fines, orders to take action to mitigate the effect of a breach (or the recurrence of a breach) or to make declarations as to non-compliance and, in the most serious of cases, temporary prohibition on acting as a PIE director.

- Companies to be required to include **"malus and clawback" powers in contractual arrangements with directors**, to enable them to: (a) reduce the amount of deferred compensation before vesting (malus); or (b) require the repayment of vested remuneration (clawback) for a period of at least two years after the award is made. These powers would be applicable in a wide range of circumstances, including where there has been: (i) a material misstatement of financial results; (ii) a material failure of risk management; (iii) misconduct; (iv) conduct resulting in financial loss; (v) reputational damage; and (vi) an "unreasonable failure" to protect the interests of employees and customers. It is proposed that this proposal be implemented initially through an amendment to the UK Corporate Governance Code, with subsequent consideration as to whether it should be applied to all listed companies and not just those which are subject to the Code.
- New requirement for PIE directors to report on the steps they have taken to prevent and detect material fraud.
- **Audit committees:**
  - **Additional requirements for audit committees of FTSE 350 companies** in relation to the appointment and oversight of auditors, covering the need for audit committees to continuously monitor audit quality and consistently demand challenge and scepticism from auditors (see under **ARGA** below). BEIS will consider extending these new requirements to the audit committees of all PIEs in due course.
  - Shareholders of premium listed companies to have a formal opportunity to propose to the company's audit committee areas of emphasis to be considered within the auditor's annual audit plan – although shareholder views should be purely advisory in nature and supplemental to the auditors' own views.
  - Updating existing guidance to audit committees to encourage better attendance from the audit committee chair (and senior auditor) at the company's AGM.
- **ARGA (replacing the FRC):**
  - New statutory objectives (see details of these proposed objectives in the box opposite) and functions, along with a new statutory levy to replace the existing voluntary levy.
  - New powers to strengthen its corporate reporting review function, including so that it can scrutinise the entire contents of a company's annual report and accounts, direct changes to be made to a company's annual report and accounts and publish more information about its findings following a review (including publishing full correspondence). These powers include being able to require an expert review (at the company's expense) to investigate issues and underlying causes in greater depth.

#### **ARGA's objectives:**

- **General objective:** "To protect and promote the interests of investors, other users of corporate reporting and the wider public interest."
- **Quality objective:** "To promote high quality audit, corporate reporting, corporate governance, accounting and actuarial work."
- **Competition objective:** "To promote effective competition in the market for statutory audit work."

- New investigation and enforcement powers to hold PIE directors to account in respect of their corporate reporting and audit duties (see under **Directors** above).
  - New powers to set additional requirements as to the role of FTSE 350 companies' audit committees in the appointment and oversight of auditors, and to monitor compliance and take appropriate action in relation to breaches (see under **Audit committees** above).
  - Stronger powers and duties to increase competition in the FTSE 350 audit market, initially through a managed shared audit regime for UK-registered FTSE 350 companies and, if needed, a managed market share cap. ARGA would also determine the level of operational separation required between the audit and non-audit arms of certain firms - this would include separate governance, financial statements prepared on an arm's length basis and regulatory oversight of audit partner remuneration and audit practice governance. ARGA would also have enhanced powers to monitor the resilience of audit firms and the PIE audit market.
  - New responsibilities for deciding which individuals and firms should be approved to audit PIEs.
- **Auditors:**
    - The creation of a new, stand-alone audit profession covering all forms of corporate reporting, not just the financial statements, to operate independently of the professional accountancy bodies.
    - New regulatory measures to increase competition and reduce the potential for conflicts of interest, by providing new opportunities for challenger audit firms and new requirements for audit firms to separate their audit and non-audit practices (see under **ARGA** above).

### Proposed scope of application of new company requirements

BEIS proposes to apply the majority of the new requirements to companies that are PIEs. The current definition of this term in the Companies Act 2006 covers UK licensed banks, insurance companies and companies whose equity or debt securities are admitted to trading on a UK regulated market. PIEs are already subject to some additional requirements with respect to statutory audits and certain companies in scope of the PIE definition with more than 500 employees are already required to publish non-financial information in their strategic report as part of their annual report.

However, BEIS is consulting on proposals that would expand the PIE definition to cover a number of larger unlisted UK companies. The two proposed options that are being consulted on are set out in the box opposite.

The thresholds used under either option in the box opposite would apply to all companies in their own right, including UK subsidiaries of non-UK companies. Additionally, in the case of UK parent companies, the thresholds would be applied to the group headed by that company. It is proposed that a parent company would therefore qualify and be regulated as a PIE if the relevant thresholds for option 1 or 2 were met when applied to the accounts of the group headed by that company (i.e., its consolidated financial statements), where the parent company is required to file group accounts in the UK (it should be noted that UK wholly-owned subsidiaries of non-UK companies may be able to rely on the exemption under the Companies Act 2006 from filing

### Expansion of PIE definition options:

**Option 1:** a broader test including those companies that are already required to include a corporate governance statement in their directors' report, i.e., companies with either:

- more than 2,000 employees; **or**
- a turnover of more than £200 million and a balance sheet of more than £2 billion.

**Option 2:** a narrower test which would only include companies with both:

- over 500 employees; **and**
- a turnover of more than £500 million.

group accounts where they are included in consolidated accounts of the parent company and other conditions are met).

The consultation also envisages that any new PIE definition should include AIM companies with market capitalisations above €200m.

BEIS does, however, propose to allow a significant lead-time before introducing a new PIE definition and suggests a phased introduction in two or more stages.

### **Timing**

Given the serious challenges that businesses are currently facing, BEIS proposes to introduce the reforms over a timetable which allows for transition periods and/or phasing in – measures with significant impacts on wider business are most likely to be considered for later commencement. For a number of the proposals, BEIS suggests introducing them initially for premium listed companies, given their experience in dealing with existing regulation in these areas, before extending them more widely to other PIEs. Many of the reforms require legislation, which the UK Government will introduce when Parliamentary time allows.

As noted above, the consultation closes on 8 July 2021.

If you wish to discuss any aspect of the consultation paper, please speak to your usual Clifford Chance contact or one of the contacts named below.

## CONTACTS

**David Pudge**  
Partner

**T** +44 207006 1537  
**E** David.Pudge  
@cliffordchance.com

**Robert Crothers**  
Partner

**T** +44 207006 1427  
**E** Robert.Crothers  
@cliffordchance.com

**Juliet McKean**  
Knowledge Director

**T** +44 207006 4577  
**E** Juliet.McKean  
@cliffordchance.com

**Phillip Souta**  
Head of UK Public  
Policy

**T** +44 207006 1097  
**E** Phillip.Souta  
@cliffordchance.com

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Clifford Chance, 10 Upper Bank Street,  
London, E14 5JJ

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London, E14 5JJ

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