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Restoring trust in audit and corporate governance: what you need to know

The UK Government has published its response to the March 2021 consultation paper on 'Restoring trust in audit and corporate governance'. The response is an important milestone in the Government's plans to strengthen the UK audit, corporate reporting and governance systems and to promote enhanced accountability. The consultation received over 600 comments and as a result some of the original proposals have been modified, however the Government has confirmed the majority will be introduced. It is anticipated that the reforms will take a number of years to be implemented and will be via primary and secondary legislation in addition to changes to the UK Corporate Governance Code 2018 ("Governance Code").

Underpinning the reform will be the creation of a new regulator, the Audit Reporting and Governance Authority ("ARGA") to replace the Financial Reporting Council ("FRC"). ARGA will have additional statutory responsibilities and powers that the FRC, the current regulator, does not have. In particular, this will include the power to investigate and sanction the directors of all Public Interest Entities ("PIE"s) for breaches of duties and responsibilities in respect of corporate reporting and audit.

The Government wants ARGA to 'exercise effective oversight of corporate reporting to raise standards and improve the informativeness of company report' and it is intended that ARGA will be able to direct changes to the content of report and accounts without having to seek a court order. This will include the entire contents of the accounts, including the corporate governance statements, directors' remuneration reports and audit committee reports.

Which entities are impacted?

The proposals provide a further step towards enhancing governance requirements for both public and private companies. The current definition of a PIE will be expanded and any UK entity, whether public or private, with both 750 or more employees and an annual turnover of £750 million or more will be included ("750:750 threshold"). There are however certain audit requirements that will continue to apply only to PIEs falling under the existing definition.

What will be the main new requirements?

It is proposed that PIEs meeting the 750:750 threshold will be required to:

- publish an Audit and Assurance Policy every three years, providing details of how the company will obtain assurance on its reporting beyond its statutory audit. Whilst such policy will not need shareholder approval, each company will need to publish an annual update on how the policy is being implemented,
- disclose their distributable reserves and explain the boards approach to dividends and returning value to shareholders,
- provide an explicit statement on the legality of any dividend,
- publish a 'resilience statement', which will replace the going concern and viability statements. Such statement should reflect what the Board considers to be short term and medium threats to the company's resilience, and
- provide detail on measures surrounding the detection and prevention of material fraud.

It is intended for the FRC to consult on strengthening the Governance Code by providing for:

- 'greater transparency about the malus and clawback arrangements that companies have in place so remuneration can be withheld or recovered from directors for misconduct, misstatements, and other serious failings', and
- an explicit statement in relevant companies' annual reports on their board's views of the effectiveness of the company's internal controls and the basis for such views. PIEs meeting the 750:750 threshold will need to confirm in their Audit and Assurance Policy whether or not they have obtained external assurance for their internal control statement.

What should companies be doing in response?

Directors and governance professionals will need to ensure that they are fully aware of the new requirements and adequately prepare. With the new proposed powers for ARGA, it will be more important than ever for directors to be fully aware of their duties and responsibilities and to keep up to date with any new legislation or regulatory requirements. Companies should consider if their induction and training and development programmes are sufficiently rigorous, relevant and fit for purpose.

Many companies are already focusing on how to enhance their internal control frameworks and the assessment of fraud considerations in their risk frameworks. For some companies which do not currently have an internal audit function, this approach may need to be reconsidered. Alongside this, companies are opting to enhance their governance arrangements, for example those relating to climate, sustainability and social issues.

There has been a lot of focus in recent year on improving reporting within the front half of the annual report and accounts. With ARGA's new powers to review and direct changes, many companies will need to either tighten or implement revised processes surrounding drafting and verification of the content. Companies should also ensure that their auditors are enhancing their procedures in response to these forthcoming changes.

Whilst it is currently only premium listed companies that are obliged to apply the Governance Code, the Code's principles and provisions are expected to continue to influence governance expectations for a significantly wider range of companies. Those falling under the new PIE definition, in particular, may wish to start considering where improvements are required in their governance arrangements.

Getting ready at an early stage can make all the difference to achieving a smooth transition to strengthened arrangements in which the board can have a high degree of confidence. At Indigo: independent governance, we have the experience and expertise to provide tailored advice and project management to your organisation. Please feel free to get in touch if you would like to explore with us how we could help you to manage these forthcoming changes.

You can find the full Government response here.