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## Investigations, Compliance and Defense

# UK's Audit and Corporate Governance Reform: Changes Afoot for UK Directors

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Earlier this month, the UK government published a White Paper on its proposals for "Restoring Trust in Audit and Corporate Governance". Concerns around the UK's audit and corporate governance framework are longstanding, but the sudden and critical failures of large UK companies such as BHS in 2016 and Carillion in 2018 added fuel to the fire of audit reform discussions.

The paper is published against the backdrop of three previous independent reports commissioned in 2018 to address concerns.[1] The government's self-proclaimed "ambitious plans" set out in the White Paper run to some 200 pages, with wide-ranging proposals aimed at stymieing the continued dominance of the Big 4 accounting firms and improving corporate governance. This client alert focuses on specific proposals which will ultimately expand directors' liability in relation to audit and reporting.

Set out below are the key takeaways on what the proposals may mean for directors' liability, in particular:

1. Who will be affected by the proposals;
2. The most significant proposals for directors; and
3. When the proposals are likely to take effect.

Who Will Be Affected by the Proposals?

- The proposed reforms primarily affect Public Interest Entities (PIEs) and, in turn, directors of PIEs.

- PIEs currently include companies with shares traded on regulated markets, credit institutions, and insurance undertakings. However, the proposals include plans to extend the definition of PIEs to include other large entities whose audit arrangements are considered a matter of public interest (such as private companies with over 500 employees, a turnover over £200 million, or a balance sheet over £2 billion, as well as AIM listed companies with market capitalisations above €200 million).

The Most Significant Proposals Affecting Directors' Liability

*Directors Accountability for Internal Controls and Dividends*

- Internal controls: Further director accountability is proposed with the introduction of an explicit directors' statement regarding the effectiveness of the internal control and risk management systems (including the basis on which any statement is made). While the White Paper puts forward a number of non-mutually exclusive options for stronger internal controls, the requirement for additional director statements and confirmations forms a key part of the government's current preferred approach. The requirement could apply to the CEO and the CFO (the approach adopted by the Sarbanes-Oxley regime in the US) or alternatively the board collectively.

- Dividends: Further director accountability for dividend decisions is proposed, with a statement to be given by directors on the legality of proposed dividends and the effects on the future solvency of the company. This proposal comes in the wake of payments of significant dividends by companies shortly before profit warnings and, in some cases, insolvency.

*Other New Reporting Requirements*

- Annual resilience statement: The introduction of an annual resilience statement is proposed. This statement will set out how directors are assessing a company's prospects and addressing challenges to its business model over the short-, medium-, and long-term, including risks posed by climate change. The government believes that the experience of COVID-19 has increased investor appetite for fuller reporting and heightened expectations that companies will be able to explain how they are preparing to cope with different risks.

- Audit and assurance policy: Another reporting requirement proposed is the requirement for an Audit and Assurance Policy. This policy will describe directors' approach in relation to internal and external assurances they have sought for the information they report to shareholders.

*Enforcement Powers Against Directors*

- The White Paper considers that the current web of regulator powers to hold directors to account (largely shared between the FRC (to be replaced), the FCA, and the Insolvency Service) is insufficient.

- The Audit, Reporting and Governance Authority (ARGA), the new regulator which will replace the FRC, is to be given the necessary power to take civil enforcement action against any PIE directors in relation to corporate reporting and audit-related responsibilities.

- Proposed sanctions include reprimands, fines, orders to take action to mitigate the effect of a breach (or the recurrence of a breach), non-compliance declarations, and, in the most serious of cases, temporary prohibition on acting as a director of a PIE.

- The new proposed enforcement regime would sit alongside existing arrangements for taking action against company directors, for example, in respect of offences under the Companies Act 2006 or breaches of existing regulations such as market abuse regulations.

- There is to be renewed focus on contractual provisions in directors' remuneration agreements, which allow for clawbacks or the withholding of pending awards to ensure that remuneration can be withheld or recovered in the event of serious director failings. The intention is for the current requirements in the UK's Corporate Governance Code to be supplemented.

<u>Timing on Implementation</u>

- The White Paper has a 16-week consultation period, closing on 8 July 2021.

- The government has not committed to a timetable for implementation. It has stressed the urgency of audit reform, but confirmed that it intends to provide a transition period and take a phased approach. Measures that do not directly impact businesses (such as establishing the new regulator ARGA) will be brought into effect most quickly, with more time for those measures which impact businesses significantly.

<u>Commentary</u>

While the exact nature of the reforms remains unclear at this time, given their proposed sweeping nature, undoubtedly companies and directors should be keeping a watchful eye on developments. For now, the publication of the White Paper offers companies and directors the opportunity to understand the landscape of potential reforms, aiding future planning. Plainly enhanced regulation will bring increased costs of compliance for companies. Furthermore, directors will need to assess how they approach their role or, indeed, the taking on of new directorships in light of the additional obligations coming down the line. There would appear to be the potential that risk-averse directors may turn down such roles and/or directors may demand more pay to reflect the risk. There are also unanswered questions around whether the proposed changes may unintentionally impact the drive for diversification of boards. Given the significance of the proposals, it is expected that market participants will be keen to have their voices heard during the next 16 weeks of consultation.

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[1] The Sir John Kingman's Independent Review of the Financial Reporting Council (FRC), the Competition and Market Authority (CMA)'s Statutory Audit Services Market Study, and Sir Donald Brydon's Independent Review of the Quality and Effectiveness of Audit.

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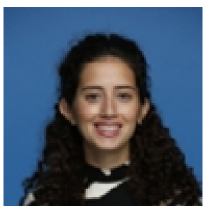

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