

BEIS

Restoring trust in audit and corporate governance

Consultation on the government's proposals

March 2021

Closing date: 8 July 2021

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Overall the ambition for radical reform is to be welcomed but being radical is in and of itself not an objective. The question is how these reforms integrate to restore trust. The evidence from the Financial Reporting Council (FRC) quality reviews and the experience of those working in the commercial environment is that the majority of audits are effective in delivering effective outcomes, acting to moderate behaviour and provide robust challenge resulting in high quality financial statements.

The focus should therefore be on the “bad apples” and the only effective way to limit their number is to have a regime where there is a high risk of being caught and subsequently prosecuted for behaviours that result in significant societal damage. It is not clear from previous experience that regulatory sanction is adequate in this regard. A more radical approach would be a fundamental shift away from the emphasis on regulatory sanction to more legal sanctions with attendant fines and jail terms. It is therefore disappointing to note the lack of discussion of the role of the Serious Fraud Office and its relationship with the regulator.

This paper though welcomed does not address the other elephant in the room being the accounting standards themselves. The question needs to be asked whether accounting standards are fit for purpose. Or, has the move away from reliability and prudence (in the traditional sense) with the related reliance on judgement, fatally undermined the ability to audit effectively?

Chapter 1 Government's approach to reform

1. Should large private companies be included within the definition of a Public Interest Entity (PIE)? Please give your reasons.

Given the broad range of stakeholders impacted by the activities and in particular the failures of large private companies it seems both reasonable and proportionate to bring them within the scope of a Public Interest Entity.

The current definition provides significant protections to a minority of stakeholders, namely capital providers. Broadening the definition sends a powerful signal that the government recognises the broader stakeholder community.

2. What large private companies would you include in the PIE definition: Option 1, Option 2 or another? Please give your reasons.

Capturing a broader range of entities as in Option 1 appears initially to be the most appealing option, given a desire to protect the broadest range of stakeholders. However, this needs to be balanced out with the practicalities. Given the challenges faced by the current regulator, there appears to be a risk that drawing the definition too broadly will overwhelm the new body's ability to deliver high quality, timely, effective, supervision and sanctioning, to work as an effective deterrent.

The uniqueness of the UK corporate regulatory scheme is that it provides sufficient, but not excessive protection for stakeholders. This is attractive to inward investors and companies. Maintaining this status is important, especially now in restoring the UK economy after Brexit and Covid.

Option 2 would therefore be a possible starting point with an ambition to expand the definition as the new regulatory regime beds down and as its skill base builds up. However, what is definitely needed is a clear interpretation of s.172(1): "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters)..." The definition should be accompanied by more guidance on the other matters to which directors should have regard.

3. Should AIM companies with market capitalisation exceeding €200m be included in the definition of a PIE? Please give your reasons.

In principle yes in order to address the broader range of stakeholder interests. However, so as not to overwhelm the new regulator a phased approach would be appropriate. A clear timetable and work plan would be required to prevent drift but signalling clearly timescales also has the advantage of allowing companies currently outside scope to prepare and skill up appropriately.

4. Should Government give newly listed companies a temporary exemption from some of the new reporting and attestation requirements being considered for Public Interest Entities?

For completeness and to prevent gamification of structures, in principle yes. However, we refer to our answer in 3.

5. Should the Government seek to include Lloyd's Syndicates in the definition of a PIE? Please give your reasons.

For completeness and to prevent gamification of structures, in principle yes. However, we refer to our answer in 3.

6. Should the Government seek to include large third sector entities as PIEs beyond those that would already be included in the definitions proposed for large companies? If so, what types of third sector entities do you believe should be included and why?

Third sector organisations as with AIM and Private Companies impact significant stakeholders and as such should be subject to rigorous oversight. In principle, a common approach across all sectors is to be welcomed. However, there are practical considerations and concerns that would need to be addressed around over-regulation and the potential for regulatory conflict. For instance, Scottish Universities currently operate under charity law and in addition have to comply with a range of Scottish and UK law impacting governance whilst being accountable to Scottish ministers, the Scottish parliament and a broad range of regulatory, funding and professional authorities.

As noted in earlier responses we would also be concerned that broadening the scope to this degree would undermine the effectiveness of the regulator. It is unlikely that individuals would have the appropriate skills and knowledge to cross regulate so the result could be an organisation whose costs outweighed the benefits or alternatively the regulator providing a superficial and not fit for purpose product.

7. What threshold for 'incoming resources' would you propose for the definition of 'large' for third sector entities? Is exceeding £100m too high, too low or just right?

See answer to 6

8. Should any other types of entity be classed as PIEs? Why should those entities be included?

See answer to 6

9. How would an increase in the number of PIEs impact on the number of auditors operating in the PIE audit market?

Recent evidence has shown greater market concentration and flight at the bottom end of the sector. The risk is that these recommendations will further strengthen the top end of the market causing even greater concentration. The 2019 FRC, Developments in Audit paper notes that between 2012 and Aug 2019 165 FTSE 350 companies moved from one member of the Big 4 to another, 7 moved from Big 4 to mid-tier or smaller and 15 moved from the mid-tier and smaller into the Big 4. There is a risk that forcing more entities into the PIE definition will lead to even greater concentration.

source: <https://www.frc.org.uk/getattachment/5d176788-3330-4b62-b18e-276c678d3d2c/Developments-in-Audit-Final-Screen.pdf>

One answer may be to lock out the Big 4 from the new entrants to the PIE definition – although arguments for (e.g., avoiding further concentration) would need to be carefully balanced with those against (e.g., questions of expertise, experience and capacity to meet new demands).

10. Do you agree that the Government should provide time for companies to prepare for the introduction of a new definition of PIE?

See earlier answers

11. Do you agree that the Government should seek to offer a phased introduction for a new definition of PIE?

See earlier answers

2 Directors' accountability for internal controls, dividends and capital maintenance

12. Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls?

In principle, recent corporate failures point to a need for the largest companies to implement more effective internal control. Inevitably this has a significant cost; however, the cost of control failures needs to be factored in. The experience from the US introducing SOX was an explosion of work and costs in the early years but the additional costs have now settled. Equally, over time there is evidence of a net benefit to companies accruing from enhanced internal control.

On balance the recommendation is to be welcomed and if implemented in such a way, there may be the opportunity to allow Mid-tier firms to build relationships with PIE management teams by performing these functions in a stand-alone capacity. This has the demerit of reducing audit efficiency but the advantage for stakeholders of a second opinion. we do not underestimate the practical challenges of this suggestion but the risk otherwise is that overall audit quality is impacted as the market is not able to expand quickly enough to absorb the increase in entities falling under the expanded PIE definition and the extra work required to support the proposed internal control framework.

13. If the control framework were to be strengthened, would you support the Government's initial preferred option (Table 2)? Are there other options that you think Government should consider? Should external audit and assurance of the internal controls be mandatory?

See above.

The proposals outlined in Table 2 appear reasonable; indeed, it is interesting to consider whether a lay person coming to this for the first time might not wonder why such arrangements were not already in place, and might wonder what has been happening instead.

Furthermore, the Table 2 option could be implemented through the co-regulatory mechanism. Co-regulation lies between self-regulation and direct governmental regulation.¹ The aim is “to combine the advantages of the predictability binding nature of legislation with the flexibility of self-regulatory approaches.”² In establishing a new regulator with specific enforcement powers, the UK government should maintain a degree of flexibility, to ensure that country remains competitive on the global market for investors.

Moreover, mandatory requirements have the advantage of providing comparability across institutions. However, mandatory requirements risk producing a “big bang” approach with significant market pressures to supply the work required. This risks undermining audit quality. One solution would be to make mandatory but give a reasonably long lead in time.

14. If the framework were to be strengthened, which types of company should be within scope of the new requirements?

To avoid the market risks discussed earlier a focus on PIE as a start with a fixed review point to assess feasibility of extension.

In this regard, it is also interesting to note the interaction of these proposals with those relating to the extended definition of a PIE. In the immediate aftermath of SOX, the data suggested a not insignificant number of companies on the NYSE delisted or went dark. If the UK’s proposals are implemented in a coordinated way, such actions here will not remove companies from their reach. It will, of course, be important to consider whether there is any risk of companies, for example, choosing other jurisdictions for an IPO as a consequence of perceived increased costs and risks. Whilst this was also a feature of the period immediately after SOX, it has not been a long-term feature as the benefits of enhanced internal control become clearer.

15. Should the regulator have stronger responsibilities for defining what should be treated as realised profits and losses for the purposes of section 853 of the Companies Act 2006? Would you support either of the two options identified? Are there other options which should be considered? What should ARGAs consider when determining what should be treated as realised profits and losses?

It is not clear that ARGAs would be the appropriate body for this given the establishment of the UK Accounting Standards Endorsement Board. As a technical issue it feels

¹ Marian Martinez, Andrew Fearn, Julie Caswell and Spencer Henson ‘Co-Regulation as a Possible Model for Food Safety Governance: Opportunities for Public-Private Partnerships’ (2007) 32 Food Policy, 301 <<https://doi.org/10.1016/j.foodpol.2006.07.005>> accessed 26 February 2020.

² *ibid* 302.

inappropriate for it to be discussed in amongst structural and general regulatory issues. Would the UK Accounting Standards Endorsement Board not be a better vehicle to explore these issues?

16 Would the proposed new distributable profit reporting requirements provide useful information for investors and other users of accounts? Would the cost of preparing these disclosures be proportionate to the benefits? Should these requirements be limited to listed and AIM companies or extended to all PIEs?

See answer to 15.

17. Would an explicit directors' statement about the legality of dividends and their effect on the future solvency of a company be effective in both ensuring that directors comply with their duties and in building external confidence in compliance with the dividend rules? Should these requirements be limited to listed and AIM companies or extended to all PIEs?

An explicit statement is unlikely to change poor behaviours without specific sanctions being applicable to failure to apply due care in making the statement. This is one of the reasons why the UK Corporate Governance 'comply or explain' approach did not work well. The initial intention behind the approach was noble but lacked enforcement mechanisms to discourage directors from not complying or providing adequate explanations for non-compliance. Thus, the enforcement mechanisms should be allocated between the two groups: stakeholders (primarily shareholders) and the regulator. Such a framework would make sure that non-compliance would not go unwitnessed.

18. Do you agree that the combination of recently introduced Companies Act section 172(1) reporting requirements along with encouragement from the investment community and ARGA will be enough to ensure that companies are sufficiently transparent about their distribution and capital allocation policies? Should a new reporting requirement be considered?

The proposed changes need time to bed down to see how effective they are. Whilst there could be a temptation to move further, it must be remembered that in many respects the most recent reporting changes simply take us to the point which was envisaged by the Company Law Reform Steering Group, where the codification of directors' duties embodying the Enlightened Shareholder Value Approach was seen as part of a mutually supportive arrangement along with enhanced narrative reporting in the form of the Operating and Financial Review. The very unfortunate intervention of the Treasury to dilute the OFR is really only now being remedied in the context of the recent reporting changes. It would, however, be appropriate to consider whether there are elements of the OFR that are not yet fully reflected in the latest arrangements, not least in relation to audit.

As has been mentioned in question 17, a clear enforcement mechanism would resolve a lot of non-compliance issues.

22. Do you agree with the proposed minimum content for the Audit and Assurance Policy? Should any other matters be addressed in the Policy by all companies in scope?

Standardising the wording of the audit and Assurance policy has the benefit of improving comparability opportunities between companies and within sectors.

There are concerns around the extension of the effective remit of the Audit Committee will inevitably dilute the time available to focus on financial sustainability.

27. Do you agree with the Government's proposal not to introduce a new statutory requirement at this time for directors to publish an annual public interest statement?

Yes. There would need to be a lot more consideration of what such a statement would achieve, what its legal status would be, the extent to which it would be enforceable rather than a form of public relations or marketing, etc. Equally, to what extent would it impact on the overall nature of the director's duties as currently expressed?

Furthermore, such a statement would duplicate the information provided in a company's annual review.

28. Do you have any comments on the Government's proposals for strengthening the regulator's corporate reporting review functions set out in this chapter?

We agree with all of the proposals made by the government in strengthening the corporate reporting. However, it is important that the new regulator will maintain a degree of flexibility. This could be achieved by co-operation between industry, government and regulator in the creation of the new corporate reporting rules. The involvement of the government would ensure sufficient protection of the public interests, while, the involvement of the private sector would discourage over-regulation. Lastly, the independent regulator would allow a neutral enforcement of these rules.

6.9 A new professional body for corporate auditors

48. Do you agree that a new, distinct professional body for corporate auditors would help drive better audit? Please explain the reasons for your view.

49. What would be the best way of establishing a new professional body for corporate auditors that helps deliver the Government's objectives for audit? What transitional arrangements would be needed for the new professional body to be successful?

50. Should corporate auditors be required to be members of, and to obtain qualifications from, professional bodies that are focused only on auditing?

51. Do you agree that a new audit professional body should cover all corporate auditors, not just PIE auditors?

Graduates are generally attracted to professional training because it allows them to develop a broad range of skills which in turn gives them a unique range of future career opportunities. We are aware that new entrants will have multiple jobs and careers in what is likely to be a long working life. Developing a corporate auditor designation encompassing all forms of audit and assurance may enhance the career's attractiveness to new entrants and to career changers. This is to be welcomed.

We already have a template for an independent organisation in the form of the Institute of Internal Auditors. It addressed a specific need to share best practice and has grown to be a highly respected and successful body in its own right. If the government is minded to develop a standalone corporate auditor institute this body may provide a starting point.

Although a standalone professional body appears interesting it also raises some significant issues apart from the obvious market disruption.

As noted in our opening comments, the evidence suggests that the majority of audits do enhance trust and improve the quality of financial statements. There is a real danger that in seeking to address high profile failures at the top end of the audit market the effective work being done elsewhere is undermined and becomes financially non viable. We are seeing a concentration of auditors as smaller firms leave the market. If staff have additional training requirements and professional regulation the pace of those leaving the market could speed up to the overall detriment of the market. A solution may be a tiered level of qualification. A more proportionate approach may be the standard qualification as now, with enhanced qualification and training required for those involved in PIE audits.