



The UK Government's response to audit and governance reform

KPMG Board Leadership Centre



The UK Government has issued its long-awaited response to the March 2021 BEIS consultation [Restoring trust in audit and corporate governance](#). The [response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems](#) sets out how the UK Government plans to act in the light of over 600 comments received, including what it intends to ask of the regulator and other stakeholders. The stated objectives are to build trust and credibility in the UK's audit, corporate reporting and corporate governance system; ensure accountability for those playing key roles in that system; and to increase resilience and choice in the statutory audit market. This, it is hoped, will further increase trust in the UK as a place to invest and to obtain investment.

The UK government response sets out their intentions to proceed with reforms that include:

- Establishing a new regulator, the Audit, Reporting and Governance Authority (ARGA), with the overarching objective to protect and promote the interests of investors, other users of corporate reporting and the wider public interest.
- Recognising the public interest in large private companies, by ensuring they meet the same high standards of reporting and accountability as are expected from large listed companies.
- Making large companies' reporting more useful, with better information about the risks they face and what information has been assured, and strengthened review powers for the regulator.
- Strengthening reporting about companies' internal controls through the UK Corporate Governance Code.
- Improving the quality of audit and making it more informative, driven by the regulator's responsibilities for standards, inspection and approving registration of auditors for the most significant companies.
- Strengthening oversight of the accountancy profession.
- Boosting resilience, competition and choice in the audit market, through the introduction of a 'managed shared audit' requirement for FTSE 350 companies, and requiring an operational separation of audit and non-audit practices.
- Making directors of the country's biggest companies more accountable for significant failures in their corporate reporting and audit related duties.

Scope and the definition of a Public Interest Entity

The UK Government intends to extend the definition of a Public Interest Entity (PIE) to large companies with both:

- 750 or more employees, and
- an annual turnover of £750 million or more.

To ensure that businesses and their auditors have sufficient time to prepare for complying with the requirements on PIEs (for example, businesses ensuring their auditor does not provide excessive or prohibited non-audit services), the UK Government will allow an adequate period between an entity exceeding the new 750:750 threshold and being subject to any new requirements. The detail will be set out in legislation, but it will be a full annual reporting period as a minimum.

Furthermore, to minimise additional burdens, the requirements to have an audit committee (or similar body), to retender the audit every 10 years and to rotate auditor every 20 years will not apply to entities that are PIEs simply because of the new size-based threshold.

We should expect a new tiered approach to reporting wherein the new corporate reporting requirements in respect of Resilience Statements, Audit and Assurance Policies, Fraud Statements and the new disclosures about dividends and distributable reserves (see later) apply only to PIE companies meeting the new 750:750 threshold.

Stronger internal controls

The UK Government considers that there would be benefits in strengthening the UK's internal control framework.

The FRC will be invited to consult on strengthening the internal control provisions in the UK Corporate Governance Code to provide for an explicit statement from the board about their view of the effectiveness of the internal control systems (financial, operational and compliance systems) and the basis for that assessment.

Note that this proposal goes much further than internal controls over financial reporting in addressing the many operational and compliance risks and control activities (which are currently covered by the UK Guidance) that companies face and that may well pose much greater risks to shareholder value.

The UK Government expects that any new Code provision would be underpinned by guidance on how boards should approach the preparation of the statement. This would be developed following a review of the FRC's existing [Guidance on Risk Management, Internal Control and Related Financial and Business Reporting](#). Any new guidance would cover the identification of acceptable standards, benchmarks or principles and address definitional issues and the circumstances in which external assurance might be considered appropriate.

Furthermore, PIEs above the 750:750 size threshold will be required to state, as part of the proposed 'minimum content' for the new Audit and Assurance Policy (see later), whether or not they plan to seek external assurance of the company's reporting on internal controls. This would not require directors to seek such assurance but would help ensure that they had at least considered the possibility. It would also provide external shareholders with a clear opportunity to raise the matter and press for more assurance if they had concerns.

Also, the FRC will be asked to explore with investors and other stakeholders whether and how the content of the auditors' report could be improved to provide more information about the work auditors have undertaken on the internal controls over financial reporting. This would be limited to observations based on work carried out as part of the statutory audit and would not amount to assurance of the control system. The FRC has agreed to take this forward as part of a consultation on the content of audit reports.

The UK Government and the regulator will review the effectiveness of the envisaged Code changes in driving improved standards of internal control and more informative reporting as part of a proposed Post-Implementation Review of the reform package and will consider at that point whether further measures are needed. If necessary, new statutory reporting requirements relating to internal controls could be introduced using existing powers in the Companies Act 2006.

Audit committee oversight

The UK Government intends to take forward the earlier proposals to give ARGA powers to set new minimum requirements for audit committees relating to the appointment and oversight of auditors as well as powers to monitor compliance with the new requirements. As part of the standards, ARGA will also include appropriate provisions to encourage shareholder engagement with an audit.

They have concluded that it is not appropriate or necessary to provide a power for ARGA to place an independent observer on the audit committee.

Enforcement against company directors

The UK Government confirms its intention to give ARGA the necessary powers to investigate and sanction breaches of corporate reporting and audit related responsibilities by PIE directors (including directors of PIEs that are not companies). It is intended that this regime should follow similar principles to the FRC's audit enforcement regime.

ARGA's new enforcement powers will apply to breaches of the directors' statutory duties relating to corporate reporting and audit. For civil regulatory enforcement to work effectively, ARGA will need to set out what it reasonably expects of PIE directors by way of compliance with their legal duties. This will provide a further opportunity to reassure directors, and individuals who are considering taking up a position as a director of a PIE, that they will be accountable only for what could reasonably be expected of a person in their position. This should also alleviate concerns about potential increases in the cost of director fees and insurance premiums due to "overstated perceptions around potential liability".

The UK Government wishes to avoid overlap or duplication of enforcement, so ARGA will work closely with other regulators to manage this. They will also work with the FRC to consider the best way to hold directors of PIEs to account if their conduct falls short of certain behavioural expectations, such as engaging in dishonest conduct, where this relates to their duties around corporate reporting and audit.

Clawback and malus

The earlier proposals considered how directors' remuneration arrangements could be strengthened in the event of serious director failings. Following consultation feedback, the FRC will be invited to consult on how the existing malus and clawback provisions in the UK Corporate Governance Code can be developed to be more transparent and rigorous, and yet flexible to meet individual business needs.

Resilience Statements

The UK Government confirms that it will continue with its proposals to introduce a new statutory Resilience Statement, albeit the proposals have been modified in light of feedback received. The new Statement will apply to PIEs above the 750:750 size threshold.

Key changes to the earlier proposals include:

- Having regard to a number of specified issues, companies should report on the matters that they consider a material challenge to resilience over the short and medium term, together with an explanation of how they have arrived at that judgement – rather than reporting against a common set of mandated risks to be addressed in every statement.
- The proposed five-year mandatory assessment period for the medium-term section of the Resilience Statement will be replaced with an obligation on companies to choose and explain the length of the assessment period.
- In the interest of integrated and holistic reporting on risk and resilience, the existing Strategic Report requirement on companies to describe the principal risks and uncertainties facing them should be incorporated within the Resilience Statement. Companies will be given the flexibility to report such risks within the short- and/or medium-term sections of the Resilience Statement, noting that different kinds of risk or uncertainty may crystallise or resolve over different time periods.
- Companies will be required to perform at least one reverse stress test rather than a minimum of two as proposed in the BEIS White Paper. The Resilience Statement will require a company to: (1) identify annually a combination of adverse circumstances which would cause its business plan to become unviable; (2) assess the likelihood of such a combination of circumstances occurring; and (3) summarise within the Resilience Statement the results of this assessment and any mitigating action put in place by management as a result.

It has been confirmed that the Resilience Statement will form part of the Strategic Report. As such, any Information provided by directors will therefore be covered by the existing ‘safe harbour’ provision in Section 463 of the Companies Act 2006.

Audit and Assurance Policies

The UK Government confirms that it will continue with its proposals to introduce a new statutory Audit and Assurance Policy (AAP), albeit the proposals have been modified in light of feedback received. The new Policy will apply to PIEs above the 750:750 size threshold.

Key changes to the earlier proposals include:

- The AAP is to be published every three years (not annually), to give companies sufficient time to review their existing assurance arrangements and gather shareholder and other views before bringing forward a new Policy. This triennial publication will, however, be complemented by an annual implementation report, in which the directors (typically through the audit committee) provide a summary update of how the assurance activity outlined in the AAP is working in practice.
- The proposal that the AAP should be subject to an advisory shareholder vote will not proceed. However, it will be mandated that companies state within the AAP they have taken account of shareholder views – and employee views – in its development.
- To help understand whether, and how, any independent assurance commissioned by a company beyond the statutory audit will be carried out, the AAP will be required to state whether any independent assurance proposed will be ‘limited’ or ‘reasonable’ assurance (as defined by the FRC), or whether an alternative form of engagement or review will be undertaken. The AAP will also be required to state whether any independent assurance beyond the statutory audit will be carried out according to a recognised professional standard.

The UK Government continues to believe that the AAP should set out whether, and if so how, a company intends to seek independent assurance over the Resilience Statement or over reporting on its internal control framework.

It has been confirmed that the AAP will require companies to describe their internal auditing and assurance process, including how management conclusions and judgements are challenged and verified internally. Also, a description of the company’s policy in relation to the tendering of external audit services, including whether a company is prepared to commission non-audit services from its statutory auditor.

Fraud Statements

Following consultation, the UK Government intends to proceed with a new requirement for directors to report on the steps that they have taken to prevent and detect fraud. This requirement will apply to PIEs above the 750:750 size threshold set out above.

They consider that auditors’ existing requirements to identify and report material inconsistencies in directors’ reporting will be sufficient in reporting on directors’ fraud statements.

With respect to the proposal that auditors should report on the steps they have taken to detect fraud and to assess relevant controls, it is intended to wait to see if recent revisions to Auditing Standards have the anticipated effect in clarifying what is expected of auditors before considering any further action.

Dividends and capital maintenance

The UK Government intends to:

- Give ARGAs formal responsibility for issuing guidance on what should be treated as ‘realised’ profits and losses – to help avoid any perception that the accountancy profession is setting its own rules.
- Require qualifying companies or, in the case of a UK group, the parent company only, to disclose their distributable reserves, or a ‘not less than’ figure if determining an exact figure would be impracticable or involve disproportionate effort.

Disclosing an estimate of the dividend-paying capacity of the group as a whole should be encouraged rather than a required element of reporting.

- Require companies to provide a narrative explanation of the board’s long-term approach to the amount and timing of returns to shareholders (including dividends, share buybacks and other capital distributions) and how this distribution policy has been applied in the reporting year.

The UK Government considers that it would be appropriate to apply these new disclosures to PIEs above the 750:750 size thresholds set out above.

Supervision of corporate reporting

The UK Government intends to proceed with most of the proposals for strengthening the regulator’s corporate reporting review powers – and specifically to ensure that ARGAs has powers to direct changes to company reports and accounts, rather than having to seek a court order, along with powers to publish summary findings following a review.

They also intend to ensure that the regulator’s new power to require or commission an expert review will be available to support its corporate reporting review work. In addition, there will be an extension to the the regulator’s powers to cover the entire contents of the annual report and accounts so that it can review areas that are not currently within scope, such as corporate governance statements and directors’ remuneration and audit committee reports as well as voluntary elements such as the CEO’s and chairman’s reports. It does not now intend to give ARGAs new powers to offer a pre-clearance service.

The purpose and scope of audit

The UK Government supports the Brydon Review’s vision for the long-term scope and purpose of audit which goes beyond the scope of the financial statements in order to become more informative for audit users.

They will look to ARGAs to drive improvements in audit as an integral part of its core objectives. They believe this will be more effective and targeted than advancing new legislation in this area.

The UK Government will not seek to establish a new professional body or regulatory oversight of a new ‘corporate auditing’ framework at this stage. Instead, they will create the conditions for the market to develop wider external assurance services, including through the new requirement on large PIEs to publish an AAP (see above) setting out their approach to the assurance of information beyond the financial statements.

They will also seek improvements from existing professional bodies to auditor qualifications, skills, and training to make for a more effective and distinctive audit profession. Progress will be assessed in the planned Post-Implementation Review.

They are not planning any legislative changes regarding the assurance of Alternative Performance Measures (APMs) and Key Performance Indicators (KPIs), and intends to retain the current ‘true and fair’ standard and current audit liability framework.

Competition, choice and resilience in the audit market

To support ARGAs’s objectives, the UK Government has decided to proceed with a package of measures they believe will increase choice and improve resilience in the audit market and to enhance professional scepticism.

First, the UK Government will legislate to require UK-incorporated FTSE 350 companies to appoint a challenger as sole group auditor or, alternatively, appoint a challenger firm to conduct a meaningful proportion (to be defined by ARGAs) of its subsidiary audits within a shared audit. This ‘managed shared audit’ requirement will be introduced on a phased basis. In recognition of the scale and complexity of certain audits, the requirement will be subject to an exemptions regime that ARGAs will operate.

Second, powers will be made available for ARGAs to operate a ‘market share cap’, either in the event of a significant firm collapse or in the event that further intervention is required once managed shared audit has had opportunity to take effect.

Third, legislation will be introduced to give ARGAs powers to require an 'operational separation' of the largest firms: this proposal will require enhanced governance of the audit practice with a view to promoting greater professional scepticism within multidisciplinary firms.

Finally, the UK Government will equip the regulator with powers to monitor the health of audit firms, including sufficient powers to address concerns around an audit firm's resilience.

Supervision of audit quality

To help ensure ARGAs' responsibilities and role in supervising audit quality are clear and can be carried out effectively, the regulator will be enabled to reclaim the approval of statutory auditors of PIEs.

Also, ARGAs will be asked to consult stakeholders to identify ways to increase the usefulness of information published on Audit Quality Review (AQR) findings and enhance the AQR process. The regulator will be encouraged to work with relevant stakeholders on the issue of legal professional privilege and this issue will be reassessed in the planned Post Implementation Review.

Next steps

The UK Government's response does not seek to set out a precise timetable, but rather outlines the actions it intends to take, including what it intends to ask of the regulator and other stakeholders. In particular, it remains the UK Government's intention to develop legislation, when Parliamentary time allows, to create ARGAs and provide for any measures that require changes in primary legislation. The UK Government has announced that it is preparing this legislation for publication in draft.

Primary legislation will set out the objectives, powers and duties of the new regulator and new legal obligations on other parties. Reform in some other areas can and will be taken forward without the need for primary legislation – for example through changes to the UK Corporate Governance Code, through regulations (secondary legislation), in codes of practice and in guidance. There is likely to be additional consultation on details of those regulations and guidance.

Where regulation is needed, the UK Government have said that it will be implemented on timescales that give market participants time to plan and prepare for it, and to boost their capacity and capability where needed.

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