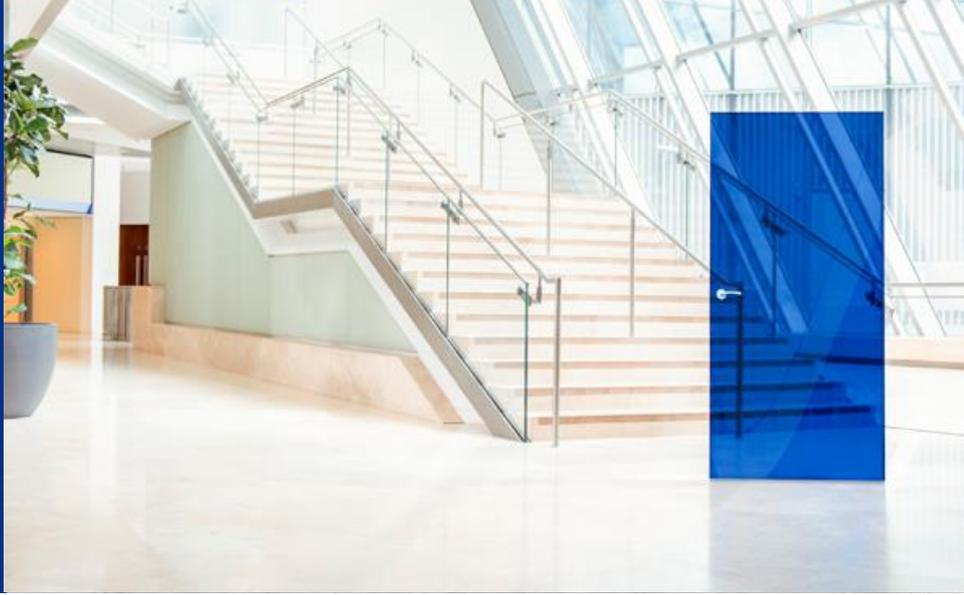




Restoring trust in audit and corporate governance

KPMG Board Leadership Centre



The White Paper [Restoring trust in audit and corporate governance](#) is the Government's response to the three independent reviews by Sir John Kingman, Sir Donald Brydon and the Competition and Markets Authority. It includes measures to enhance the quality of corporate governance, corporate reporting and audit; and establish the strong, effective, independent regulator envisaged by Sir John Kingman. Launching the new reforms, Business Secretary Kwasi Kwarteng said, "by restoring trust in our corporate governance regime and encouraging greater transparency, we will provide investors with clarity and certainty, cement the UK's position as the best place in the world to do business, and protect jobs across the country".

Most of the proposals relating to audit, corporate reporting and corporate governance are focussed on Public Interest Entities (PIEs). The current definition of a PIE covers predominantly publicly listed companies, but the Government are consulting on options for expanding the PIE definition to cover the largest private companies and potentially third sector entities with a public benefit purpose.

The Government recognises that any changes to the PIE definition would need to be introduced at an appropriate pace to provide companies with the time they need to prepare. To achieve this the Government envisages a significant lead-time before introducing a new PIE definition.

Directors' accountability for internal controls

The White Paper sets out three options for strengthening the UK's internal controls framework. They are not mutually exclusive.

[Option A. Require an explicit directors' statement about the effectiveness of the internal control and risk management systems](#)

Essentially this would be strengthening the existing UK framework by requiring the board to explain the outcome of their annual review of the risk management and internal control systems and make a statement as to whether they consider the systems to have operated effectively. Additionally, they would disclose the benchmark system, if any, that has been used to make the assessment; explain how the directors have assured themselves that it is appropriate to make a statement; and if deficiencies have been identified, set out the remedial action taken and over what timeframe.

[Option B. Require auditors to report more about their views on the effectiveness of companies' internal control systems](#)

Under this option, the auditors' report would be required to say more about the work that they already undertake to understand the company's internal control systems and how that work has influenced the approach taken to the audit – but without requiring a formal attestation of their effectiveness.

This option could be reinforced by placing an explicit duty on the board to disclose to the auditor and audit committee any significant internal control deficiencies or weaknesses of which they are aware.

[Option C. Require auditors to express a formal opinion on the directors' assessment of the effectiveness of the internal control systems](#)

This option would require the auditor to undertake additional audit and assurance work to be in a position to express a formal opinion on the directors' assessment - potentially limited to key internal controls over financial reporting, or a sub-set of that. It would have similarities to section 404(b) of the US's Sarbanes-Oxley Act which requires the company's auditor to attest to and report on management's assessment of the internal control structure and procedures for financial accounting.

The Government's initial preferred approach is Option A – a directors' statement about the effectiveness of the internal controls, but (unlike the US's approach which mandates external auditor attestation in most cases) leave the decision on whether the statement should be assured by an external auditor to the directors, audit committee and shareholders.

The Government's initial preferred option for strengthening internal controls

Directors' responsibility statement

Directors should be required to acknowledge their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

Annual review of internal control effectiveness and new disclosures

Directors should be required to:

- carry out an annual review of the effectiveness of the company's internal controls over financial reporting;
- explain – as part of the annual report and accounts - the outcome of the annual review, and make a statement as to whether they consider the systems to have operated effectively;
- disclose the benchmark system that has been used to make the assessment; and
- explain how they have assured themselves that it is appropriate to make the statement.

If deficiencies have been identified, these should be disclosed and the directors should set out the remedial action that is being taken and over what timeframe.

Principles and guidance

In deciding on the approach to be taken to the internal control effectiveness statement, directors should be guided by principles and guidance developed or endorsed by the regulator reflecting audit committee best practice.

External audit and assurance

Decisions about whether the internal control effectiveness statement should be subject to external audit and assurance should usually be a matter for audit committees and shareholders. Decisions should be based on judgements about the strength of companies' systems and controls and whether extra assurance would be proportionate. This should be considered as part of the proposed Audit and Assurance Policy (see later).

Companies should be required to have their internal controls assured by an external auditor in limited circumstances (e.g. where there has been a serious and demonstrable failure of internal controls or where material control weaknesses have persisted over several years).

Enforcement

The regulator should have powers to investigate the accuracy and completeness of the directors' internal control disclosures and, if necessary, order amendments or recommend an external audit of the internal controls.

There should be effective powers to sanction directors where they have failed to establish and maintain an adequate internal control structure and procedures for financial reporting.

Scope

The requirements should be set out in legislation and phased in over a period of time. They should apply initially to premium listed companies who are already familiar with the concept of an annual review (with possible temporary exemptions for newly listed companies where gross revenues remain below a specified threshold) and extended to other PIEs after two years.

Company directors

The Government intends to provide the Audit, Reporting and Governance Authority (ARGA) with the necessary powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities by PIE directors.

The proposed regime will give the regulator new powers to take civil enforcement action against PIE directors in relation to breaches of existing PIE directors' duties relating to corporate reporting and audit (and any new duties which are introduced further to this consultation, for example in relation to internal controls).

Existing statutory duties relating to corporate reporting and company audits include:

- the duty to keep adequate accounting records;
- the duty to approve accounts only if they give a true and fair view;
- the duty to approve and sign the annual accounts;
- the duty to approve the directors' report; and
- the duty to provide a statement as to disclosure to auditors and to provide information or explanations at the request of the auditor.

This new enforcement regime for PIE directors would not replace existing arrangements for taking action against company directors, for example in respect of offences under the Companies Act or breaches of the FCA Listing Rules, FCA Transparency Rules or Market Abuse Regulation.

The Government also proposes to strengthen *malus* and clawback arrangements to provide better reassurance against rewards for failure. Initially this will focus on amending the UK Corporate Governance Code to recommend that certain minimum clawback conditions or 'trigger points' are included in directors' remuneration arrangements and that these have a minimum period of application of at least two years after an award is made.

A Resilience Statement

A new Resilience Statement – addressing business resilience over the short, medium and long-term – is proposed for PIEs.

The short-term section of the Statement would incorporate companies' existing going concern statement, including disclosure of any material uncertainties considered by management during their going concern assessment, which were subsequently determined not to be material after the use of significant judgement and/or the introduction of mitigating action.

The medium-term section of the Statement would incorporate the existing viability statement requirements to provide an assessment of the company's prospects and resilience, and to address matters which may threaten the company's ability to continue in operation and meet its financial liabilities as they fall due. The mandatory assessment period should be five years, rather than the three year period currently chosen by most companies who currently produce viability statements. Furthermore, with a view to better evidencing the scenario planning carried out by companies, the Government initially intends to require companies to include at least two reverse stress testing scenarios in their Resilience Statement.

The Government also proposes to require further specific disclosures in both the short and medium-term sections of the Resilience Statement. These might include:

- threats to liquidity, solvency and business continuity in response to a major disruptive event (such as a pandemic) which disrupts normal trading conditions;
- supply chain resilience and any other areas of significant business dependency;
- digital security risks (both including external cyber security threats, and the risk of major data breaches arising from internal lapses);

- the business investment needs of the company to remain productive and viable;
- the sustainability of the company's dividend and wider distribution policy; and
- climate change risk.

The long-term section of the Statement would set out what the directors consider to be the main long-term challenges to the company and its business model, and how these are being addressed. These might include the impact of long-term changes in demographics, technology and consumer preferences.

The White Paper specifically asks for views on whether the Resilience Statement should specifically address the impact of climate change on the company's business model and financial planning.

Dividends and capital maintenance

The following reforms are proposed in relation to dividends and capital maintenance:

- companies (the parent company in the case of a group) should disclose the total amount of reserves that are distributable or, if this is not possible, the "known" distributable reserve, which must be greater than any proposed dividend;
- in the case of a group, the parent company should provide an estimate of distributable reserves across the group; and
- directors should state that any proposed dividend is within known distributable reserves and that the payment of the dividend will not, in the directors' reasonable expectation, threaten the solvency of the company over the next two years.

Views are also invited on proposals to give ARGA new powers in relation to how companies should calculate their distributable reserves. Currently, guidance in this area rests with the professional accountancy bodies.

Audit and Assurance Policies

For PIEs, a new Audit and Assurance Policy is proposed as a means to better articulate the extent to which the annual report and other disclosures have been scrutinised – whether by the company auditor or someone else. It is proposed that the Audit and Assurance Policy includes, as a minimum:

- an explanation of what independent assurance, if any, the company intends to obtain in the next three years in relation to the annual report and other company disclosures beyond that required by statutory audit. This would include an explanation of what independent assurance the company plans to obtain in relation to: the Resilience Statement and other disclosures related to risk; and the effectiveness of the company's internal controls framework;

- a description of the company’s internal audit and assurance processes. This might include how management conclusions and judgements in the annual report and accounts can be challenged and verified internally, and whether, and if so how, the company is proposing to strengthen its internal audit and assurance capabilities over the next three years;
- a description of what policies the company may have in relation to the tendering of external audit services; and
- an explanation of whether, and if so how, shareholder and employee views have been taken into account in the formulation of the Policy.

It is proposed that risk and viability reporting, and the effectiveness of a company’s internal control framework, should be routinely considered for possible additional assurance as part of the formulation of every new Audit and Assurance Policy, since the consequences of inadequate reporting or processes in these areas could be particularly significant.

Audit committee oversight

The Government proposes to require ARGA to impose additional requirements on audit committees in relation to the appointment and oversight of auditors. Such requirements would cover the need for audit committees to continuously monitor audit quality, and consistently demand challenge and scepticism from auditors. It will be for ARGA to consider how the new requirements it develops will fit alongside the existing obligations which apply to audit committees.

The Government considers that any new requirements should allow for audit committees to exercise discretion and professional judgment and for innovative best practice to develop. The requirements set by the regulator will set minimum standards which audit committees will be free to exceed as they wish.

The Government also proposes to impose a duty on ARGA to monitor compliance with the new audit committee requirements, including through a power to require information and/or reports from audit committees, and a power to place an observer on audit committees if necessary.

Any additional requirements set by the regulator should initially apply in relation to audit committees of FTSE 350 companies. However, the Government will monitor the implementation and effectiveness of the requirements and consider extending to the wider PIE community PIEs in due course.

Engagement with shareholders

The White Paper proposes a number of new measures to encourage more meaningful engagement between a company and its shareholders on matters affecting audit quality.

These include a formal mechanism by which shareholders of a quoted company can propose additional matters for emphasis within the scope of the company’s external audit, and proposals for better communication to shareholders following the resignation or dismissal of the auditor of a PIE.

Audit purpose and scope

The proposals include:

- a new corporate auditing profession to operate independently of the professional accountancy bodies;
- new overarching principles for auditors, to reinforce good audit practice;
- a new duty on auditors to take a wider range of information into account in reaching audit judgements, in particular whether financial statements give a “true and fair view”; and
- new obligations on both auditors and directors relating to the detection and prevention of material fraud.

Fraud

It is proposed that directors of PIEs be required to report on the steps they have taken to prevent and detect material fraud. The Government believes this will reinforce directors’ primary responsibility for fraud prevention and detection and may, in some cases, enhance the focus on the risks relating to fraudulent financial reporting. It will discuss with the FRC and other interested parties the need for supporting guidance.

The Government also intends to require auditors of PIEs, as part of their statutory audit, to report on the work they performed to conclude whether the proposed directors’ statement regarding actions taken to prevent and detect material fraud is factually accurate.

It is also proposed that auditors be required to report on the steps they took to detect any material fraud and assess the effectiveness of relevant controls while carrying out their audit.

Choice and resilience in the audit market

The Government plans to increase choice, competition and resilience of the statutory audit market through:

- the introduction of a managed shared audit regime (not joint audits) for FTSE350 companies and, if needed, taking a reserve power for a managed market share cap;
- requiring operational separation between the audit and non-audit arms of certain firms, as determined by ARGA. This will include separate governance, financial statements prepared on an arm’s length basis, and regulatory oversight of audit partner remuneration and audit practice governance; and

- statutory powers for the regulator to proactively monitor the resilience of the audit market and audit firms, including powers to require audit firms to address any viability concerns that are identified.

A strengthened regulator

In fulfilling its objective to protect and promote the interests of investors, other users of corporate reporting, and the wider public interest, it is proposed that ARGA, the new regulator, will have a more pro-active role in identifying and assessing serious issues relating to a company's corporate reporting or audit.

This will be facilitated by strengthening the regulator's information gathering and investigatory powers – including the power to require an expert review, paid for by the company, to investigate issues in greater depth and explore the underlying causes.

The White Paper also includes proposals for strengthening the regulator's powers relating to its corporate reporting review work. The key measures proposed are:

- powers to direct changes to company reports and accounts, rather than having to seek a court order which is the position at the moment;

- increased transparency for the existing Corporate Reporting Review (CRR) process, by enabling ARGA to publish summary findings following a review and, if necessary, full correspondence; and
- the extension of the CRR process to the whole of the annual report and accounts. This will bring in scope areas that are currently outside its remit such as corporate governance statements and directors' remuneration and audit committee reports, as well as voluntary elements such as the CEO and chairman's reports.

Critically, the White Paper also includes proposals to improve the transparency of the regulator's Audit Quality Review (AQR) reports by publishing Audit Inspection Reports on individual company audits without the consent of the audit firm or the company. Safeguards are proposed in respect of sensitive information.

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In light of the current challenges to the UK economy, the consultation period will run for 16 weeks until 8 July. Subject to the outcomes of the consultation, the Government will bring forward primary legislation to take forward the proposed reforms when parliamentary time allows.

The KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

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