National Audit Office

FRAB Briefing: BEIS consultation on Restoring Trust in Audit and Corporate Governance

James Osborne, National Audit Office

June 2021

Introduction

- BEIS published its consultation paper *Restoring trust in audit and corporate governance in March*:
- The consultation sets out a package of measures aimed at improving the UK's audit, corporate reporting and corporate governance systems.
- It includes proposals to respond to the earlier reviews
  - the Independent Review of the Financial Reporting Council (the "Kingman Report");
  - the Competition and Markets Authority's market study on the audit of FTSE 350 companies; and
  - Sir Donald Brydon's Independent Review of the Quality and Effectiveness of Audit.
- The Government has asked for responses by 8th July

Background

- The consultation document points to the reasons why reform is needed:

  "The UK is consistently placed as one of the leading destinations for foreign investment in Europe and around the world, thanks to the strength of its workforce, innovation, and approach to better regulation. This includes the UK's internationally-respected system of audit and corporate reporting, which is mirrored by many countries around the globe. The Government is determined to improve the UK's standing still further…..and will ensure that the UK's audit and corporate reporting framework does all it should to safeguard the interests of investors and others".

- The case for reform is based on the premise that stakeholder and wider public trust in the credibility of directors' reporting and the statutory audit has been shaken by major corporate collapses which have caused serious economic and social damage (e.g. insolvencies of BHS in 2016 and of Carillion in 2018).
- Alongside this, the FRC has concluded that up to a third of audits carried out by the seven largest audit firms to be in need of improvement or significant improvement. There are also concerns about a lack of competition and resilience in the audit market, and a failure of the audit product to meet the growing expectations of its users.

Focus of consultation

- The consultation is wide ranging, covering 4 broad areas:
  - Directors
  - Audit, auditors and audit firms
  - Shareholders
  - The audit regulator
- Note, the consultation focuses on the arrangements in place for large companies (both listed and private) and, in the main, does not make proposals for reporting or audit of public sector bodies. Possible implications for public sector audit and reporting are considered later in this paper.
- **Slides 5 to 8** are extracts taken from the Consultation Paper's Executive Summary. **Slides 9** onwards are the NAO's initial assessment of areas that will warrant consideration once the consultation has concluded – the aim of presenting these now is to support a wider discussion.

Directors

- Directors are responsible for running their companies and are responsible for a company's accounts and reports. The **current framework is inadequate in holding directors to account** where they neglect their reporting responsibilities. There are also **weaknesses in reporting and accountability in three key areas of management relating to internal controls over financial reporting, dividend and capital maintenance decisions**, and the steps that directors are taking to consider and strengthen a company's future resilience.

- The Government proposes **reporting and attestation requirements of directors covering internal controls, dividend and capital maintenance decisions, and resilience planning** to heighten directors' accountability in these key management areas.

- Proposals also seek to give the regulator **investigation and civil enforcement powers** to hold to account directors of large businesses which are of public importance for breaches of their duties in relation to corporate reporting and audit.

Audit, auditor and audit firms

- Audit, done well, should be an ally of good business behaviour and a spur to directors to meet their legal obligations to shareholders, creditors and other stakeholders, which ultimately serves the public interest.
- However, recent experiences have questioned **whether the statutory audit is performing the public interest function expected of it**. The audit product has not changed significantly for decades. Auditors check for directors' compliance with legal duties and accounting standards and provide an opinion that the accounts are free from material misstatement. Although important, **it does not address the increasing expectations of the users of company reporting that the audit report should be more forward looking and informative**.
- The UK audit market has failed to deliver increased competition, and by extension increased resilience, in the supply of audit services - 97% of FTSE 350 audits are undertaken by four audit firms. This concentration is not helped by the fact that those firms also compete to provide a wide range of other business services to the largest companies.
- The Government proposes to create **a stand-alone audit profession** with a reach across all forms of corporate reporting, not just the financial statements. The Government is also proposing new regulatory measures to increase competition and reduce the potential for conflicts of interest, by providing new opportunities for challenger audit firms and new requirements for audit firms to separate their audit and non-audit practices.

Shareholders

- Shareholders, as the owners of companies, have a vital role to play in the corporate governance framework. They vote on director appointments, approve dividends, approve the appointment of auditors and vote on directors' remuneration and other matters. Institutional investors have a stewardship role, seeking to create long term value for their clients through oversight of the companies in which they are invested. Shareholders are the primary users of company reporting and audit and should have a strong interest in its quality, accuracy and reliability because it provides a basis for informed investment decisions and the efficient allocation of investment capital across the economy.
- There are concerns, however, that asset managers and asset owners **do not sufficiently prioritise audit as a stewardship issue of importance**. Institutional shareholders have also been criticised for poor stewardship in the period before the collapse of some companies.
- The Government proposes to improve stewardship by giving investors better opportunities to engage with companies, particularly on audit matters. These include a proposal for **companies to be required to set out their approach to audit through publication of an audit and assurance policy** on which there would be an advisory shareholder vote. Shareholders would also have a formal opportunity to propose to the audit committee areas of emphasis to be considered within the auditor's annual audit plan.

The audit regulator

- The Kingman Review identified **significant weaknesses in the FRC’s effectiveness in overseeing and holding directors, auditors and investors to account for their respective roles** within the regulatory and corporate governance framework. The Review noted the absence of a meaningful statutory base for the regulator’s work, the absence of clear statutory objectives, and inadequacies in its enforcement powers in key areas of audit supervision, reporting and directors’ accountability. It noted weaknesses in the regulator’s ability to foster competition in the audit market. It also pointed out limitations in the FRC’s capacity to be forward-looking and in its ability to act on intelligence and identify potential corporate problems at an earlier stage before they become irreversible.
- The Government proposes legislation to **establish the FRC’s successor body, the Audit, Reporting and Governance Authority** (ARGA) which will have statutory objectives and functions along with a new statutory levy to replace the existing voluntary levy. ARGA will have new powers to strengthen its corporate reporting review function, its oversight of audit committees and to enforce the corporate reporting duties of directors. Also, the regulator will have responsibility for deciding which individuals and firms should be approved to audit PIEs.

Public sector considerations

- As noted earlier, the consultation focuses primarily on the arrangements for large companies. Nonetheless, there are various considerations for public sector reporting and audit, not least as the public sector typically looks to apply the same standards as corporate entities.
- The following is an initial assessment of some of the areas that will warrant consideration and discussion with relevant stakeholders (such as HM Treasury, FRAB, and Parliament) once the consultation has concluded:
  - Public sector equivalence of strengthened requirements on Directors;
  - Audit and Assurance policies for public sector entities
  - Expansion of the definition of Public Interest Entities
  - Audit scope and reporting
- The consultation makes specific proposals in relation to regulatory oversight of the Comptroller and Auditor General addressing the FRC's current statutory oversight over the NAO's Companies Act audit portfolio.

Director requirements

- Proposals around attestations on internal controls and resilience planning could be extended to public sector entities, alongside additional assurance requirements.
- It will be for the relevant authorities to determine the scope of any extension to existing requirements and where they would apply, considering the benefit and cost.
- Public sector auditors have varying powers to publicly report on matters that come to light through their work which they currently exercise at their discretion.

Audit and assurance policies

- The consultation proposes introducing a requirement for companies to set out their approach to audit through publishing an audit and assurance policy.
- The consultation envisages a significant role for Audit Committees in setting the policy and for shareholders in influencing the policy through an advisory shareholder vote.
- The policy would go beyond consideration of financial statements audit to cover wider assurance over corporate reporting.
- These proposals have been generally well received in the corporate sector in discussion forums.
- Whilst Audit Committees are well established for public sector entities, consideration would be needed in relation to:
  - Authority to set audit and assurance policy;
  - Equivalence of shareholder role, e.g. Parliamentary Select Committee; and
  - Ability to direct work of auditors, e.g. Auditors General.

Public Interest Entities

- The consultation proposes to expand the definition of Public Interest Entities (PIEs).
- Audits of PIEs are subject to additional reporting requirements, more stringent ethical requirements including limitations around provision of non-audit services, enhanced quality arrangements such as appointment of Engagement Quality Control Reviewer, and are subject to FRC/AQR regulation.
- At present, the definition of PIE captures a limited number of companies within the public sector. There is no equivalent definition for public sector entities which are not companies.
- The consultation invites comment on the scope of definition for PIEs, specifically for large third sector entities.
- The expansion of the PIE definition will increase the number of public sector entities captured, strengthening the case for a distinct definition for public sector entities.

Audit scope and reporting

- The consultation proposes strengthening requirements on auditors to consider wider information, including director conduct, in forming their opinion.
- Similar requirements already exist, as set through Practice Note 10, for auditors to consider regularity and propriety when forming their opinion.
- Public sector auditors already have varying powers to publicly report on matters that come to light through their work which they currently exercise at their discretion.

Independent supervision of Auditors General

- The Government proposes to transfer responsibility for overseeing the quality of Companies Act audits performed by the auditors general from the Secretary of State to Parliament.
- These proposals have been drafted with specific reference to the existing arrangements in place for the C&AG/NAO given the FRC's current statutory remit over the NAO's Companies Act audit portfolio.
- The proposals are designed to respect the C&AG's statutory independence from the bodies he audits and aligns his accountability to Parliament, rather than to a Secretary of State through a government appointed regulator.
- Under the proposals, the Public Accounts Commission would take on the responsibility for the oversight of the quality of the C&AG's/NAO's financial audit work.
- The consultation paper is silent on the impact on the other auditors general but this may lead to further discussions with the other national auditors.