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UK SOX – practical implications of BEIS' proposals

27 September 2022

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2022 Seminar Programme schedule

UK SOX – practical implications of BEIS' proposals James Roe – Partner, Corporate Tom Balogh – Executive Director, A&O Consulting	**Tuesday 27 September** 12.30-1.30pm
Seize the day: Tailoring financial services regulation to bolster markets in the UK Bob Penn – Partner, Financial Services Regulatory James Roe – Partner, Corporate Amanda Thomas – Partner, International Capital Markets Emma Danforth – Partner, Banking	**Thursday 29 September** 9.00-10.00am
Recent developments in banking and finance law Richard Hooley – Consultant, Banking	**Friday 07 October** 12.30-1.30pm
FCA & PRA Enforcement themes and trends Calum Burnett – Partner, Litigation & Investigations Sarah Hitchins – Partner, Litigation & Investigations Arnondo Chakrabarti – Partner, Litigation & Investigations Marc Teasdale – Managing Director, A&O Consulting Oliver Palmer – Associate, Litigation & Investigations	**Wednesday 12 October** 9.00-10.00am
The Financial Services and Markets Bill: What happens next? Bob Penn – Partner, Financial Services Regulatory Kirsty Taylor – PSL Counsel, Financial Services Regulatory	**Thursday 13 October** 9.00-10.00am

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Contents

Summary

UK SOX – practical implications of BEIS' proposals

The Treasury has now published its intentions with respect to strengthening audit and corporate governance. This includes its decision with respect to mandating more stringent internal control requirements (previously talked about as UK SOX). The Treasury does not intend to legislate for any such requirements. However, it has invited the FRC to consult on strengthening the UK Corporate Governance Code to require an explicit statement from directors on the effectiveness of internal control systems (financial, operational and compliance). In addition, PIEs with >750 employees or >£750m turnover will, as part of their proposed audit and assurance policies, have to state if they intend to seek external assurance on the reporting on internal controls.

We believe premium listed companies will be expected to report annually on the effectiveness of their internal controls. Other listed and large companies will be encouraged to do so. This raises a number of interesting questions, in particular regarding the framework and extent of the review required, how it sits alongside developments in sustainability, and how it is compatible with the Government's broader policy objective of making the UK more competitive. It raises practical considerations regarding what companies should be doing now, what they may be required to do in the future, and directors duties and potential liabilities. The proposed new regulator, ARGA, will have toolkit of investigative and enforcement options that directors will also need to be aware of.

This seminar follows from an earlier seminar on the same subject. We will provide an updated view, extend our discussion into non-financial procedures and controls (including sustainability), and take a closer look at director responsibilities and liabilities.

Biographies

James Roe
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James is a corporate lawyer and equity capital markets (ECM) specialist. His experience includes advising companies, investors, underwriters and governments on the full range of equity capital markets and listed company transactions in the UK and on overseas exchanges, including initial public offerings, secondary offerings, demergers, acquisitions and disposals, and other significant transactions. He is also a governance and sustainability specialist, with a focus on corporate disclosure, reporting and risk management. He is recognised as a leading lawyer by Chambers, Legal 500 and IFLR1000.

Tom Balogh
Executive Director – London
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Tom Balogh is an Executive Director in Allen & Overy's strategic and regulatory consulting business. He is experienced in working with the largest global financial institutions and start-up technology and financial firms and has deep experience in both UK and US regulation. Tom has worked with both large and small corporate and financial institutions, including projects relating to non-financial risk management and control frameworks. Prior to joining A&O, Tom was a Director in EY's risk advisory business, where he worked for eight years in both London and New York.

UK SOX – practical implications of BEIS' proposals

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Restoring trust in audit and corporate governance

September 2022

Notes

2

Agenda

What we will cover today:

- High level overview of the updated proposals.

And, at the same time, we will seek to address the following questions:

- What are the potential impacts for companies from having a new regulator, ARGA?
- What do we now know about the internal control requirement? Is it consistent with other regulatory reforms ? Does it potentially negatively impact the UK's competitiveness?
- How much information should be subject to external audit/assurance?
- What is the impact of the proposed reforms on directors' accountability and liability? Do they face increased risk ?

 1

Notes

3

Background to reforms

A number of factors contributed to the Government's desire to strengthen the UK's audit and corporate governance framework

2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022

Failures

– Trust in directors' reporting and audit impacted by high-profile failures, including:
  - BHS insolvency in 2016
  - Carillion in 2018

Independent Reviews

– Independent reviews launched to address these concerns in 2018, including:
- Sir John Kingman's *Independent Review of the FRC*
- CMA's *Statutory Audit Services Market Study*
- Sir Donald Brydon's *Independent Review of the Quality and Effectiveness of Audit*

Government Proposal

– BEIS consultation paper *Restoring trust in audit and corporate governance*, published March 2021

– Proposals address findings of each review

Government's Response

– BEIS received over 600 responses to the white paper and has stated it will proceed with the following reforms:
- Establishing a new regulator, Audit, Reporting and Governance Authority (ARGA)
- Recognising the public interest in large private companies
- Making large companies' reporting more useful

 2

Notes

4

Government response to the consultation

The Department for Business, Energy and Industrial Strategy (BEIS) published its response to reform corporate governance and audit in the UK on 31 May 2022.

Key Points

New Regulatory Framework

ARGA will be the new regulator, with investigative and enforcement powers, and will be accountable to Parliament and other stakeholders.

The new regulatory perimeter will extend to Public Interest Entities (PIEs) with 750+ employees and £750m of turnover (the 750:750 test).

Scale of reforms

A number of measures have been rolled back from the original positions set out in the White Paper.

- A number of the corporate reporting reforms will be implemented
- But, the nature and quality of audit will be allowed to develop over time
- Operational separation, managed shared audits, and enhanced oversight of auditors and accountants

Interaction with other regulatory reforms

The response explicitly states intention to complement the reforms prompted by Lord Hill's review.

Accountability

The Response seeks to make directors more accountable; ARGA will have powers to impose civil sanctions on directors.

Investors, through disclosures and interaction, will also have greater opportunity to assess and hold directors to account.

Timing of reforms

There is no precise timeline for the reforms, as the paper only outlines the actions to be taken.

Legislation is expected to be introduced in the 2023/24 session, at the earliest with ARGA's new powers coming into force by 2024.

Notes

5

Areas of Reform

The reforms cover an array of areas for reform:

Corporate Governance

- **Internal controls** – UK Corporate Governance Code provisions
- **Fraud** – actions taken to prevent and detect fraud
- **Director accountability –** civil liability for breach of statutory obligations
- **Audit and Assurance Policy** – will impact internal auditing and assurance processes and external audit tendering policy

Reporting

- **Resilience Statement** – reporting on matters constituting a material challenge to resilience
- **Audit and Assurance Policy** – external assurance of reporting on internal controls
- **Dividends and capital maintenance** – disclosure of distributable reserves
- Supervision of **corporate reporting**

Audit / assurance

- Supervision of **audit quality**
- **Audit Committee** oversight
- **Market opening measures** – managed shared audit and market share cap
- **Accountancy profession** – new statutory regime for the oversight of accountancy

 4

Notes

6

The new regulator and its powers

ARGA will be established as the new statutory regulator, replacing the FRC. It will be funded by a mandatory levy on the industry. Legislation is needed but it is expected that all ARGA's powers will be in force by 2024.

Objectives

ARGA's overarching objective will be to protect and promote the interests of investors, other users of corporate reporting and wider public interest.

ARGA will have three operational objectives:

- Promoting high quality audit and reporting
- Promoting effective competition
- Acting as an effective 'system leader' for local public audit

ARGA will also retain the FRC's statutory duty to promote economic growth. The Government has not yet set out the details of ARGA's governance structure and whether it may be similar to the FSMA model, as governs the PRA and FCA.

Powers

ARGA will have new powers to supervise and sanction breaches of corporate reporting and audit-related responsibilities by PIEs and directors. Some of these powers include:

- **Civil enforcement regime** in relation to directors' statutory duties on audit and corporate reporting (although no powers to prosecute offences).
- Wider remit to **scrutinise the entire contents** of annual reports and accounts, including corporate governance reporting and voluntary elements.
- Directing companies to **amend their reporting or accounts** where necessary (replacing the FRC's existing ability to seek a court order).
- Requiring or commissioning an **expert review**, extending to the regulator's corporate reporting review work.
- **Publishing the information** necessary for it to be an effective regulator, such as summary findings following a review.

 5

Notes

7

The enlarged regulatory perimeter

As part of the new regulatory framework, the regulatory perimeter is expanding to capture a wider array of companies.

Public Interest Entities (PIEs)

The consultation considered how to broaden the definition of PIEs to include companies which are economically significant, or significant to society. To address this, the definition of PIEs has been expanded to include the **750:750 test**:

Entities whose transferable securities are admitted to trading on a regulated market

Large private companies with both 750 employees and an annual turnover of £750m

- Companies traded on the Alternative Investment Market (AIM) or other multilateral trading facilities and Limited Liability Partnerships (LLPs) will be PIEs if they meet the 750:750 test
- Lloyds syndicates and local authorities are exempt
- The Government will not require these size-based PIEs to meet all of the same audit requirements as existing PIEs

The expansion of the definition of PIEs, and so the regulatory perimeter in relation to audit and corporate governance, is indicative of a wider trend of increasing regulations and requirements applicable to non-listed companies.

Other areas of recent change include:

Corporate governance

Sustainability reporting

Notes

8

Changes for Audit firms

A number of changes will impact Audit firms. The design is to increase audit quality and was trailed in earlier reports. However, there is likely to be an increased cost of audit as a result.

Market Opening

- **"Managed Shared Audit"**: FTSE 350 firms will need to either appoint a challenger firm as auditor or to conduct a 'meaningful proportion' of subsidiary audits
- **"Market Share Cap"**: ARGA will have powers to include a market share cap if necessary but this will not be implemented yet
- ARGA will have a strong role in defining *meaningful proportion* is, and (with Government) to develop an *exemptions framework*

Operational Separation

- Legislation to give ARGA powers to require *Operational Separation.* There will be increased transparency over audit pay but proposals do **not** include separate profit pools for multi-disciplinary firms
- This is intended to give ARGA more ability to influence audit quality through partner pay

Supervision of Audit Quality

- ARGA will have powers to publish "information necessary for it to be an effective regulator" although no specific power or requirement to publish individual Audit Quality Reports ("AQR"). This could allow them to publish information if they deem it necessary after consultation
- The consultation also showed that there are criticisms of the AQR process which has led to the Government asking ARGA to engage with investors to improve the usefulness of the information it publishes

Notes

9

New reporting requirements

The reforms include a number of key changes to disclosure and reporting requirements, both legislative and Code-based.

Internal Controls

- Under proposed amendments to the UK Corporate Governance Code, boards must provide for an explicit statement about their view of the effectiveness of the internal controls systems and the basis for that assessment
- Under the Audit and Assurance Policy (AAP), PIEs must state whether they plan to seek external assurance of the company's reporting on internal controls

Resilience Statement

- Companies must report on matters that they consider a material challenge to resilience over the short and medium term, as well as an explanation of how they have arrived at this judgement
- The resilience statement requires companies to: annually identify a combination of adverse circumstances which would cause its business plan to become unviable; assess the likelihood of such a combination of circumstances occurring; and summarise the results and any mitigating actions

Audit and Assurance Policy

- In the AAP, companies must describe their internal auditing and assurance processes and publish the policy every three years
- The AAP must set out whether a company intends to seek independent assurance over any part of the Resilience Statement or reporting on its internal control framework

Dividends and capital maintenance

- Companies must disclose their distributable reserves, or a "not less than" figure if determining an exact figure would be impractical or involve disproportionate effort
- Companies must provide a narrative explaining the board's long-term approach to the amount and timing of returns to shareholders and how this distribution policy has been applied in the reporting year

 8

Notes

10

Internal Controls Systems Statement

Although the legislative "UK SOX" approach has not been taken forward, directors will have to provide an explicit statement about the effectiveness of internal controls systems. It is not yet clear what the final impact will be.

Code-based approach

- This requirement will be part of the UK Corporate Governance Code. As such, it will be enforced on a 'comply or explain' basis
- This requirement will directly impact premium-listed companies, as well as the broader range of companies which apply the Code
- It will also impact other firms through influencing governance expectations and best practice

Scope

- The effectiveness statement will cover financial, operational and compliance systems, and the entire board will be responsible for the statement
- The Government will not mandate external assurance, but the Audit and Assurance Policy ("AAP") explains Board's consideration of external assurance of the internal controls statement
- The framework(s) used and the basis upon which the statement is to be prepared are subject to consultation and subsequent guidance

Next steps

- Companies, particularly audit committees and Chairs, and bodies representing them are encouraged to remain involved in the FRC's consultation process
- Companies should continue to ensure their controls are fit for purpose, considering past internal audit reviews and whether upcoming reviews should include risk analysis of which controls require strengthening

Notes

11

Resilience Statement

The reforms introduce the resilience statement, a statutory disclosure to assess the resilience of the company to material risks, over the short and medium term. This will replace the going concern and viability disclosures in the Governance Code.

The statement will require companies to report on matters they consider a material challenge to resilience over the short and medium term. Companies will be required to have regard to certain specified matters (similar to the s172 statement).

Original proposal	New statutory requirements
The Resilience Statement should incorporate and build on the existing going concern and viability statements.	The statement will strengthen and replace the relevant provisions in the Corporate Governance Code, namely Provisions 28 (emerging and principal risks), 30 (going concern) and 31 (viability).
The short- and/or medium-term sections should provide disclosures on how a company is addressing certain risks or resilience issues, including threats to business continuity, supply chain resilience and cyber security.	The statement should include a high-level explanation of the company's approach to maintaining and enhancing resilience, in the context of its strategy, business model and the environment in which it operates. Companies should have regard to certain specified matters, but are not required to report on specific risks.
The short-term section should include material uncertainties to a company being a going concern even if these were rendered immaterial following mitigating action or the use of significant judgement.	Companies within scope should identify any material uncertainties to going concern that existed prior to the taking of mitigating action or the use of significant judgement, which the directors consider are necessary for shareholders and other users of the statement to understand the current position and prospects of the business.
The medium-term section should include two reverse stress tests and should cover a five-year forward look.	The statement must include one reverse stress test, i.e. a set of circumstances which would cause business to become unviable, assess likelihood of set of circumstances arising, and identify mitigating actions.

Notes

12

Directors' accountability – existing rules

- Directors have a number of statutory duties, including:
  - To approve accounts only if they give a true and fair view
  - To approve / sign / prepare annual accounts, directors report and strategic report
- The company has a number of duties under the listing and disclosure rules, including:
  - Take reasonable steps to establish and maintain adequate procedures, systems and controls
  - Periodically publish accounts and other financial information
- Board also has a number of obligations under the Corporate Governance Code, including:
  - Procedures for managing risk and overseeing internal controls
  - Monitoring risk management and internal control systems and, at least annually, carrying out an effectiveness review

Notes

13

Directors' accountability – existing rules

- Enforcement:
  - The directors owe CA 2006 duties to the company and its shareholders, who can enforce the director duties through the courts
  - While the FRC does not have powers to take criminal action, referrals can be made to relevant prosecution agencies
  - The FCA can enforce breaches of the Listing Rules and UK MAR
  - The Insolvency Service has powers to disqualify directors
- Enforcement involves significant resources and in some areas, cases are few and far between

 12

Notes

14

Directors' accountability – proposed reforms

- Introduce a number of new corporate reporting obligations
- Introduce a civil enforcement regime for the existing and new statutory corporate reporting obligations
- ARGA will be given the power to enforce breaches by directors of their statutory duties in relation to audit and corporate reporting
- The reporting obligations will be reinforced by behavioural requirements – when reporting / signing off, directors will be expected to adhere to certain standards of behaviour
- Guidance / clarification on how compliance can be demonstrated and how directors are to conduct themselves is expected

 13

Notes

15

Directors' accountability

When considering the implications of the new regulatory framework, there are some key outstanding points to note.

A new, funded regulator tasked with holding companies to account

- How it perceives its purpose / objectives and how it pursues them is of great importance

The new requirements need to be compatible with the move towards digitalisation – i.e. focus on data, not documents.

Companies will need to ensure their D&O insurance policies adequately cover their directors in light of the new rules.

ARGA will have enhanced powers to monitor and investigate compliance with the rules, and a suite of potential sanctions for non-compliance:

- What does that mean for companies internal annual reporting assurance procedures?
- How can directors protect themselves?

Not yet clear how the enhanced corporate reporting regime will dovetail with the prospectus and listing regimes

- The standards applied to prospectus disclosure, periodic reporting and ad hoc reporting need to be consistent as far as possible
- Prospectus and annual reporting styles are very different

The interaction between ARGA and the FCA is important, and to be worked out

 14

Notes

16

Audit Committee oversight

To support its objectives to promote high-quality audit and effective competition, ARGA will have powers to oversee the audit process in FTSE 350s. ARGA will monitor and Government may extend to PIEs.

ARGA's powers to oversee Audit Committees

These powers will include:

- The power to set minimum requirements on audit committees in relation to appointment and oversight of auditors.
- Powers to put in place provisions to encourage shareholder engagement with audits, including the ability to consider and respond to the audit plan and risk report.
- Powers to monitor and enforce standards, including powers to obtain information and reports and carry out a review (similar to S166 FSMA).

Powers not given to ARGA:

- The power to place an independent observer on the Audit Committee.
- Powers to appoint an independent auditor in specific circumstances, such as when quality issues had been identified around a company's audit.

ARGA will draft minimum standards and guidance to avoid conflict with current requirements for Audit Committees from other regulators. These will be subject to consultation.

 15

Notes

17

What can be done now?

Notes

18

Future consultations

Following this consultation, the Government intends to commission further consultations on specific aspects of the reforms.

1. Internal control provisions and **effectiveness of internal controls** systems in the UKCGC (FRC).
2. Guidance on what should be treated as **'realised' profits and losses** (ARGA).
3. Increasing transparency around **malus and bonus clawbacks** in the UKCGC (FRC).
4. Improvement of information in auditors' reports on **financial reporting** (FRC).
5. Removing **Going Concern and Viability Reporting** provisions from UKCGC (FRC).
6. Transparency and accountability in **supplier payment reporting** (Government).

17

Notes

19

Practical steps to take

What could you do now

Risk and Control Matrix:

- Ensure the matrix defines each risk and corresponding control
- Ensure risk ownership is clearly allocated
- Assess the effectiveness of fraud risk management and controls

Annual Report and Accounts:

- Review processes and controls to ensure reports and accounts are "true and fair"
- Review robustness of non-financial disclosure controls

Policies and Procedures:

- Review distribution policy against requirements for dividends and distributable reserves
- Identify existing policies and processes which prevent and detect material fraud
- Review effectiveness of internal auditing and assurance policy

Resilience Statement:

- Identify and document previous and short/medium term areas of material challenge to resilience
- Review policies and procedures for reverse stress testing and run practice tests

 18

Notes

20

Final thoughts

1. Given the lack of legislative approach, the unknowns around ARGA's appetite for a hard regime and consultation outcomes, continue to create an uncertain horizon.

2. It looks like there will be increased focus on effectiveness of internal controls – the market could still drive towards a "SOX" style outcome even if this does not look like current Government intent.

3. It is likely that the outcomes will include additional cost on firms and responsibility for Directors.

 19

Notes

21

Questions?

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