SCL SOCIETY OF CONSERVATIVE LAWYERS

RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

A commentary on The Department of Business, Energy & Industry's White Paper

Simon Randall CBE

About the author

Simon Randall CBE is a longstanding member of the Society. He is a solicitor specialising in local government, charities and housing associations including corporate governance. He is a former Reviewer of Complaints to the Institute of Chartered Accountants of England and Wales (ICAEW). Recent papers by Simon "Transforming Public Procurement" with Harry Gillow, and "New opportunities = new homes?" can be found on SCL website at www:conservativelawyers.com

Acknowledgements

The views expressed in this paper are those of the author alone, who takes sole responsibility for all errors and omissions.

The author would like to thank Lord Sandhurst QC, Chair of the Society's Research Committee and Mark Dunkley, the Society's Treasurer, for their helpful comments on the text.

London, September 2021

INTRODUCTION

Two articles in recent issues of the *Financial Times* encapsulate the serious problems which the Government are attempting to address in their White Paper[1]. The first on 19 March 2021 appeared in the leader column:

> "Trust in company accounts is the keystone of the whole edifice of business and finance. If numbers cannot be relied upon, the faith of investors, employees and the public is undermined. Confidence in UK plc has been shaken by several high-profile failures in recent years, and the response has been slow. This has left Britain facing a balancing act: introducing an equivalent to the US Sarbanes-Oxley regime without piling unfair costs and burdens on to the companies struggling to recover from the pandemic."

The second article on 26 May 2021 was an interview with the chief executive of the Financial Reporting Council ("FRC"), the body currently responsible for supervision of auditors, who disconcertingly admitted that [the FRC] was not up to the job during a series of business scandals and highlighted the need for greater effort in detecting fraud.

These scandals have already damaged the UK's standing in the corporate world with both UK and overseas corporate entities being subject to poor quality audits. These cases have become household names and include Patisserie Valerie, Carillion, Autonomy, Silentnight and Ted Baker in the UK together with recent reports that the FRC is embarking on a probe of the 2019 Greensill Capital and Wyelands Bank audits and Wirecard in Germany. Perhaps more significantly the FRC's review of audits of FTSE 350 companies for the year 2019/2020 considered that one third of the audits needed improvement.

The White Paper runs to 230 pages with 98 individual questions and incorporates the Government's response to three independent reviews dealing with the FRC, the statutory audit services market and the quality and effectiveness of audit. The Government also published an update to a separate report on local authority financial reporting and external audit which is also referred to in the White Paper.

This commentary outlines views on many of aspects in the White Paper and outlines suggestions to improve both audit and corporate governance generally.

THE GOVERNMENT APPROACH TO REFORM

The author broadly supports the approach, although regrets that due to the need for complex primary and secondary legislation it will take possibly three or four years before full introduction and implementation. The Government must show a higher degree of urgency if our corporate sector (particularly financial services) is successfully to compete in the post-Brexit world.

There should be quicker action to expand PIE designation (particularly to large charities and housing associations), creation of the proposed new regulator and introducing changes to Section 172 of the Companies Act 2006.

Public Interest Entities ("PIEs")

PIEs are subject to more stringent audit and general requirements and oversight as it is considered they are important to the economic stability of the UK. They are currently defined in accordance with Directive 2006/43/EC of the European Parliament[2] as:

- Entities whose transferable securities are admitted to trading on a regulated market;
- Credit institutions;
- Insurance undertakings.

1.Restoring trust in audit and corporate governance – GOV.UK (www.gov.uk), 18 March 2021

2. Notwithstanding Brexit, this remains the relevant definition until any changes.

The Government's aim in expanding the PIE definition is broadly to ensure that:

- There is a clear articulation of the public interest to provide increased investor protection;
- The impact is proportionate with there being benefit in new entities having extra regulation;
- The definition is aligned with existing thresholds.

The Government proposes to extend the UK's PIE definition to include large companies within limits regardless of whether or not they are admitted to trading on a regulated market. It suggests that the limit could involve entities with more than 2,000 employees or a £200 million turnover and £2 billion assets, and AIM companies with over £200 million market capitalisation, or suggests an alternative for entities with over 500 employees and a £500 million turnover, and AIM companies, as above. The White Paper acknowledges that many large private companies would fall within these limits.

Large private companies (including limited liability partnerships and private equity groups) should be included as PIEs as they are likely to have fewer shareholders and a smaller board of directors and thus less likely to have independent financial supervision and so place more reliance and responsibility on their auditor. Arguably the thresholds should be lower than recommended and be used for AIM companies and third sector entities included as PIEs.

THIRD SECTOR ENTITIES

The White Paper invited comments on whether third sector entities, such as housing associations and charities, should be registered as PIEs. The author suggests the following should be included as PIEs, the largest of which have significant income and assets.

1. Housing Associations – attached at Appendix A is a schedule with brief financial details of the nine largest associations based upon their 2019/2020 accounts as appearing in Social Housing Magazine February 2021. They have a key role in the provision of housing in England and Wales concentrating on social rented housing (with Government-supported social housing grant), shared ownership, open market sales and renting. All these associations are charitable or have key charitable entities within their group structures. As the figures indicate, if the four largest entities were able to be floated on the London Stock Exchange they would appear in the top 10 quoted property companies with income which exceeded all the principal quoted companies. Of the nine housing associations, no fewer than six are audited by the one company to whom they also pay considerable fees for consultancy work.

Whilst only one housing association has ever failed, if any of those listed in Appendix A got into financial difficulties there would be significant issues for those thousands of families housed by such association, their housing assets partially provided through government funding and for the sector as a whole which may have to absorb some of the housing stock. The Regulator of Social Housing ("RSH") is responsible for supervising housing associations, and this includes checking the financial viability carrying out annual checks of their accounts using a risk-based approach and assessing financial strength.

Some housing associations now sail in choppier waters and face new hazards. Associations are increasingly undertaking activities involving greater risk such as building for sale or market renting to subsidise their social housing developments. One association group has a significant sport and leisure subsidiary which has been adversely affected during the pandemic with the closure of many of its facilities.

The author proposes that larger associations should become PIEs, which should provide higher standards of auditing and perhaps open the association audit market to other companies. This approach will also require the RSH to strengthen its financial supervision significantly in conjunction with the new regulator – the Auditor, Reporting and

Governance Authority ("ARGA"). The Sanctuary Group listed in Appendix A is already a PIE and hopefully sets a trend for others to follow.

2. Charities – attached at Appendix B are brief details (based upon their most recent annual accounts) of some of the largest and best-known charities operating in the UK with significant income and/or net assets. Three of the big four accountants audit four each of the listed charities with the remaining seven charities instructing several different firms. These charities can be divided between those with large endowments providing grant aid to a range of activities within their corporate charitable objectives from their income and those whose income is largely obtained through fund raising, legacies and contract work to promote their recognised activities. These latter charities will have suffered during the pandemic. Unlike the RSH, the Charity Commission, who regulates its 190,000 charities, concentrates on governance and allied issues with less emphasis on financial stability. Thus, the larger charities need to have better financial regulation with co-regulation between the Charity Commission and ARGA.

Charity Commission Inquiries and investigations give rise to some concerns in this area. These include the Professional Footballers Association Charity and the failed Kids Company. These raise disquiet in terms of the whole charity sector.

3. Universities – the Government suggest that they might come within the PIE umbrella which might be welcome in view of the financial issues they have faced during the pandemic through lockdown requirements and the significant fall in foreign students and some have looming pensions obligations.

The author suggests that the threshold for all three entities should be either income of £100 million or net assets of £500 million.

Local Authorities

Local authorities are subject to a different legislative basis for audit under the Local Audit and Accountability Act 2014, but the author considers that they should be subject to similar regulatory strictures as PIEs. This is discussed further below.

PIEs summary – no delay

The author considers the Government should introduce the planned PIE designations as quickly as possible and deals below with issues relating to the number of auditors within the housing association and charity sectors.

The author realises that, as articulated by the ICAEW, any significant increase in PIEs would put strains on auditing firms and the profession as a whole. However the cost involved in staffing up ARGA and the additional cost of audit fees for PIEs is necessary to reassure investors and the public generally as to the integrity of audits of the country's larger corporate entities, charities, housing associations and universities.

DIRECTORS' ACCOUNTABILITY

Section 172 of the Companies Act 2006.

There is one important issue relating to a redrafting of Section 172 which has been suggested by an all-party group known as the Better Business Act campaign. They recommend that the Section is amended to make it clear than any company should be duty bound to operate for the benefit of its members as a whole and the wider society and environment and reduce any harm the company creates or costs it imposes on wider society or the environment, with the goal of eliminating any such harm or costs. They introduce a requirement upon the directors to produce a strategic report each financial year recording how they have performed their duties under this section. James Kirkup, director of the Social Market Foundation, wrote in *The Times* on 3 June 2021 that this is an "overdue change in the law that could transform and save British capitalism". He points out that the pandemic has changed society's evolving demands of business. And he suggests that "As customers, investors and employees, people are increasingly keen for companies to show they can make a profit and a difference".

The Financial Conduct Authority recognises the importance of enhanced climate-related disclosures and issued a consultation paper, CCP21/18, with a return date of 10 September 2021. The paper proposes further requirements on standard listed companies dealing principally with climate change issues to support the transition to net-zero carbon emissions.

The Government should urgently pick up the baton and require all entities, companies, housing associations, universities and larger charities and public bodies to report annually on environmental, social and governance matters ("ESG") affecting their organisations. This could be achieved by appropriate amendments to Section 172 and detailed regulations issued under the same section.

CORPORATE REPORTING

This chapter in the White Paper deals with the proposed new corporate reporting including the contents of the proposed Resilience Statements. There are significant reservations about some of the recommendations arising out of the following three issues:

1. Remuneration – pay reports are increasingly being challenged by shareholders at annual general meetings on the basis of advisory votes. The FTSE 100 Informa Group had more than 60% of those voting rejecting the report, 60% voted against Rio Tinto's pay deal and over 70% voted against Wm Morrison stripping out the cost of the Covid-19 crisis from bonus calculations. The author proposes that Government should seek to impose an additional obligation upon all companies (and non-company or third sector PIE entities) to provide detailed executive pay reports for approval at a general meeting and that decisions on such reports should be binding. As *The Financial Times* on 13 May 2021 wrote "Boards [should] wake up, re-evaluate the link between pay and performance, and, if necessary, rein in payouts that, through luck rather than good CEO judgement, now look excessive".

2. Advisory voting – the White paper suggests in Para.3.2.12 that a company's Audit and Assurance Policy should be subject to an advisory shareholder vote. The author considers that in view of the growing public interest in the conduct of our companies voting on pay reports, ESG issues as reflected in our suggestion in respect of Section 172 and other key issues should, like the annual report and accounts, be binding on the company or other entity.

3. Implications for Charitable entities – The recent Supreme Court decision in *Lehtimaki* and others v Cooper [2020] UKSC 33 raises some potentially far-reaching implications for all charitable corporate entities. The case dealt with a charitable entity which was a company and the decision stated that members of such companies had fiduciary duties to the charitable purposes or objects of the charity, rather than to the company itself, and must exercise their votes accordingly. It is arguable that all shareholders of charitable community benefit societies (the status of most housing associations) have similar duties. This would have significant implications for shareholders of all housing associations whether community benefit societies or companies such that they should be entitled, at the very least, to more transparency from the board of the association in respect of information with binding votes in the issues referred to above.

4. In addition to the duties of a director under the Companies Act 2006, the Government should legislate to impose duties covering issues such as remuneration ESG (under Section 172) and the Audit and Assurance Policy. There should be similar binding duties upon board members or trustees of housing associations and larger charities.

REGULATION OF CORPORATE ACCOUNTING

The broad thrust of the Government's proposals for strengthening the regulator's (ARGA) corporate reporting functions brings a necessary change in approach. However, the RSH and the Charity Commission should also have similar powers in respect of both housing associations and charities respectively registered with them in respect both those designated as PIEs and also other large entities within both categories as designated by the relevant regulator.

COMPANY DIRECTORS

The author supports the proposals for ARGA's powers to investigate and sanction breaches of corporate reporting and audit-related responsibilities. It is essential that the relevant regulator's enforcement powers apply to all PIEs whether companies or not and consequently to directors (or the equivalent) of all such entities. It follows that the RSH and Charity Commission would be responsible for such investigation and sanctions jointly and severally with ARGA. Allocation of primary responsibility must be clear.

The conduct of directors including withholding information from the auditor is of concern. Shareholders and the general public should expect the highest standard of conduct from directors of our companies including particularly those registered as PIEs. This is essential to restore trust in corporate governance.

A similar issue is the non-disclosure of a conflict of interest by a director which could both lead to a financial loss for the company (or gain for the errant director) and reputational damage. Such conduct should be incorporated within the conditions which would trigger clawback from a director's remuneration.

AUDIT PURPOSE AND SCOPE

This is arguably the most important issue within the audit section of the White Paper as it addresses the key functions of our auditors and their work(s). This, as recorded by the FRC, results in a significant number of less than satisfactory audits of some of our large companies which has often led to some of the widely reported company failures. The author applauds the Government's intent to require auditors to consider relevant director conduct and wider financial and other information when signing off their audit. This implies that auditors should not necessarily rely on statements as to the company's position signed by directors particularly if the auditor has any reason to doubt the veracity of such statements.

Tackling fraud

Registered housing associations are obliged to report any fraud (however small) to the RSH and report how the consequences have been handled. Such an obligation should be imposed as a matter of course on all PIEs to report to the relevant regulator and their auditors. Such incidents may well reveal more significant issues for the auditor (internal or external) to investigate but will not necessarily root out the serious fraud which appears from time to time.

Auditor education and skills

This is the only reference to education and training in the White Paper and it is encouraging to note that the FRC is currently considering the current framework for auditor education. However, this issue is becoming particularly significant for two key reasons. Firstly, charities, housing associations, local authorities or social enterprises respectively require very different audit skills. Secondly, the number of interested accountants within the housing association and local authority area has dropped dramatically thus leaving those entities with less choice. Local authorities are addressed below but there is a serious crisis with delays in finalising accounts, and potential auditors showing lack of interest, not least because of poor remuneration.

A new professional body for corporate auditors

The regulation of accountants is already confusing for the general public with five professional accountancy bodies, four of which are recognised supervisory bodies. Creating another professional body for corporate auditors could add to this confusion which is recognised by the Government in the White Paper. The issue is exacerbated when it comes to professional misconduct and how a member of the public can raise complaints against a firm of accountants or an individual accountant, and the effectiveness of sanctions imposed.

There is thus an overlap between the work of the FRC (soon to be the ARGA) and the ICAEW, this must be clarified in any new structure.

AUDIT COMMITTEE OVERSIGHT AND ENGAGEMENT WITH SHAREHOLDERS

There are two important issues relating to the powers of ARGA in respect of auditing and the related involvement of shareholders. The latter does need to be seen in the context of greater transparency and other issues raises affecting shareholders. In particular the Supreme Court judgement in the *Lehtimaki* case which has implications for shareholders (or members) of charitable companies limited by guarantee does have implications for housing association shareholders. As shareholders in non-charitable entities exert more influence over these companies, case law may also take into account their role in promoting the purposes and objects of the company.

The White Paper proposes that there should be "*better*" engagement from shareholders about the audit and "*greater*" engagement from investors on matters relating to audit quality. The issues relating to the removal or resignation of an auditor require more openness when such an event occurs. The Government should go further by permitting shareholders to remove an auditor and annually have a binding vote as to whether the appointment should be confirmed for the following year.

COMPETITION, CHOICE AND RESILIENCE IN THE AUDIT MARKET

This is an important issue for the audit sector and, as the figures in the White Paper indicate, the big four accountants have an overwhelming share of the FTSE 350 market. However as the comments about larger housing associations and charities show, the same firms also have a large share of auditing in such areas as well. The author, therefore, supports any measures to encourage greater competition.

The White Paper raises the vexed question of the separation between audit and non-audit practices. Whilst the White paper seems to imply that "the Government intends to take appropriate powers to enable the regulator to deliver a full structural separation in future", the document itself seems to accept a high level of integration in the short term. This stance is wholly unsatisfactory as there are inevitable conflicts of interest in firms who are handling both audit and general consultancy work. Accordingly, the Government should legislate to require audit firms and any associated services such as general consulting and tax to be legally separated and be independent entities with no common or associated shareholders.

Once again, the Financial Times of 7 June 2021 has raised the issue affecting the Big Four firms attempts at globalisation and recommends that one way for them is "to advance towards the goal of operating seamlessly internationally [and for them] to spin off and consolidate its consulting operations".

A STRENGTHENED REGULATOR

The plan to establish a new and strengthened regulator will require considerable finance to undertake its duties as suggested in the White Paper and those arising from an increase in the number of PIEs. Even though ARGA's remit may be somewhat limited it should nevertheless be the principal organisation monitoring the quality of auditing generally in the UK.

The Government proposed the following general objective for ARGA:

> "To protect and promote the interests of investors, other users of corporate reporting and the wider public interest"

However, if the number of PIEs is extended to include housing associations and larger charities, use of the word "investors" is clearly inappropriate; and "other users of corporate reporting" does not take into account the millions of housing association tenants dependent upon their landlord or those individuals receiving help and assistance from charities.

The more appropriate general objective for ARGA should be:

> "To protect, promote and enhance the interests and rights of all investors in listed companies and shareholders/members of third sector entities and the wider public interest".

ADDITIONAL CHANGES IN THE REGULATOR'S RESPONSIBILITIES

ARGA will be responsible for supervision of accountants and their professional bodies. This is a critical responsibility and whilst there are six key professional bodies, it is important that any duplication is avoided and that the general public is kept informed particularly about how they can complain about the activities of an errant accountant or his/her firm.

Local Authority audit

There are concerns about the current state of local authority auditing. A fundamental rethinking of such auditing is needed so as to improve local taxpayer and community involvement in the auditing system. These latter considerations do not appear to have been considered in whole, or in part, by the independent review of local authority financial reporting in England by Sir Tony Redmond which preceded this White Paper.

Local authority audit in England is in disarray with issues relating to the failure of many authorities to finalise their accounts by the 31 July deadline, now extended to 30 September, and lack of interest among accountancy firms in undertaking such work due partly to the perceived poor levels of remuneration. Local authority finances are under considerable pressure because income has been reduced during the pandemic and some have engaged in risky commercial property ventures (such as Croydon, which is effectively bankrupt), the need for speedy quality audits becomes more urgent. There is a strong argument to justify larger local authorities being registered as PIEs and being subject to all the relevant audit and other requirements. Such proposal has merit particularly when one examines (for example) the extent and value of local authority housing assets as illustrated by the eleven authorities in Appendix C.

The Redmond report considered there should be an improvement in the transparency of local authorities' accounting to the public where the action to date is the requirement for an audit to issue a transparency report with accounts under The Local Auditors (Transparency) Regulations 2020 issued by the FRC. Whilst local authorities are obliged to publish all payments of £500 and over, the procedure for a local taxpayer or other individual to challenge a local authority on any payments is extremely limited and unlikely to be known by the overwhelming majority of citizens. The author has had personal experience challenging expenditure with inadequate assistance from the relevant auditor and, perhaps not surprisingly, opposition from the authority. In view of the delay in finalising accounts the formal procedure for challenging expenditure should be amended if the Government really wishes there to be appropriate transparency.

(A) Every taxpayer should receive a straightforward explanation of the authority budget when the council tax demand is sent through the post. Currently this frequently involves a quasi-political statement from the council leader.

(B) When the authority's accounts have been finalised by 31 July (or amended date) under the present legislation the authority has to advertise the fact and confirm that there is a 30 day time limit for objections. This is conventionally done on the authority's website or by an advert in the local newspaper.

This arrangement should be amended to provide for every taxpayer to be notified by email, if they are so registered, that the accounts have been finalised and informed of the procedure for objecting to any expenditure and the time limit for so doing should be to 60 days. The authority should provide contact details of any organisation or individual who could co-ordinate such objections and notify any interested organisations that the accounts have been finalised.

(C) Every authority should offer independent assistance to any proposed objector as this should simplify the process.

(D) The legislation provides no scope for local taxpayers to challenge any decision-making during a financial year as the principal powers of the auditor relate to action which could be taken as part of the auditing process.

This is a lacuna in the legislation which should be changed to confirm and strengthen the important roles of the Section 151 or Monitoring Officer.

CONCLUSIONS

The Government's White paper is welcomed by the author as it is vital for the country's economy that our auditing standards and corporate governance are of the highest order.

Some key issues merit special consideration:

1. The proposed reforms should be undertaken in a shorter timescale than anticipated in the White Paper.
2. More companies and larger housing associations, charities and universities should become PIEs and be subject to more stringent audit requirements.
3. Section 172 of the Companies Act 2006 should be significantly widened to enhance ESG issues and apply to a wide cross-section of public, private and third sector entities.
4. Shareholders of Companies Act entities and members of third sector entities should have binding votes on range of issues.
5. There need to be stricter rules to have complete separation of audit and other services for the same organisation
6. Local government electors should be given strengthened powers to challenge local authority audited accounts.

APPENDIX A – HOUSING ASSOCIATION 2019/20 ACCOUNTS

HOUSING ASSOCIATION	No. of units	Gross turnover £m	Operating surplus £m	Total assets £m	Asset value per unit £	Debt £m	Debt per unit £
Places for People	209,312	894.10	216.90	5,614	26,821	3,167	15,131
Clarion Housing Group	126,090	841.5	234.2	8,814	69,571	4,024	31,768
L&Q	105,262	915	183.0	13,624	129,429	5,528	52,517
Sanctuary Group	102,686	763.0	175.6	4459	43,423	3,102	30,209
Notting Hill Genesis	66,453	731.5	153.6	8,584	129,174	3,608	54,290
Peabody	66,364	662.0	157.0	7,470	112,561	2,797	42,164
The Guinness Partnership	64,039	359.4	87.2	3,638	56,809	1,375	21,468
Sovereign	59,681	411.2	126.5	4,309	72,200	1,897	31,787
Metropolitan Thames Valley	57,836	464.9	96.2	5,155	89,131	1,936	33,649

Source: Social Housing February 2021

APPENDIX B – SOME LARGER CHARITIES

CHARITY	INCOME	NET ASSETS
Wellcome Trust	£411.74 million	£32.71 billion
Garfield Weston Foundation	£84.761 million	£7.463 billion
Children's Investment Fund Foundation	US $1.121 billion	US $5.862 billion
Leverhulme Trust	£111.487 million	£3.516 billion
Bridge House Estates	£44.8 million	£1.536 billion
National Trust	£545 million	£1.291 billion
Esmée Fairbairn Trust	£4.790 million	£1.142 billion
The Henry Smith Charity	£35.054 million	£1.088 billion
Cancer Research UK	£567 million	£298.1 million
Save the Children International	US $1.169 billion	US $68.683 million
Royal Commonwealth Society for the Blind	£340.877 million	£31.323 million
Royal National Lifeboat Institution	£197.2 million	£733.8 million
Oxfam	£387.4 million	£93.4 million
British Red Cross Society	£244.9 million	£182.5 million
Royal National Institute for the Blind	£106.273 million	£115.556 million
Great Ormond Street Hospital	£91.464 million	£479.323 million
NSPCC	£117.602 million	£80.254 million
Denise Coates Foundation	£88.115 million	£337.806 million

Source: Extracted from Annual Reports and Accounts for 2019/2020

APPENDIX C – SOME LOCAL AUTHORITY HOUSING DETAILS

LOCAL AUTHORITY	No. of units	Total assets (£000)	Asset value per unit £)	Debt (£000)	Debt per unit (£)	Turnover (£000)	Operating surplus (£000)
Birmingham	60,185	2,563,820	42,599	1,099,653	18,271	278,200	83,500
Leeds	56,684	2,392,882	42,214	826,505	15,114	219,583	65,786
Southwark	37,147	3,428,222	92,288	449,357	12,097	264,407	36,333
Islington	25,240	3,155,580	125,023	445,275	17,642	198,475	29,377
Lambeth	23,973	2,442,441	101,883	406,488	16,956	173,767	28,302
Camden	23,216	2,425,654	104,482	484,952	20,889	182,712	20,598
Hackney	21,841	2,493,281	114,156	110,219	5,046	144,451	-1,685
Lewisham	13,796	1,352,214	98,015	57,543	4,171	94,887	17,912
Bristol	26,833	1,737,087	64,737	244,568	9,114	119,811	19,733
Westminster	11,837	1,668,307	140,940	261,283	22,073	108,850	15,628
Sheffield	38,989	1,412,844	36,237	345,969	8,874	149,994	30,131

Source: Social Housing March 2021

For further information on the Society of Conservative Lawyers contact:
The Administrative Secretary, The Lodge, Deaks Lane, Cuckfield RH17 5JB
administrator@conservativelawyers.com
www:conservativelawyers.com

September 2021