5 June 2019

<u>Law Society and CLLS response to the independent review into the quality and effectiveness of audit</u>

The views set out in this response have been prepared by a Joint Working Party of the Company Law Committees of the City of London Law Society (CLLS) and the Law Society of England and Wales (the Law Society)(together the "Committees").

The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

The Law Society is the professional body for solicitors in England and Wales, representing over 160,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

The Joint Working Party is made up of senior and specialist corporate lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to company law and corporate governance.

The Committees welcome the Review. We agree that not everything is broken and that many audits are conducted to a very high quality. We share the desire not to discard what is good in the search for what is better and the importance of this Review working with other reviews on related topics. We think it is important that the Review also considers the cost of potential changes and whether the potential benefits will outweigh that cost. We are concerned that some of the ideas put forward in the consultation may inadvertently risk undermining the important relationship between shareholders and directors and the responsibilities of directors for managing the company's business for the benefit of shareholders as a whole. We also think it is important to bear in mind the difference in the size and complexity of companies subject to audit. It is not clear to us whether the review is concerned only with companies whose shares are listed or traded, or whether it extends to large private and public companies whose shares are not listed or traded or also to smaller companies that are subject to audit.

Q1: For whose benefit should audit be conducted? How is it of value to users?

We believe the question of for whose benefit audit should be conducted should be clearly separated from the question of to whom an auditor owes a duty and so to whom they may have liability. We believe that, as at present, an auditor should have a duty to the existing shareholders of the company by which they are appointed. There are others who may benefit from audited accounts being made public, including employees and those who deal with the company. However, we do not think it is sensible or practicable to extend an auditor's duties to such people or impose liability on an auditor for those persons use of the audited accounts.

Q3: Should UK law be amended to provide greater clarity regarding the purpose of an audit and for whom it is conducted? If so, in what way?

As the Review explains, it is case law which sets out for whom an audit is conducted, rather than this being set out in the Companies Act 2006. We think the position is clear as a matter of law and do not believe the law needs to be amended to provide greater clarity. However, we recognise that this may not be clear to all users of accounts. We think there are ways in which the government could make the present position clear to users of accounts without changing the law. For example, a regulator could make this clear by way of a code or guidelines.

Q4: Do respondents consider there is an expectation gap?

Yes, we do consider there is an expectation gap. We are concerned that some public comments suggest that a company which has audited accounts should never become insolvent and that the fact that it has done so inevitably indicates a failure by the directors or auditors or both to meet their responsibilities, without any investigation as to whether they have met the relevant requirements and standards of care. It will never be possible to achieve a situation where no company with audited accounts becomes insolvent and it needs to be made clearer to the public that a company whose accounts have been audited may still become insolvent. We suggest it would be worth considering a statement in the accounts that the preparation of accounts and their audit is not (and cannot be) a guarantee that the company will continue to be viable business.

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

We are not clear whether it is proposed that all companies that are required to prepare accounts should have to make such a statement or only a subset of those companies (and, if so, which). We are also not clear whether the intention is that any such requirement would apply to all directors or only some of them (and, if so, which). As the Review knows, Provision 29 of the UK Corporate Governance Code 2018 says "The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls." The company's corporate governance report should state if the company has complied and, if it has not, should explain the position.

We are not clear if what is being suggested is something similar to the requirements of the Sarbanes-Oxley Act of 2002 ("**SOX**"). This includes a requirement to define and place responsibility for the company's financial statements with the CEO and CFO, requiring public companies to include in their annual reports a report of management on the company's internal controls over financial reporting. The report is required to include (i) a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; (ii) management's assessment of the effectiveness of the company's internal control over financial reporting; (iii) a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and (iv) a statement by the company's auditors that they have issued an attestation report on management's assessment of the company's internal control over financial reporting (the "Section 404(b) requirement"). Alongside the requirement for management to issue this report, SOX introduced stiff penalties for executive officers who falsely issue such certifications.

Those provisions of SOX placing liability for the financial statements and related internal controls on the executives (as opposed to the board as a whole) raise significant concerns about collective board responsibility for the company's accounts and reports. Any reform which introduces an enforcement regime which treats certain members of the board differently from others and holds them to different standards risks undermining the principle of collective board responsibility and thereby potentially weakening, rather than strengthening, good corporate governance. It is also worth noting that, although in the UK the CEO and CFO are typically board members, this is less commonly the case in the US and this distinction should be kept in mind when comparing the UK and US regimes.

It is also important to recognise the costs and regulatory burden that the SOX regime placed on small business, which ultimately led to the introduction of the Jumpstart Our Business StartUps (JOBS) Act in 2012 to alleviate some of this burden. In particular, the JOBS Act reduced the number of companies subject to the Section 404(b) requirement by establishing a new class of issuer called the emerging growth company ("**EGC**"). Under the JOBS Act, certain regulatory requirements are phased in for EGCs during a five-year period, giving these newly public companies time to develop before subjecting them to the full burden and cost of SOX compliance.

When the requirement for CEO and CFO certifications was first introduced as part of SOX, many CEOs and CFOs sought independent legal advice on the robustness of the internal controls systems they had put in place in order to provide them with additional comfort in the context of providing the required certifications. Similarly, the need to formalise many internal policies before the auditors were prepared to issue their report on the company's internal control systems was seen as particularly burdensome, especially for smaller issuers.

We are firmly of the view that any changes to the current regime must be both proportionate and risk-based, having regard to the size and resources of those being regulated. Equally, it is important to consider whether adopting aspects of the SOX regime would in fact improve auditing standards and accountability in a meaningful way rather than simply resulting in greater costs and administrative burden.

If companies or directors are required to make a public statement without the wording of that statement being prescribed, we wonder if there is a risk that the statement made will be anodyne. If Guidance is to be given about the sorts of things that the board should consider when making a statement it would be important that there should not be a “one size fits all” approach, in view of the different sizes of companies that could be subject to the requirement.

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)? Q16: Should there be greater transparency regarding identified “events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern”?

The Companies Act 2006 does not set out a test of going concern. Listed companies are required by LR9.8.6 (3) to include a statement by the directors on the appropriateness of adopting the going concern basis of accounting in their financial statements. We do not comment on the accounting standard requirements. We note the FRC is consulting on a revised ISA on Going Concern and we welcome the focus there on enhanced challenge and reporting by auditors of the management’s assessment of going concern, which should give greater assurance on this matter. As explained before, we think there is a misapprehension by some members of the public that if accounts have been prepared on a going concern basis the company will not become insolvent before the next accounts are prepared.

The FRC Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks (April 2016) sets out helpful guidance for companies as to what they should consider. Companies required to prepare a strategic report must include information about the company’s principal risks. There are also provisions in the UK Corporate Governance Code requiring (on a comply or explain basis) a company subject to the Code to describe its principal risks in the annual report, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated. The Code also requires the board to:

(i) state whether it considers it appropriate to adopt the going concern basis of accounting, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements;

(ii) explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate;

(iii) state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

Under FRS 102, when management is aware, in making its going concern assessment, of **material** uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties

We are not convinced that a requirement for a separate statement on events or conditions that may cast significant doubt on the entity's ability to continue as a going concern if such uncertainties are not material will drive higher standards or result in better disclosures.

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

We are concerned that a requirement to make a statement about the sustainability of the entity's business model beyond that provided in the viability statement would not be clear. The word "sustainability" is very vague and companies would not be clear as to the period by reference to which they would need to judge this. The Companies Act 2006 (s414C) requires a strategic report to describe the principal risks and uncertainties facing the company. We consider that this and the viability statement, when read together, should provide sufficient information if done well. We note that the FRC is reviewing viability reporting and think it would be premature to come to a conclusion before that review has finished.

Q29: What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

We recognise that the obligations on companies to prepare accounts are a mixture of company law and accounting standards, as are the requirements relating to what is a distributable profit. We think questions of capital maintenance are a matter purely of law. We do not think auditors are best placed to determine matters of law and, in many cases, they will need to liaise with lawyers to reach a view on a question relating to accounts or distributable profits which involve a question of law and accounting standards. As the directors are responsible for preparing the accounts and for making decisions about payments out of distributable profits or which might arguably involve questions of capital maintenance, it is important that the directors should be able to take advice from whichever adviser(s) they think appropriate.

We welcome the Government's statement that it plans to review the approach to payment of dividends and making distributions. We do not think it is helpful to have statutory provisions which mean there is a need for technical guidance on distributable profits. We consider that the fact that the statutory provisions on distributable profits also require 170 pages of technical guidance, some of the statements in which has given rise to technical disagreements between the Institutes of Accountants and the Committees demonstrates that it would be helpful for the Government's proposed review to consider whether this could be simplified.

The current requirements combine statutory requirements with common law principles that are less well understood. The statutory requirements apply a purely balance sheet test that has regard only to the distributable reserves of the company making the distribution (and not to other group companies). There is no explicit statutory requirement as part of the provisions on making distributions to consider cash flow solvency, although the director's duty to promote the company's success will require them to consider the effect of the dividend on the company's ability to pay its debts. Insolvency law is also relevant as a dividend may be a transaction at an undervalue that is voidable under s238 Insolvency Act 1986 and may also be a transaction defrauding creditors under s423 Insolvency Act if the transaction is entered into to prejudice the interests of someone with a claim against the company or who may make a claim.

Where an auditor identifies something which they think is a problem as a matter of law, we think the right approach is to raise it with the company so the company can decide whether to take separate advice on it.

Q30: Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

We think a problem arises because there are different views as to what is the correct interpretation of the law. As set out above, a system for determining whether profits are to be treated as realised or not that is so complex and lengthy is not helpful for companies wishing to determine their distributable profits (or for their advisers). However, this is a different question from whether companies are required to state their distributable profits or not in their accounts.

Q31: Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

Our view is that the Companies Act 2006 does not require a company to state its distributable profits or reserves as a separate line item in its accounts, although we note that there have been opposing views on this point (in particular opinions from George Bompas QC and Martin Moore QC in 2015).

We note that the Financial Reporting Lab produced a helpful report in November 2017 on Disclosure of dividends – policy and practice. We think that better implementation of the suggestions made in this report would be helpful as it concentrates on the company's dividend policy, what is done in practice to achieve it and the associated risks and constraints.

A company may only make distributions from its profits available for distribution. This is determined by reference to that individual company's accounts. Even if a parent company has subsidiaries that have profits available for distribution by those subsidiaries, those profits do not become available to the parent company until after a dividend has been made to that company. We think that, if there is a desire to know not only the profits available for distribution by the parent company of a group as shown in its individual accounts but also to have information in the consolidated accounts about the distributable profits available to the parent and its subsidiaries, there would be some challenges in determining this information and presenting it in a way that is not misleading as to the availability of the distributable profits to the parent company.

We think that some companies may have difficulties in giving precise details of their distributable and non-distributable reserves. It may be easier for them to make a statement that they have distributable reserves of "at least" a stated level. However, the amount of distributable reserves and non-distributable reserves may change (positively or negatively) because of events (which may or may not be within the company's control) and so information at a particular date may not be helpful. To comply with their duties as directors and to ensure the company does not make an unlawful return of capital at common law, the directors have to have regard to the position at the time they propose to make the dividend or other distribution and not just rely on the level of distributable reserves as at the last accounts date. Therefore we think that including a distributable reserves figure on the accounts might, without some further explanation, lead investors to expect a future level of dividends which the directors might decide is not appropriate. We therefore prefer the Financial Reporting Lab approach to this topic.

Q33: Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

The UK Corporate Governance Code 2018 includes a provision for the boards of listed companies to understand the views of their key stakeholders. This is a new provision and should give key stakeholders an opportunity to raise any concerns they have, including about the audit process, with the board. We think it is more appropriate for stakeholders to raise concerns with the directors directly. We also think that the annual general meeting of shareholders is the appropriate place for discussion about the audit report.

Q42: Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?

No, we do not think it would be appropriate to make auditors potentially liable or otherwise accountable to all stakeholders who reasonably rely on their audit work and their published auditor's report. The number of stakeholders who might come into this category is very high and the purposes for which they may rely on the auditor's report may be very different. The auditor will not know the identity of all these stakeholders or the purposes for which they will use the auditor's report. If liability were extended in this way, it seems unlikely that auditors would be able to obtain insurance against the potential liability for a reasonable premium. If auditors are unable to obtain insurance at a reasonable premium the cost of audit could become very high and some audit firms might be driven out of the market, so reducing choice for companies.

Arguments about the persons to whom an auditor should owe a duty of care were considered in the case of Caparo Industries plc v Dickman and we do not think it is appropriate to change the approach taken there. We think it is only appropriate to impose accountability on an auditor where there is sufficient proximity between the auditor and the person to whom it is potentially liable ie the existing shareholders of the company for the purpose of performing their supervisory rights as shareholders. An auditor may also agree to owe a duty of care to others. Third party stakeholders dealing with the company can protect themselves by contract eg by requiring the company to warrant to them that the audited accounts are accurate. Other stakeholders such as employees and pensioners are protected in other ways by legislation.

The question of to whom auditors should owe a duty of care was also looked at as part of the consultation that preceded the Companies Act 2006. This was coupled with a consultation on the right of an auditor to limit their liability. The Review concluded that it was not appropriate to extend the duty of care and that if any such extension were to be contemplated it would have important ramifications for the duties owed by other professionals and so should be the subject of a wide ranging analysis, possibly by the Law Commission. We believe that that is still true. The Companies Act did introduce provisions permitting contractual limitation of liability agreements. However, to our knowledge, given the views expressed by institutional investors about such agreements they are not used in practice.

We do not understand what is meant in paragraph 120 by the suggestion that "It may be important to distinguish between parties to whom auditors might be responsible and those to whom they may be liable for any failure; these need not be the same groups." The consultation does not explain what form this "responsibility" would take. In any case, we think there is a real risk that if some form of "responsibility" is imposed, particularly if imposed by statute, the auditor would be held liable to that person as a matter of tort law unless the statutory provision explicitly made it clear that this was not to be the case. If a statutory provision did make it clear that there was to be no liability, presumably the statute would also set out exactly what the result or penalty would be if the auditor did not meet its responsibility. It would need to be clear to the auditor what he or she would need to do to meet this responsibility.

Q52: Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

We are concerned that the relationship between shareholders and directors should not be undermined by encouraging shareholders to raise concerns with auditors rather than with the directors or the audit committee. It is not clear to us what the purpose of a meeting outside the AGM would be or what shareholders might expect the result of such a meeting to be. Again, we are concerned that a small group of shareholders might be keen to use such meetings to demand more work on a particular area of interest to them but where the directors believe the cost would be disproportionate or inappropriate or not for the benefit of members as a whole. If shareholders with differing views attend such a meeting, how should an auditor respond? We think it is better for shareholders with concerns either to raise these at the AGM or with the board or audit committee. If such an idea is pursued, careful thought would need to be given to the mechanics of any such meetings. For example, would you need shareholders holding a certain minimum number or amount of shares to call such a meeting, what notice would be needed, how often could such a meeting be called, who would bear the costs of the meeting, who would decide where the meeting would be held?

Q53: How could shareholders express to auditors their ex ante anxieties to help shape the audit plan? Should shareholders approve planning materials for each audit, including scope and materiality?

We believe that if shareholders have concerns about the audit plan they should raise these with the directors or audit committee. Directors have a duty to promote the success of the company for the benefit of its members as a whole. They must have regard, amongst other things, to the need to act fairly as between members of the company as well as the interests of stakeholders. Shareholders are not subject to such requirements to consider the interests of the company as a whole or to have regard to stakeholders' interests and a particular shareholder or group of shareholders could have concerns not shared by other shareholders.

We do not think it would be practicable for shareholders to become involved in approving planning materials. What would the position be if there is a difference of opinion between different shareholders or between shareholders and the directors (who have potential liability for the preparation of the accounts)? Also, listed companies announce the dates on which they will announce financial information in advance. If problems in planning an audit cause delays in this timetable, that could create problems for the company. The directors' role is to manage the company and to report to shareholders. We think there is a danger that introducing shareholders into the process at a detailed level will detract from the directors' responsibilities and could make it very difficult for the directors to meet their responsibilities.