10 July 2020

The Law Society of England and Wales and City of London Law Society joint written evidence to the Business, Energy and Industrial Strategy Select Committee's inquiry into delivering audit reform

1. The views set out in this response have been prepared by a Working Party of 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").

2. 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 Company Law Committee is made up of senior and specialist corporate lawyers from the CLLS who have a particular focus on issues relating to company law and corporate governance.

3. The Law Society of England and Wales (The Law Society) is the independent professional body that works globally to support and represent 200,000 solicitors, promoting the highest professional standards and the rule of law.

4. Services, and in particular legal services, play an important role in facilitating the globalised market, both directly and indirectly. Latest figures show that legal services contributed £60bn to the economy in 2018 and has the highest balance of trade among professional services in the UK. The concentration of legal and financial services in the City is a key factor to the UK's economic prosperity.

5. Our legal services export market is the second largest in the world, and the largest in Europe. Legal services support around 552,000 full time employees, and the sector was worth almost £60bn (GVA) in 2018. England and Wales remains an open jurisdiction and the proud home of over 200 foreign firms and over 2700 registered foreign lawyers from nearly 100 separate legal jurisdictions. Our members make a net contribution of £4.29 billion to the UK balance of trade and play a vital faciliatory role in wider international trade.

Introduction

6. The Committees are concerned to ensure that the UK approach to audit of companies is effective, cost-effective and provides a high quality service that

will be of benefit not only to shareholders but also to other stakeholders (recognising that this should not of itself alter the person(s) to whom duties in respect of audit are owed). It is important that the approach adopted is clear and carefully thought through and that it fits well with the approach in existing laws and regulations or clearly identifies where change is needed. It is also critical that stakeholders and society more broadly have a clear understanding of the purpose and scope of an audit and the level of assurance it can provide as to the financial health of the company in question at a particular point in time and, importantly, the limitations that are necessarily inherent in any such assurance process. There is a wide range of companies subject to audit and it is important that the approach adopted recognises this and adopts a proportionate approach.

7. The UK must remain an attractive place for businesses to incorporate, whilst also being an attractive place where investors can invest with appropriate confidence in the level of assurance that an audit can provide, and it is therefore important that the approach adopted is considered in the context of the approach in other jurisdictions. This is more vital than ever because of the combination of the coronavirus pandemic contraction and the general uncertainty as a result of Brexit.

8. The Committees have responded to those key questions where they think they can contribute to the BEIS's Committee's inquiry. Copies of three responses to the earlier consultations which contain further details of our views on the relevant topics are available in the link set out in the footnote.[1] Those earlier responses should be considered in conjunction with the comments set out below.

9. We would be happy to provide further information to the BEIS Committee, if that would be helpful.

Do the proposals from the three reviews of audit fit together as a coherent package that can deliver meaningful reform?

10. The Committees welcome the work of the Kingman, Brydon and CMA reviews (the three "Reviews") and have previously commented on each Review.

[1] CMA: http://www.citysolicitors.org.uk/storage/2019/10/Response-to-BEIS-Initial-Consultation-final-version-12-09-2019.pdf

Kingman: http://www.citysolicitors.org.uk/storage/2019/06/Law-Society-and-CLLS-response-to-BEIS-Kingsman-review.pdf

Brydon: http://www.citysolicitors.org.uk/storage/2019/06/Law-Society-and-CLLS-response-to-the-Brydon-review-03-06-19.pdf

However, we do have concerns that the three Reviews do not fit together as a coherent package and that they are based on the future creation of the ARGA without a clear legislative timetable. We consider that it would have been better to first begin with the Brydon Review and to consider and conclude on the following before progressing with the other reviews:

(a) the purpose of audit;

(b) for whose benefit audit is conducted; and

(c) how audit is to be of value to users.

It would then be appropriate subsequently to address the issue of how auditors and preparers of accounts should be regulated and by whom and how audits should be conducted.[2] The risk is that, without a clear legislative timescale, progress will be made on the non-legislative measures only with the result of a confused patchwork landscape of regulation and practice.

11. Generally, the Reviews failed to recognise that the companies subject to audit range greatly in size – from (i) very large companies whose shares may or may not be listed to (ii) much smaller companies whose shares are not listed and whose shares may be held mainly or only by shareholders who are also directors (or are connected to the directors, for example other family members) and so are closely involved with the business. This difference in size means there is a need for a proportionate regulatory landscape. Smaller companies, including those whose shares are listed, are unlikely to have the same resources available to them as large listed companies.

12. Smaller companies are, generally, unlikely to pose the same systemic risks or risks of prejudice to the public if they fail and may have fewer stakeholders with an interest in their audited accounts. The Reviews have not all made it clear which companies their proposals relate to or that a proportionate approach (depending on whether the company's shares are listed or not and the size of the company) will be adopted. It is important that the proposals take this into account. We believe that any reforms that are proceeded with should start with the FTSE 350 only and not all PIEs and only be extended to a wider group once they have proved to be effective and it can be demonstrated that such other companies are in need of the same reforms.

13. Generally, the Reviews have not always recognised the existing laws that are relevant to the areas they have been considering (and which may already provide some of the powers that a Review thinks is needed). It is not always

[2] See preliminary comments B and C in the response to the BEIS consultation on the CMA recommendations.

clear whether a proposal is intended to replace an existing power completely or be complementary to it[3].

14. This is also relevant to the law relating to the payment of dividends and the maintenance of capital. This is a complex area of law and we would welcome a separate review that could both simplify some of the complexity and give new emphasis to the existing duty to consider the company's ability to pay its creditors[4] . We believe that such a review should be completed and any proposals for change should be brought forward before pursuing any particular proposal relating to dividends from the Reviews, including the Brydon Review recommendation that the directors should have to make a statement when proposing a dividend that its payment "in no way threatens the existence of the company in the ensuing, say two years". We do not think it would be reasonable to expect directors to make such a statement as this seems to suggest a guarantee that the company will be able to continue in existence for at least two years. This may not be the case due to circumstances that may be unforeseeable when the statement is made.

15. We are also concerned about how proposed reforms will fit with the UK's corporate governance landscape and, in particular, the UK Corporate Governance Code (the "Code") which is currently a product of the FRC, but expected one day to be a product of the ARGA (once it exists). We believe the Code (under which the listed company must apply the seventeen Principles of the Code and comply with the Provisions or explain what action the company has taken and why) has many benefits. It allows standards to be improved regularly in response to changes in society's expectations of listed companies and those who apply all or part of the Code (or similar documents) on a voluntary basis, across a range of sectors. Some of the proposals in the Reviews overlap with areas already covered by the Code (for example in relation to viability statements). We think there needs to be more careful thought as to what is required and what is the best way to achieve the desired result – whether by legislation or through the Code, the QCA Corporate Governance Code, the AIC Code, other sector specific codes for other areas of corporate activity (for example, registered providers) and/or, for companies whose shares are not listed, the Wates Corporate Governance Principles for Large Private Companies.

16. We are also concerned that proposals relating to the Audit, Reporting and Governance Authority (ARGA) will need to consider how its powers fit with

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[3] See, for example, our response to the consultation on the Kingman recommendations, paragraphs 34 to 40, as to the fit between the Secretary of State's powers to require the production of information and the court process for revising defective accounts and the proposed powers for the planned ARGA.

[4] See our response to Q29 in the response to the Brydon Review.

those of other regulators, in particular the CMA, the Financial Conduct Authority (FCA) and the Insolvency Service. When ARGA exercises a power in relation to a listed company, it will be important for it to consider whether the company may have an obligation to make an announcement to the market about action to be taken by ARGA and to take this into consideration and, if need be, liaise with the FCA. Listed companies also have obligations under the Listing Rules and Disclosure and Transparency Rules relating to report and accounts and if ARGA is to have responsibility for review of the annual report, there could be overlaps here too. It is also possible, depending on what companies are to be covered, that there will be overlaps with regulators in other jurisdictions.

17. We are also concerned that some proposals risk damaging the coherence of UK company law and will, perhaps inadvertently, change the relationship established by company law between (i) shareholders and directors (ii) the board's collective responsibility for decision-making and (iii) the relationship between directors and other stakeholders. The BEIS consultation on the CMA proposals suggested that the regulator should engage shareholders in monitoring compliance and taking remedial action. Any engagement between a regulator and the shareholders of a company initiated by the regulator should be used with great caution[5].

18. The Brydon Report suggests that shareholders should be given a formal opportunity to propose any matters that they wish to be covered in the audit. However it is not clear if a company would only have to adopt a proposal if a majority of shareholders support it by passing an ordinary resolution. We do not in any event see a need for additional rights and powers in this area given the existing courses of action open to shareholders. Under the Companies Act 2006, shareholders already have the ability to propose a resolution at a shareholder meeting (which could relate to matters to be covered in the audit) and to have a statement circulated and, if the company is a traded company, to include something in the business to be dealt with at the AGM. We are particularly concerned that the proposals in the BEIS consultation on the Kingman Review to treat some board members differently from others risks undermining collective board responsibility for accounts and could lead to other board members being less engaged[6].

19. We support the desire to achieve better quality audits. One of the suggestions to achieve this has been to require either joint audits or mandatory shared audits. Although there may be arguments that having two

5 See paragraphs 1.8 and 3.4 of our response.

6 See paragraphs 26-31 of our response.

independent audit firms involved will improve the degree of challenge there is little evidence that joint or shared audits lead to higher quality, nor is it clear how joint and several liability for the joint auditors would work in practice. Companies already face significant challenges sometimes in finding one firm willing and qualified to act as an auditor and this will increase if the company has to find two firms. There may also be conflicts between the firms that will need to be managed. There is also a question as to whether the increased cost for the company is justified by any higher standard that is delivered. We think it would be better to use peer reviews targeted at companies where there are doubts about a particular audit[7]. The doubts expressed by the Brydon Report about the CMA joint audit proposal[8] again show a lack of coherence between the three Reviews.

20. The Brydon Recommendations include a recommendation that the concept of “true and fair” be replaced with the term “present fairly, in all material respects”. The reasons given for this are the increasing use of estimates and judgments and the fact that the audit intends to provide assurance that the company accounts are free of material misstatements. It states that it is difficult to see how either the directors or the auditors can communicate that the accounts are “true” in accordance with any reasonable person’s understanding of the word and that this contributes to the expectations gap. We appreciate that this language will be the subject of heated and detailed debate, but from a natural meaning of the language and understandability perspective, something is lost by losing the word "true". The proposed new language is not something which the average stakeholder would understand. We think that clarity and simplicity of language and meaning is vitally important for such an important statement. The language used goes to the heart of trust in business and regulation.

21. The Companies Act 2006 imposes the obligation on directors to be satisfied that the accounts give a true and fair view. The Brydon Reviews scope only related to the process of audit of accounts and did not extend to a review of whether accounts should present a true and fair view or not. We think it would be wrong to proceed with the proposed change without more detailed consultation on the proposal, including how any such change would be viewed by investors from outside the UK who are familiar with the true and fair requirement. We also have concerns that the words “in all material respects” themselves are likely to create uncertainty.

[7] See paragraphs 5.8 and 13.1 to 13.4 in our response to the BEIS consultation on the CMA recommendations

[8] See paragraphs 1.8 and 3.8 of the Brydon Report.

22. The Brydon Recommendations also recommend that the auditor should be required to state whether the directors' section 172 statement is based on "observed reality, on the basis of the auditor's knowledge of the company and its processes". The requirement on the directors is to describe how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duties. We do not see how an auditor could state that the statement is based on "observed reality" unless the auditor attends all the relevant board meetings and we believe this is not a proportionate requirement. In some cases, even this would not be enough, as the matters referred to in the statement may include other actions taken by the directors outside board meetings.

23. We think there is a temptation to believe that introducing legislation, of itself, will result in better behaviour by companies and auditors and avoid future failures of businesses. Often, what is needed to avoid a company failing is a change of behaviour, which may involve making directors aware of the standards they should follow and what best practice looks like. We believe this can often be better achieved by the use of codes, rather than legislation, and the sharing of good practice. (Improvements in corporate governance in the last thirty years and greater diversity on boards are just two examples of this.)

24. Similarly, it is important to guard against the risk that, if a regulator is set up on a statutory basis and companies continue to fail, the answer is thought to be more powers for the regulator or stricter rules for the regulated companies. An increase in regulatory requirements can impose costs on companies which are not effective and make the UK a less attractive place to incorporate. The focus should be on identifying the relevant standard of behaviour expected from companies and auditors, working to ensure that companies and auditors are aware of these standards and are meeting them. It will also be important that shareholders, potential investors and other stakeholders have a clear understanding of the nature and scope and limitations of the audit process and the level of assurance that it can be expected to provide as to the financial health of the company in question both at a point in time and going forward. Where a company does fail, it is important to differentiate between (i) cases where those involved have fallen below the standard expected of them and (ii) cases where those involved have met the relevant standards, but nonetheless the company has failed. Often it is assumed without investigation that, because a company has failed, there must have been a failure to meet the relevant standard or some failing in the audit process.

Which reforms can be delivered without legislation and what progress has the FRC made in implementing such reforms ahead of future legislation?

25. We believe there are reforms that can be delivered without legislation, particularly where the subject matter is already dealt with by corporate governance codes or similar statements of good practice. The UK's approach to corporate governance (which requires the companies subject to the Code to apply the Principles and either to comply with detailed provisions or to explain the approach they do use and how this achieves the Principles) provides flexibility that accommodates the different size and resources of the companies subject to the Code. It also allows for a difference of approach as between companies, because a company can choose not to comply with a provision but explain what it does do and why, so as to enable shareholders, potential investors and other stakeholders to assess the approach being adopted from an informed position.

26. It also allows the Code to be reviewed more frequently than would be the case where a legislative approach is taken and to be changed more easily where change is needed, for example to reflect changing societal expectations. Because of the flexibility of this approach, the standards set in the Code can be set at a high level, recognising that it may take a year or so for most companies to meet the new standards expected. Examples of areas where we think reforms can be delivered without legislation include:

- requirements on companies in the Code to describe their principal risks in the annual report, to set out what procedures are in place to identify emerging risks and explain how these are managed or mitigated;
- requirements relating to the viability statement;
- better reporting on dividend policy in line with the Financial Lab's report in November 2017;
- guidance to audit committees and more examples of good practice (see paragraph 4.1 of our response to the BEIS consultation on the CMA recommendations).

27 We recognise that primary legislation will be needed to create the ARGA and to give it new powers. It will be very helpful for all if a clear timetable is set out and a draft bill is prepared at the earliest opportunity to facilitate technical debate ahead of the point when parliamentary time will allow for its introduction to one of the houses as a bill. However, we hope that ARGA will have the ability to regulate through the use of codes of best practice which can be flexible and react appropriately to changes of circumstances and to development of practices. It is important that any proposed legislation relating to ARGA is subject to sufficient time for consultation and scrutiny, particularly

in view of the rather piecemeal approach so far to the proposals for reform. It is also important that ARGA should be required to consult on proposed codes of best practice and changes to these. If ARGA is to be given powers to require companies to take certain actions or to impose penalties on companies or individuals, there must be an appropriate mechanism for those subject to such directions or penalties to challenge them. Where reforms are achieved by the FRC as part of its transition into ARGA without legislation or prior consultation with stakeholders, we believe there should be Parliamentary scrutiny and oversight to ensure the reforms achieve what was intended.

28. As explained above, in some areas, there is already legislation which gives certain powers e.g. to the Secretary of State or places obligations on a company in relation to its report and accounts. It is important that any proposals are clear as to how they fit with (or replace) these existing provisions.

29. Any review of the requirements as to payment of dividends and maintenance of capital is likely to involve changes to the Companies Act 2006. Any such changes should be the subject of a separate holistic review with appropriate consultation and consideration of the possible alternatives, recognising the need to create a coherent framework that fits with the broader framework of applicable law and regulation.

30. We do not comment on the progress made by the FRC in implementing reforms ahead of future legislation. However, we note that companies subject to the Code are required to report against the latest version of that Code (July 2018) for the first time in 2020 and that it is therefore early days to draw conclusions about the impact that the Code is having on the behaviour of companies subject to it. The same is also true for unlisted companies that have adopted the Wates Principles.

How will audit reform fit with wider corporate governance reform?

31. It is important that audit reform does fit with wider corporate governance reform. For this to be the case, we think it is necessary to determine the purpose of audit and to decide what reforms are needed to achieve this purpose. It is also important that it is clear to whom an auditor owes a duty and the potential liability they will face if they fall below the relevant standard. One of the areas which has not received much attention relates to auditor liability limitation. This is a complicated area and will need more detailed consideration. The Brydon Review recommends that company law be amended to provide that use of limited liability agreements proposed in good faith is not a breach of directors' responsibilities. However, if the use of such

agreements is to be encouraged, it will also be necessary to consider whether institutional shareholders would be willing to support them and, for companies with shares traded outside the UK, whether the regulations in the relevant country allow such an agreement.

32. As explained, above, we think there are risks that some proposals, as currently formulated, may in practice make some directors feel less accountable for the report and accounts and undermine the collective responsibility of the board for the report and accounts. They may also, inadvertently, interfere with the relationship between shareholders and directors.

33. As also explained above, we are generally in favour of using codes as far as possible to promote corporate governance reform and it is important that audit reform does not cut across that.

For further information please contact David Pudge (David.Pudge@CliffordChance.com) of the CLLS Company Law Committee or Edward Craft (ECraft@WedlakeBell.com) of The Law Society Company Law Committee.