What would restore your trust in audit and corporate governance?

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Editor's note: although Amin is a member of UKSA's Policy Team, he is writing in a personal capacity.

All too often, apparently healthy companies collapse. We then find the accounts were seriously misleading, or even completely fraudulent. To name just three personal 100% losses, Carillion plc (a large personal loss, with in my view misleading accounts), Aero Inventory plc and Globo plc (both small personal losses, with in my view fraudulent accounts).

What can be done to stop this happening repeatedly?

Government consultation

As reported in the 8 April UKSA news item "Are you happy with the quality of corporate reporting? Have your say" the Government issued a big consultation document in March: "Restoring trust in audit and corporate governance"; 232 pages with 98 questions.

Just reading the main chapter headings, without bothering with the many sub-headings, shows how wide-ranging it was:

1 The Government's approach to reform
2 Directors' accountability for internal controls, dividends and capital maintenance
3 New corporate reporting
4 Supervision of corporate reporting
5 Company directors
6 Audit purpose and scope
7 Audit Committee Oversight and Engagement with Shareholders
8 Competition, choice and resilience in the audit market
9 Supervision of audit quality
10 A strengthened regulator
11 Additional changes in the regulator's responsibilities

I consider that acting as the voice of individual shareholders is one of the most important things that UKSA does. That is why I volunteer on the Policy Team.

Our response

UKSA's approach is to respond to consultations jointly with ShareSoc, except when there is a specific reason for responding alone.

UKSA and ShareSoc's joint response echoed the scale of the Government's document, 77 pages with just over 25,000 words! You can download it from this link.

When responding, we don't confine ourselves to just the questions asked. For example, section 11 of the consultation document covered whistleblowing, but asked no questions. That did not stop us sending in nearly 800 words on whistleblowing, because we consider it very important.

Similarly, the consultation document said nothing about the problems caused by the nominee share ownership system which disenfranchises many individual shareholders. Despite that, we made it our second key point.

Our key messages

We made eight key points. (If you make too many, they cannot all be key!) They are listed below, with

some very selective and lightly edited extracts from the response document.

However, even if 77 pages of response are too daunting, I strongly recommend reading the six pages in the response document which set out our key points in full.

1. Regulatory capture

Historically, the FRC (Financial Reporting Council) Board and its main committees have been dominated by accountants. ARGA (the new Audit, Reporting and Governance Authority) and its main committees must be representative of the users of accounts, the customers.

2. The share registration system disenfranchises the beneficial owners of shares

Following dematerialisation, large numbers of beneficial owners have found themselves being forced to use stockbrokers' nominee companies. In most cases, they are denied the ability to vote, are unable to receive communications directly from companies whose shares they beneficially own, and have no right to attend a company's AGM.

We included a whole Appendix expanding on this key point.

3. The method of appointing auditors requires radical change

Audit partners know that if they sufficiently upset the Chief Financial Officer or the Chief Executive Officer (rather than shareholders), the likelihood will be the loss of the audit engagement. Accordingly, the present system of appointing and removing auditors creates a fundamental tension between the auditor's professional duty to shareholders to be challenging and the auditor's economic interest in retaining the audit.

We recommend that for PIEs (Public Interest Entities) the audit firm should be directly appointed by ARGA, with ARGA agreeing the audit fee. Only such radical change can ensure that auditors are motivated solely by the imperative of maximising audit quality and challenging any corporate reporting that they consider deficient.

4. Change the legal responsibility of directors

We recommend that the law should stipulate that the legal duty of directors is to act "with utmost good faith" towards the company, towards each other, and towards auditors. "Utmost good faith" is a concept well established in the law of insurance and in the law of partnerships. Imposing this obligation upon directors should have a salutary behavioural benefit, and by "raising the bar" beyond their existing responsibilities would also make it easier to sanction directors who fall short.

Furthermore, ARGA and other regulators should cease fining companies for any reporting or company law failures. Although such a fine is legally paid by the company, its economic cost always falls upon the shareholders, all of whom are innocent qua shareholders.

5. More legal protection for whistleblowers, regulators, and auditors

We consider that a system for significant financial compensation, modelled on that used in the USA, is required to protect whistleblowers in the UK. Furthermore, whistleblowers should have legal privilege for their disclosures if made in good faith.

In several recent financial scandals, regulators were too slow to act, waiting in the hope of building an irrefutable legal case, because they feared litigation being brought against them by aggressive company directors. We consider that ARGA and its staff need stronger legal protections so that any person seeking to challenge ARGA through the courts should be required to prove actual malice on the part of ARGA or individual members of staff.

We consider that auditor resignation statements should be absolutely privileged, alongside a strengthened duty upon auditors to report fully and frankly all the circumstances leading to the cessation of the audit engagement.

6. Expanding the number of firms capable and willing to audit PIEs

We recommend applying a market share cap to the Big 4 audit firms, initially fairly loose to enable time for adaptation, but with that cap later becoming tighter. This would create a guaranteed market for

challenger firms.

We also recommend a statutory system to cap audit firms' liability in the event of a failed audit. At present, auditors face open-ended liabilities for which the Big 4 firms cannot buy adequate cover in the insurance market. The risk of such open-ended liabilities is a major impediment to challenger firms seeking to increase their PIE engagements.

7. Is ARGA the most appropriate body to undertake oversight and regulation of the actuarial profession?

We recommend finding a different home for actuarial regulation to allow FRC/ARGA to focus on governance, reporting and audit.

The PRA (Prudential Regulation Authority), which employs around 80 actuaries, is a much larger repository of regulatory actuarial expertise than the FRC and would be best placed to take on all the actuarial responsibilities currently vested in the FRC.

However, it will be important that FRC/ARGA, the new actuarial regulator, the PRA and The Pensions Regulator (if neither of these latter two become the actuarial regulator) have a memorandum of understanding on matters where their regulatory duties overlap.

This current review should also consider specifically the need for accounting and audit quality in the insurance sector.

8. Implementation planning, monitoring of progress and funding ARGA adequately

The FRC has estimated that the implementation of much-needed reform of annual reporting is likely to be a ten-year project. This seems appropriately pragmatic and requires long-term planning. Government needs to continue to monitor progress and ensure ARGA reports on progress against its goals.

It is vital that ARGA has all the resources it needs in this respect. The consultation talks about the funding of ARGA by statutory levy (a system which many consider unsatisfactory), but there is no discussion of the level of resource that ARGA might require even over a five-year, let alone a ten-year, horizon.

The FRC's budget for 2021/22 is £52.2m. In comparison, the pure administration costs borne by the taxpayer of winding up of Carillion were £148m, while the wider economic costs to the economy were an order of magnitude greater. The additional costs to the taxpayer for the completion of the Royal Liverpool Hospital alone have been estimated by the NAO at £739m.

Money spent on proper funding of ARGA in future will be money well spent.

How did we get the response done?

The response lists seven joint authors, and others within UKSA and ShareSoc also had views on these issues of course. How do you get a response done without everyone tripping over each other, or having things fall through the cracks?

In March, UKSA adopted a 9-page consultations response process which you can download from this link. The Policy Team created it after recognising that some of our consultation responses in 2020 had taken more effort than they should have done.

This particular consultation was the first time the formal response process was used in "real life". I volunteered for the role of Lead Author. To keep it brief, the process worked extremely well.

The essential requirement is that the Lead Author focuses on the need to create text, manage the timetable, and keep the team in lockstep. For example, serious effort would be wasted if someone started commenting on a superseded version of the draft response! Such things happen very easily if you are not careful.

To conclude, I would like to thank my fellow authors for never complaining that I was following the process too strictly. Obviously, I was cut out to be a dictator!