

UK Corporate Reform

Directors' accountability for internal controls

April 2021



EY

Building a better working world



Background to directors' accountability for internal controls

On 18 March 2021, the Department for Business Energy and Industrial Strategy (BEIS), released the consultation paper (CP) 'Restoring trust in audit and corporate governance'. The Government's objective is to support the attractiveness of the UK market to investors and restore society's trust in businesses. This includes ensuring directors are accountable for how they run their companies and strengthening corporate frameworks.

The CP recommends a number of changes including:

- ▶ Amending the definition of Public Interest Entities (PIEs) to include large private and other companies¹
- ▶ Safeguards over dividend and capital maintenance
- ▶ New corporate reporting on resilience, tackling fraud and payment practices, and the introduction of an Audit and Assurance Policy
- ▶ Strengthening supervision of corporate reporting, company director responsibilities and Audit Committee oversight
- ▶ Changes to the statutory framework of the audit market, including audit purpose, quality, competition
- ▶ A new, more powerful regulator, the Audit, Reporting and Governance Authority (ARGA), replacing the Financial Reporting Council

In addition, Chapter 2 of the CP proposes new reporting and attestation requirements covering internal controls over financial reporting (similar to the US Sarbanes-Oxley regulations), also known as 'UK SOX'.

Specifically in relation to internal controls, the paper outlines three options. These are not intended to be mutually exclusive:

- ▶ Directors need to make an annual statement on the effectiveness of the internal controls. This should include details of the benchmark system used, as well as how they have assured themselves it is appropriate to make a statement and, where deficiencies have been identified, the remedies taken.

- ▶ The external auditor's report in the company's annual report should describe the work the auditor has undertaken to understand the company's internal control systems whilst performing their audit. This will not include a formal opinion on the effectiveness of the company's internal controls.
- ▶ The auditor to provide a formal opinion on the directors' annual attestation on the effectiveness of the company's internal controls. This may potentially be limited to key internal controls over financial reporting.

A preferred option is proposed within the CP which would mandate a directors' statement on the effectiveness of the internal controls (option 1 above), but (unlike US SOX) leave the decision on whether the statement should be assured by an external auditor to the directors, audit committee and shareholders.

In addition to the above, Chapter 6 (Audit purpose and scope) proposes additional requirements for the auditor to report on the steps taken by the directors over the prevention and detection of material fraud, as well as potentially including formal assurance over Alternative Performance Measures and Key Performance Indicators (KPIs), including those linked to executive remuneration.

¹ The CP proposes extending the UK PIE definition to include large private companies, identifying two options which align with existing reporting obligations: 1) Companies required to include a corporate governance statement (>2,000 employees or turnover >£200m and Balance Sheet total >£2bn), or 2) Threshold for additional non-financial reporting for existing PIE's (>500 employees and turnover >£500m).

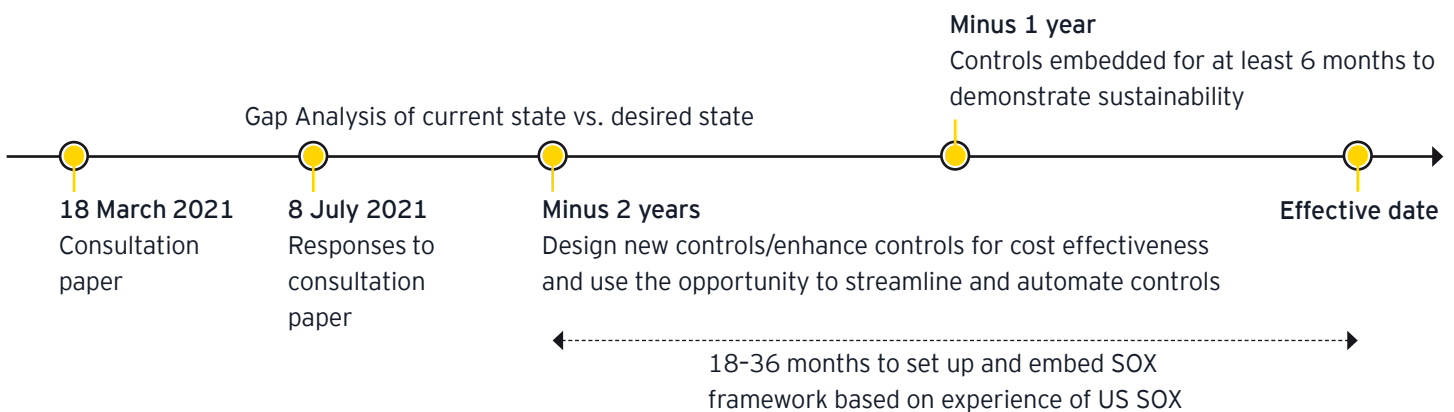
Questions to ask yourself

1. Do you understand the current and proposed UK PIE definitions? How will these apply to your organisation and hence which entities will be in scope?
2. What processes and controls do you have over areas beyond financial reporting, for example: environmental, social and governance, fraud, remuneration, other non-financial KPIs?
3. What frameworks, standards and policies does your organisation use to manage its internal controls? Are these documented?
4. Do you understand your end-to-end data flows and controls over your key end-to-end processes, and are these documented?
5. Are you comfortable that adequate internal controls currently exist which would allow the directors to attest to the effectiveness of internal controls over particular financial reporting. Are these to a standard that is auditable?
6. Do you have a view as to where your current control deficiencies lie (including IT)?
7. Are there existing frameworks in place which can be leveraged – e.g., US SOX or equivalent, risk and control self-assessment frameworks, or the Senior Managers and Certification Regime?
8. Do you have the necessary skills to assess the likely requirements of the CP?
9. Do you have any current in-flight change programmes which may be impacted or require future proofing? What action do you need to take now?
10. Could the internal controls framework be used to help leverage other requirements such as regulatory reporting? Can value be gained from greater synergies and efficiencies?

What is the timeframe?

Whilst the CP does not explicitly state the 'effective date', we expect the measures may be applied for the larger organisations (premium listed companies) within the next 2-3 years, with other PIEs and potentially other large private entities following after. Below is an example of how it may be applied, on this basis:

Set up your Steering Committee



From our experience, including US SOX, successful programmes can take between 18-36 months to implement and embed. We expect many firms will stand up projects before the end of the consultation period and prior to the publication of the final legislation.

What actions must you take now?

Having considered the consultation paper and its key elements, we suggest the following actions:

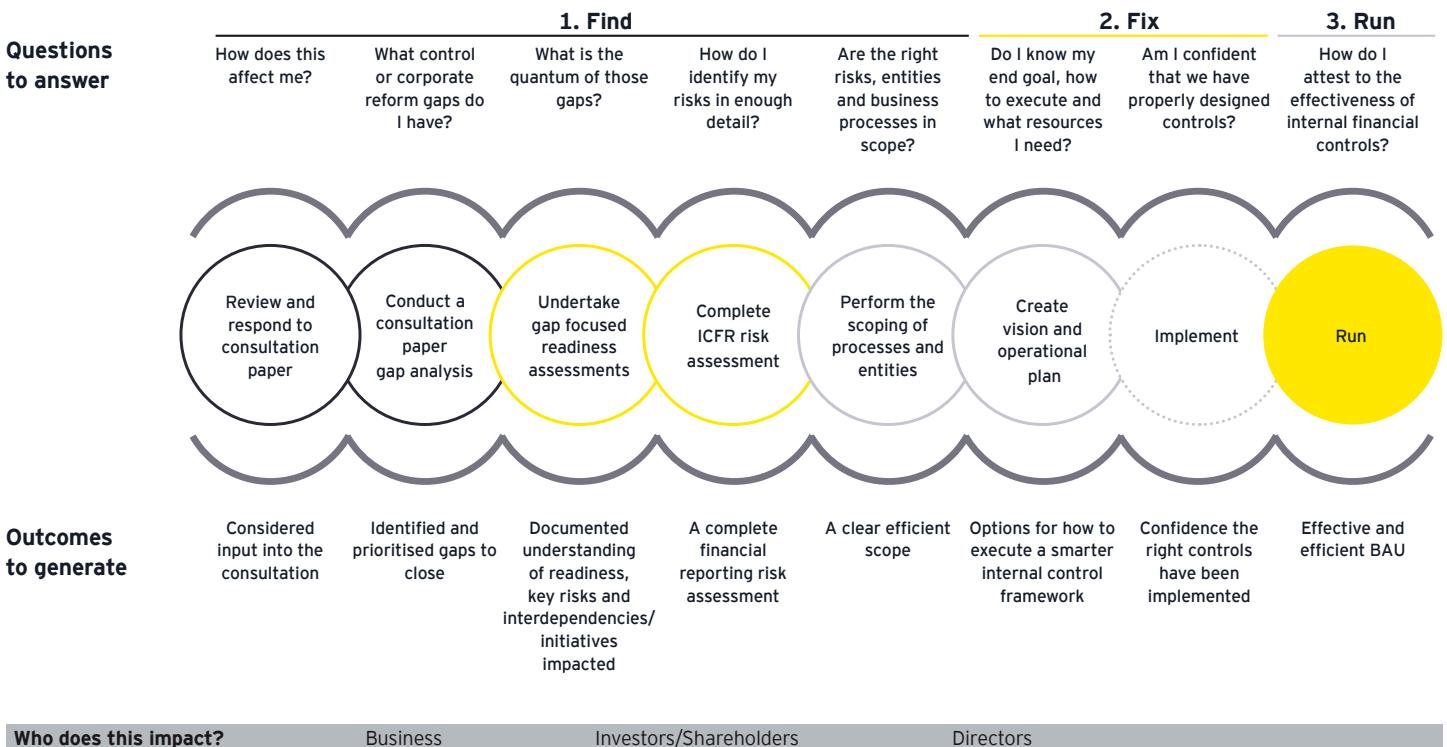
1. Conduct a consultation paper gap analysis – What are the key gaps for your organisation?
2. Determine what is in scope:
 - ▶ Legal entities (PIEs)
 - ▶ Business divisions
 - ▶ Geography
 - ▶ Processes and controls
3. Undertake readiness and risk assessments as highlighted by the consultation paper gap analysis
4. Estimate the timing, cost and effort to comply
5. Identify impacted current and planned change initiatives. What needs to be future-proofed now?



How to respond to UK corporate reform

Including the journey to internal controls compliance (UK SOX)

Organisations should look to smart and efficient ways of implementing a UK SOX-style regime. We recommend companies employ a three-step approach to meeting the requirements, whilst considering longer-term opportunities to transform their control environment. There are eight key considerations on the compliance journey:



Who can I contact for support?



Dan Feather

Partner, Assurance
Ernst & Young LLP
dfeather@uk.ey.com



Jacqui Hine

Associate Partner, Assurance
Ernst & Young LLP
jhine@uk.ey.com



Julian Marsh

Partner, Financial Services
Ernst & Young LLP
jmarsh1@uk.ey.com



Saheet Gohil

Associate Partner, Financial Services
Ernst & Young LLP
sgohil@uk.ey.com



Neil Mathur

Partner, Consulting
Ernst & Young LLP
nmathur@uk.ey.com



Piers Clinton-Tarestad

Partner, Consulting
Ernst & Young LLP
pclintontarestad@uk.ey.com



EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

© 2021 EYGM Limited.
All Rights Reserved.

EYG No. 002682-21-UK
ED None

EY-000132297.indd (UK) 04/21.

Artwork by Creative Services Group London.



In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com