

Proportionality:

What the listed market
needs from the proposed
audit and corporate
governance reforms

Contents

01 Executive
Summary

03 The main findings
in graphs

05 Will the
reforms work?

07 Toil and trouble

09 Why the size of
the PIE matters

13 Who wants to be
a director?

15 London markets
falling down

17 Next steps

On 18 March 2021, the government published a consultation White Paper called, *Restoring trust in audit and corporate governance: proposals on reforms*, with the aim of strengthening the UK's framework for major companies and the way they are audited. The consultation closes on 8 July, 2021.

The headline message about these proposed reforms is that they will prevent high-profile corporate failures like Carillion plc, privately-owned BHS, and AIM-listed Patisserie Valerie, and will introduce more competition to the audit market.

We asked our clients if they thought the reform proposals would achieve these aims. This report reflects their opinions and observations and provides much needed insight into how audit reform will impact on businesses and the listed markets.

A big thank you to all the companies, investment companies and advisers that took part.



Not enough bang for too much buck

There is no quibbling over the need to reform the audit and corporate governance regime.

Almost three-quarters (73%) of respondents to our survey agree that change is required to a lesser or greater extent. Unfortunately, that is where agreement with the government's proposals starts and ends, as the overall impression is that the new requirements will be a lot of extra work for no noticeable reward.

Respondents are unanimous in the opinion that the proposed reforms will increase the cost and internal company resources required to complete an audit, but only 36% believe that these reforms, if implemented as proposed, will bring about an improvement to the current situation – which is hardly a ringing endorsement.

The proposals will significantly increase costs and bureaucracy, without a corresponding improvement in corporate governance and the audit market.

This lack of proportionality is echoed throughout the report, whether we are talking about the costs to value ratio of the work required to comply with the new regulations, or the regulations to risk ratio of including AIM and private companies within the Public Interest Entities ("PIE") definition, and could have considerable consequences for the LSE and AIM.

Respondents believe that over-burdening growth enterprises with disproportionate amounts of regulation could drive companies to seek finance elsewhere, either by looking to alternative markets; funding growth through successive tranches of private equity funding; or simply relocating outside of the UK to dodge the PIE bullet.

Introducing proportionality would twist the kaleidoscope and the reforms would be seen in a much more favourable way.

Moving from a one-size-fits-all approach to a more tailored corporate reporting regime would change the optics on the proposed reforms. Over 80% of respondents say they would prefer to see a tier system based on market capitalisation or some other size criteria.

PKF Littlejohn will be championing the cause of proportionality in our consultation with government in response to the

proposed reforms. At the very least, we'd like to see an impact assessment introduced at the end of the two year first wave of Premium listed LSE companies to adopt the new requirements, before the regulations are rolled-out to all other companies falling within the scope of the PIE definition.

The results of our survey are insightful and compelling and make for interesting reading!

The main findings in graphs:

73%

say reform is needed

64%



say the proposals won't address the issues, and may even make things worse.

23%

Only 23% think the reforms will improve auditor choice.

↓ 20%

Less than 20% believe that AIM companies should be PIEs.



71%

give the proposed changes a thumbs-down for improving brevity and comprehensibility

45%

Only 45% give the government's managed shared audit proposal a thumbs-up.

81%

believe the new PIE definitions will discourage companies to list in the UK.



100%

expect the costs and resources involved in completing an audit to increase.



27%

Only 27% give a thumbs-up to the reforms encouraging greater public trust in accounts.



68%

think that measures to strengthen internal control frameworks will be overly burdensome and restrict entrepreneurship for smaller listed companies.

Will the reforms work?

Despite the recognised need for reform, there is a distinct lack of confidence among respondents that the proposals will get to the root causes of dissatisfaction with the corporate governance regime, or achieve the hoped for corporate reporting improvements in quality, brevity, and trust, or deliver increased auditor choice.



The accounts are incomprehensible to everyone and, as a result, they are of declining interest to all the parties to whom they are supposed to convey useful information.”

Quality:

27%

Only 27% think the reforms will improve audit quality.

Trust:

68%

have no faith that a new statutory requirement to consider wider information within the annual report will result in audits becoming more trusted, more informative and hence more valuable.

73%

are doubtful that the proposed reforms will encourage greater public trust in companies' audited financial statements.

Brevity:

19%

Only 19% think the proposed changes will promote brevity and comprehensibility in accounts and annual reports.

Choice:

73%

don't think the proposed reforms will improve auditor choice, of which 27% think they could make it worse.

Companies are sceptical that managed shared audits will improve choice. On the contrary, it seems likely that the proposal will add yet more complexity and cost into the process, while there seem to be simpler solutions (such as market share caps) that may be more effective.

45%

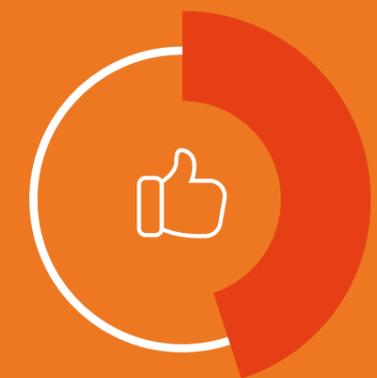
Only 45% give the government's managed shared audit proposal a thumbs-up.



I look forward to seeing how increasing regulations will 'promote brevity and comprehensibility'!”



There's too much extraneous rubbish.”



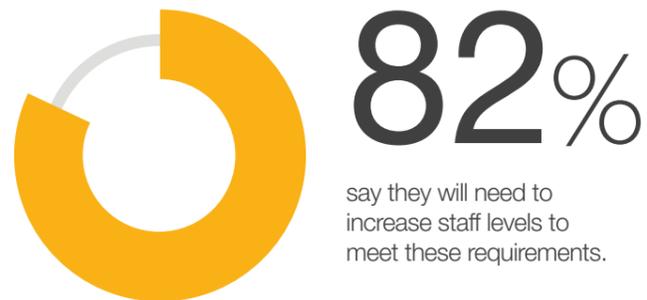
Toil and Trouble

The proposed reforms represent a significant increase in regulations for all businesses, large and small, but particularly for those defined as public interest entities (“PIEs”). PIEs will face a considerable ramping-up of corporate governance and reporting requirements to unprecedented new levels.

The proposals will bolt-on an Internal Controls Statement, a new Resilience Statement, an Audit and Assurance Policy, and more...

“For a company to properly comply and be able to backup these additional statements, which represent a substantial underpinning of new internal planning, controls and procedures, will require a significant increase in the risks and compliance workloads for companies.”

Mark Ling, Head of Capital Markets, PKF Littlejohn



68%

100% believe the proposed changes will increase the cost and internal resources required to complete an audit, with 68% expecting the increase to be significant.



Unfortunately, respondents are not convinced that the game is worth the candle:

“More regulation will increase costs and have little real impact where it is needed.”

“For relatively few, albeit high-impact, failures, the level of proposed reform seems disproportionate.”

This is particularly true for entrepreneurial and growth businesses:

“Regulation is killing business, especially small businesses, with no tangible returns to shareholders.”

“Reforms in corporate governance are much needed, but the ‘one size fits all’ approach in the UK discourages growth and innovation. We need more flexible governance systems, specifically aimed at technology and growth businesses.”

“The government has to be careful not to get the balance wrong: there could be too much extra work for too little added benefit – it’s a proportionality issue.”

Joseph Archer, Partner - Capital Markets, PKF Littlejohn

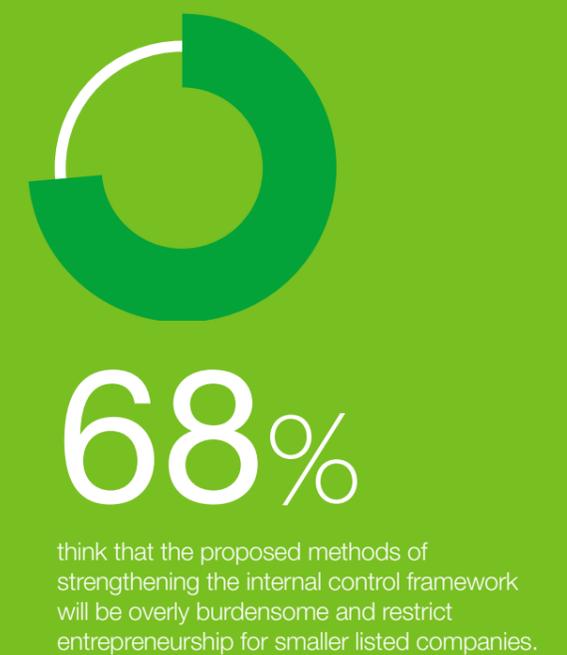
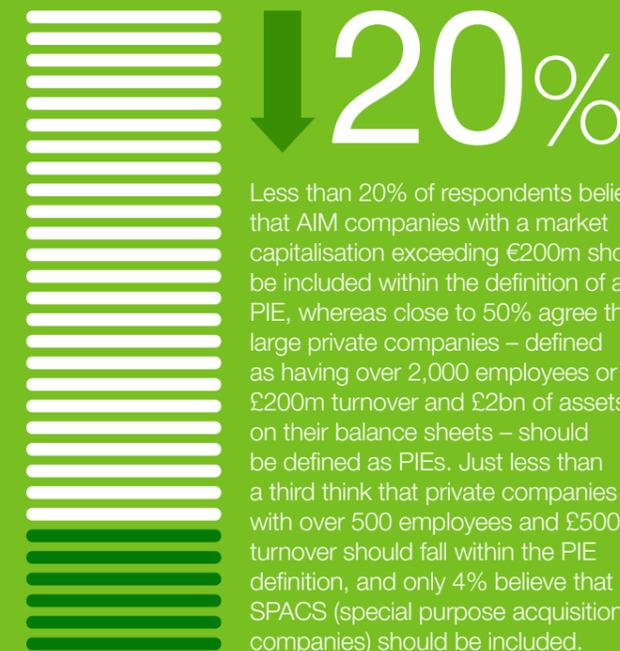
Why the size of the pie matters

One measure under consideration is broadening the definition of Public Interest Entities (“PIEs”) to include a wider range of businesses that are subject to more stringent regulations because they are considered to be of strategic national importance. Currently around 2,000 listed companies, financial institutions and insurers are defined as PIEs, but this is set to increase by at least 50% or even double, under the new regulations.

“The scoping around the definition of a PIE is key to the success or failure of these new reforms. Include too many, smaller companies (judged by head-count as well as market capitalisation) and the new regulatory burdens will be disproportionately onerous compared to the actual reduction in the risk of a business failure considered to be nationally significant.”

Mark Ling, Head of Capital Markets, PKF Littlejohn

Our respondents agree:



“The £200m market capitalisation definition for PIEs brings alot of companies into the scope of the regulations given the risk of a failure that could impact the public. Many in the market are questioning whether a £500m market capitalisation would be far more appropriate.”

Dominic Roberts, Partner - Capital Markets, PKF Littlejohn

To avoid the real possibility of the reforms doing more harm than good, respondents would like to see a phased introduction of the regulations and a corporate reporting system tailored to size and risk potential.

2/3

Two-thirds believe newly listed AIM companies should be given temporary exemptions from PIE requirements so they can become accustomed to the reporting regulations.



82%

agree that a tier system for PIE corporate reporting would be better.



Too much 'box-ticking' is required that distracts companies from focusing on the actual operations and improvement opportunities."



Surely small entities should be exempt from a lot of these requirements."

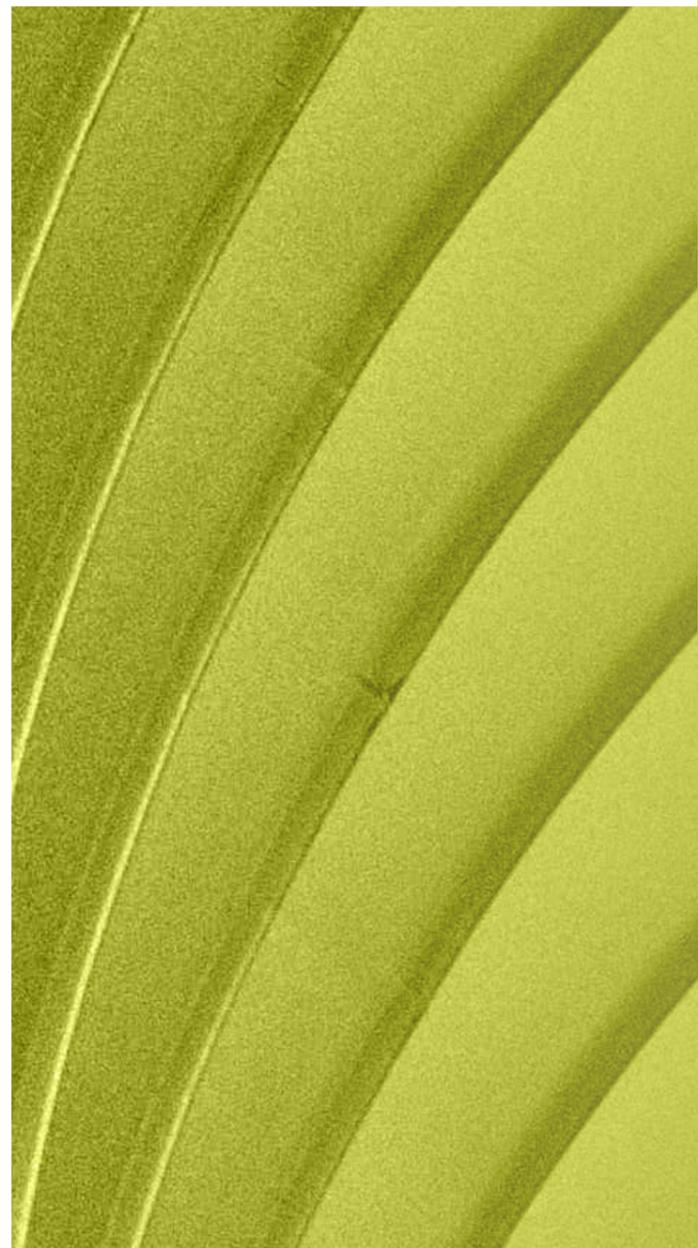
Who wants to be a director?

The proposed directors regime for PIEs will significantly increase the accountability of directors making them more visible, impacting their remuneration and making it easier to prosecute them. But there are real fears that the increased regulatory burden, combined with less reward and greater personal risk will discourage individuals from being directors in future.

“The proposals will severely limit the pool of directors, both executive and non-executive, and will materially increase the cost to compensate for risk.”

“Being a director of a PLC already requires a set of behavioural standards. There should be less regulation, not more.”

“These proposals will increase the cost and complexity for those already compliant with best practice, whilst having a negligible impact on those intent on bad behaviour.”



81%

believe that the enforced inclusion of malus and clawback provisions in directors' remuneration packages would discourage individuals from becoming directors, but...



52%

...only around half believe that the provisions would encourage good behaviour.

“If you are a company director, you should be behaving legally already – these new statements don't add anything significant to a director's existing obligations and responsibilities. The proposals should be viewed holistically, alongside the requirements already present in company law.”

Dominic Roberts, Partner - Capital Markets, PKF Littlejohn

London markets falling down

The increased number of smaller companies that will fall within the scope of the PIE regulations, combined with the increased volume and rigour of the regulations themselves, will encourage companies to look for alternatives to the LSE and AIM.

“If it is too burdensome for a company to list in order to raise finance on the capital markets, many may opt to rely on successive bouts of private equity or overseas investment in order to fund growth. It is vital that the new regulations, in their final form, maintain a range of UK-based options for companies to access capital, which will provide UK investors with exciting investment opportunities in the future.”

Mark Ling, Head of Capital Markets, PKF Littlejohn

81%

say that companies will be discouraged from listing in the UK.



“Companies are drowning in regulation, most of which is never used by stakeholders and for which the cost is making UK listings less attractive.”

“Corporate governance standards for public companies and their directors should be similar to those for private companies, so that the listings markets remain an attractive access to capital. Otherwise businesses will use private equity to access capital until they are huge.”

“For a company that is considering listing on the London markets in the near future, the decision would be easier. By moving its headquarters to another jurisdiction it could avoid falling within the PIE definition and thereby avoid all of the additional regulations.”

It seems counterintuitive to inadvertently encourage entrepreneurial companies to leave the UK at a time when the country will be relying on these businesses to drive economic growth in the post-Brexit, post-pandemic future.”

Dominic Roberts, Partner - Capital Markets, PKF Littlejohn

Given that the proposed regulations will only apply to UK companies, many may think about re-domiciling to avoid them:

1/3

Over a third think that it could encourage existing UK listed companies to re-domicile to avoid falling within the scope of the PIE regulations.



“It would be one factor in a decision to move, not the trigger.”

Next steps:

Our research shows that companies see the proposals' lack of proportionality as a hammer to crack a nut.

While reform is seen to be needed to instil confidence in the UK market, both at a company level and at an auditor level, these proposals don't get to the root causes behind the White Paper which is not just centred on audit, but a more fundamental concern with corporate governance and reporting.

The proposals are not proportionate and will impact all companies equally, inflicting additional burdens and costs on small and mid-cap listed companies on both the LSE and AIM markets as well as larger private companies that don't represent a risk to the UK economy, but are important to the UK economy because of their growth potential. As a result, the negative impact to entrepreneurial companies outweighs the potential benefit of a more robust regulation regime for public interest companies.

In order to make these reforms functional, the government needs to introduce proportionality.

↑80%

Over 80% agree that for companies within the scope of the PIE definition, a tier system would be more appropriate for the expanded corporate reporting requirements instead of the one-size-fits-all approach currently proposed.



"I certainly believe that a tier system should be applied across the board with respect to audit requirements, corporate reporting and accounting standards."

PKF Littlejohn believes that regulations should be proportionate to size and risk. We'd like the proposed reforms rebalanced with the heaviest regulatory burden applying only where the risk of corporate failure is the most important and significant, and we encourage the government to introduce a tier system of corporate reporting and governance.

In particular, we'd like to see a commitment to a strategic impact assessment following the initial two year period in which Premium listed LSE companies will adopt the new measures, before the roll-out to all PIEs. We think this suggestion is proportionate, practical and could prevent the potential negative impacts of the reforms on entrepreneurial companies, as well as the London market.

It is clear that the proposed changes address a far broader range of topics than just audit and auditor choice, and will have a significant impact on companies' corporate governance.

We would urge you to put your views on the proposals and suggestions for how they might be improved, to government, by emailing: audit.consultation@beis.gov.uk

The consultation closes on the 8 July, 2021, so there is still time to make your voice heard.

About PKF

Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

We have a strong reputation with publicly listed companies, and understanding these highly regulated, technically complex businesses has become a specialism of ours. We focus on delivering consistent quality and making all our clients feel valued.

Our specialist capital markets team has vast experience working with companies listed, or looking to list, on a range of international markets including the London Stock Exchange Main Market (Premium and Standard), AIM, AQUIS, NASDAQ & OTC, ASX and TSX & TSX-V.

PKF in the UK...



Ranked 8th largest Audit Practice in the UK in the latest Accountancy Daily rankings



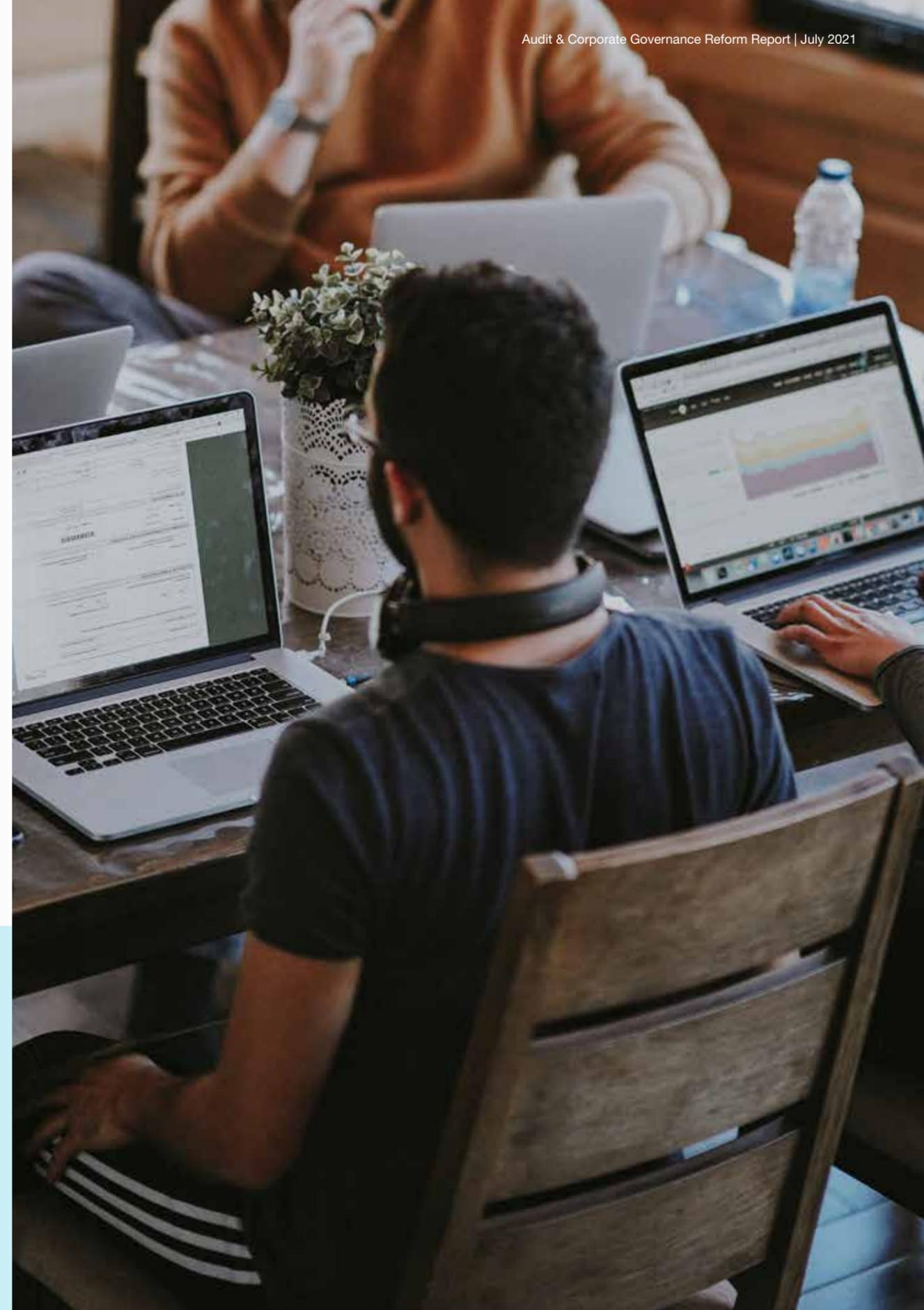
£150 million annual fee income



2,025 staff



6th ranked auditor of listed companies in the UK

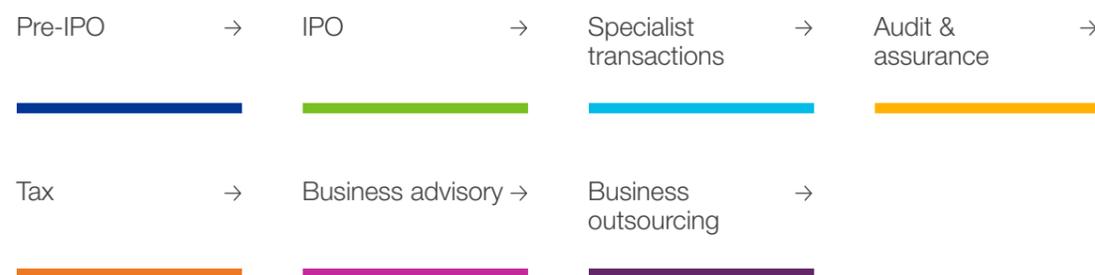


Our Capital Markets credentials

Our auditor rankings from 



How we can help



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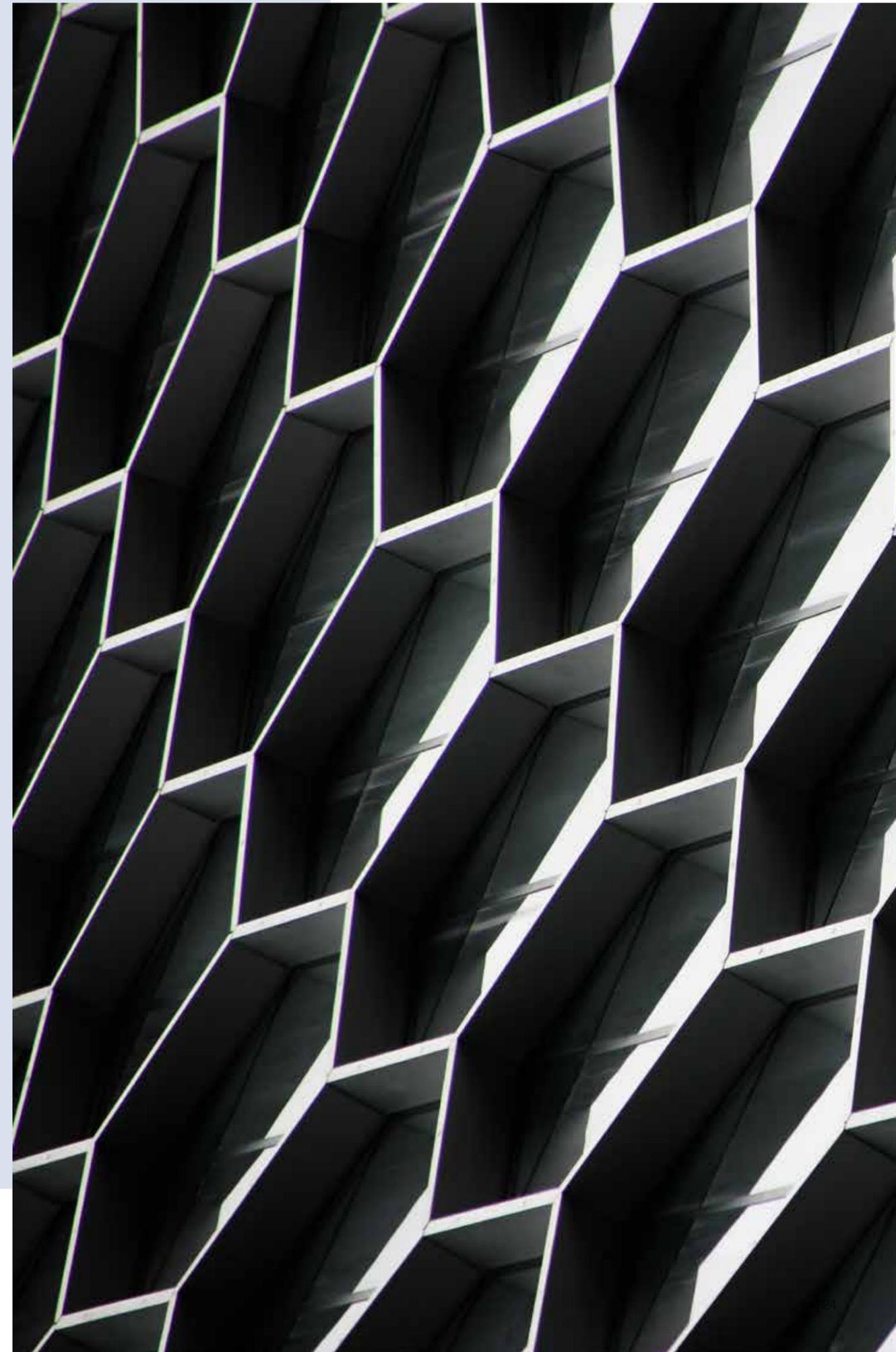
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