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WHEN IT MATTERS MOST

Increasing director accountability: The new Audit Reform and Corporate Governance Bill

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Last month, King Charles III opened the first session of the new parliament by outlining the Labour government's priorities. Among these was the much-anticipated draft Audit Reform and Corporate Governance Bill. It has been six years since Sir John Kingman delivered his independent review of the Financial Reporting Council (FRC), and the call for robust audit reform has remained strong.

The primary goal of the bill is to bolster the trust of investors and the public in the financial practices of major businesses in order to foster economic growth and stability. Recent high-profile debacles such as the collapse of BHS, which resulted in the loss of 11,000 jobs, and the collapse of Carillion, which left 30,000 subcontractors unpaid, £1 billion in debt, and a pension deficit of at least £500 million, have underscored the urgent need for reform.

Currently, only directors who are members of accountancy bodies can be held accountable by the FRC for making incorrect financial statements. This limits the extent and means by which some directors can be held to account for financial misconduct.

The proposed legislation seeks to close this loophole by ensuring that all directors of significant UK companies can be held accountable for their financial reporting and audit duties. There are plans to reform the FRC into a new regulator, the Audit, Reporting and Governance Authority (ARGA) which will have powers to investigate and sanction directors for neglecting their responsibilities, presenting inaccurate accounts or submitting misleading financial statements. These measures are designed to ensure that there are tangible repercussions for directors, thereby deterring misconduct and promoting greater transparency.

Expansion of directors' duties?

Directors owe certain duties as a director of a company, including the duty to act in a way that the director considers, in good faith, would promote the success of the company and the duty to exercise reasonable care, skill and diligence in carrying out their duties as a director.

The duty to promote the success of the company requires directors to have regard to the desirability of the company maintaining a reputation for high standards of business conduct and, in certain insolvency related scenarios, to consider or act in the best interests of the company's creditors.

The duty to exercise reasonable care, skill and diligence is twofold:

1. **The objective standard:** using the general knowledge, skill and experience that may be reasonably expected of a reasonably diligent person carrying out the functions performed by the director; and

2. **The subjective standard:** using the general knowledge, skill and experience of that specific director, meaning that where a director has specific experience or skills e.g. an accounting qualification or financial reporting / audit experience, they will be held to the standard expected of a reasonably diligent person possessing those skills or experience when performing their functions.

As well as regulatory consequences, a director who breaches their statutory duties may face civil consequences including:

- **Derivative Claims:** Shareholders can bring a derivative claim on behalf of the company against the director for breach of duty. This action aims to hold the director accountable and enables the company to obtain redress against the director in question, including payment of compensation or damages.
- **Restitution:** The director might be required to repay any personal profits made as a result of the breach or compensate the company for losses incurred.
- **Disqualification:** Under the Company Directors Disqualification Act 1986, a director can be disqualified for a period of up to 15 years for misconduct, including a breach of duty.

Breaches of duty can also significantly damage a director's reputation, affecting their future career opportunities and business relationships.

The draft Audit Reform and Corporate Governance Bill will compliment and reinforce these existing duties by increasing directors' accountability, particularly in relation to financial statements and internal controls.

Challenges and criticisms of the Audit Reform and Corporate Governance Bill

While the Bill has been generally welcomed, there are challenges and criticisms:

- **Implementation costs:** Companies may face increased compliance costs associated with implementing new governance and audit requirements.
- **Complexity:** Some argue that the reforms could add complexity to the audit process, potentially leading to confusion and increased administrative burdens.
- **Effectiveness:** Critics question whether the reforms will be effective in preventing corporate failures without addressing deeper systemic issues.

Conclusion

The new Audit Reform and Corporate Governance Bill represents a significant step towards strengthening corporate governance and audit practices in the UK. By enhancing accountability, transparency, and resilience, the bill aims to restore trust in the corporate sector and ensure the long-term sustainability of UK businesses. However, its success will depend on effective implementation and ongoing evaluation to address challenges and adapt to changing market conditions.

Further information

If you have any questions or concerns about the topics raised in this blog, please contact Katie Allard or Mei Chung.