

View from the UK: Recent Developments in Brexit and Corporate Governance



David Gottlieb

Partner

London

dgottlieb@cgsh.com



Chrishan Raja

Associate

London

craja@cgsh.com



Dan Tierney

Associate

London

dtierney@cgsh.com

In 2020, businesses operating in the UK will need to grapple with the continued uncertainty caused by Brexit and will need to closely monitor a number of important corporate governance and reporting developments expected in the coming year.

Continued Uncertainty Caused by Brexit

When we first wrote about Brexit-related risks in our 2017 memo, "[The Change in Administration in the United States and Brexit and Political Uncertainty in the United Kingdom and Europe](#)," few would have predicted

that the ensuing political uncertainty would remain at the top of the UK corporate agenda three years later.

2019 saw businesses continue to face elevated levels of political uncertainty in the UK as the minority Conservative Government, led first by Prime Minister Theresa May and then by Prime Minister Boris Johnson, was unable to secure parliamentary support for any form of Brexit.

With the Conservative Party having secured a decisive majority in the House of Commons in the General Election held on December 12, 2019, the key question is whether there is now a light at the end of the Brexit tunnel. While the UK will now almost certainly leave the EU on January 31, 2020, the path from there is still opaque.

If, as we currently expect, the UK leaves the EU substantially on the terms of the revised Withdrawal Agreement that was agreed to with the EU in October 2019, a transition period will apply until December 31, 2020. During this period, EU law will continue to apply in the UK in much the same way as it did pre-Brexit, and so most businesses are unlikely to experience any significant differences in the UK legal framework within which they operate during 2020.

While the pace of corporate governance reforms that we have seen in the UK over the last few years has begun to slow, boards should be aware of some important changes that will begin to take effect this year. In the related audit area, the prospect of significant reform remains very much on the agenda for 2020.

But what the legal framework will look like from 2021 onward is very much still up in the air. In particular, it is not yet clear what the future trading relationship between the UK and the EU will look like, which will depend on the outcome of difficult UK-EU negotiations that are likely to occupy much of 2020. And with Prime Minister Johnson having ruled out any extension to the transition period beyond December 31, 2020—which many consider to be an unrealistic timeframe for the conclusion of trade negotiations of unprecedented scope—there remains a real risk of a “no trade deal” Brexit after this date.

Corporate Governance and Reporting Developments

While the pace of corporate governance reforms that we have seen in the UK over the last few years has begun to slow, boards should be aware of some important changes that will begin to take effect this year. In the related audit area, the prospect of significant reform remains very much on the agenda for 2020.

The Corporate Purpose Debate

In the US, the debate around the role of non-shareholder interests in corporate decision-making accelerated in 2019, most notably with the CEOs of more than 150 major US public companies pledging to act for all of their “stakeholders”—customers, employees, suppliers,

communities—as well as shareholders.¹ A similar debate has also been raging on the other side of the Atlantic, driven most recently by new reporting requirements that will start to apply in 2020.

By way of background:

- The core duty of a director of a UK company² requires the director to act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole. For a commercial company, “success” will typically mean a long-term increase in its financial value. This duty is the UK equivalent to the Delaware duty of loyalty.
- In seeking to promote the success of the company for the benefit of its shareholders as a whole, a director should consider a non-exhaustive list of wider social factors, including the interests of the company’s employees, the need to foster the company’s business relationships with suppliers and customers and the impact of the company’s operations on the community and the environment.
- In the event of a conflict between what would benefit the company’s shareholders and what would benefit one or more of these wider social factors, the interests of shareholders must prevail. Nonetheless, this so-called “enlightened shareholder value” principle obligates the directors of a UK company to take into account the interests of stakeholders other than shareholders in their decision making.

While the enlightened shareholder value principle has formed part of UK corporate law since 2007, critics have complained—particularly following a number of recent high-profile corporate collapses—that some boards are still failing to take into account the interests of their broader base of stakeholders or, at the very least, are failing to do so in a transparent manner.

¹ See Business Roundtable, Statement on the Purpose of a Corporation (August 2019), available [here](#).

² Section 172 of the Companies Act 2006.

In response, the UK government has enacted legislation that will require UK companies that are required to include a “strategic report” in their annual report and accounts³ to include an additional statement describing how the directors have had regard to the wider social factors referred to above (this is referred to as the “section 172(1) statement”).

The Financial Reporting Council (FRC), the current regulator for corporate governance matters in the UK, has proposed a three-pronged disclosure approach, whereby companies should outline:

- The issues, factors and stakeholders the directors have considered and why.
- The main methods of engagement with the company’s stakeholders.
- The effect of having regard to those wider social factors.

This new requirement applies to accounting periods commencing on or after January 1, 2019, so we will begin to see the first mandatory section 172(1) statements in the 2020 reporting season (although some companies have already included voluntary disclosures in their annual report and accounts).

This new requirement will sit alongside the revised UK Corporate Governance Code, which requires companies to effectively engage with their workforces and other stakeholders; and a number of related disclosure requirements that aim to enhance transparency around stakeholder engagement.⁴ Boards will need to reassess whether their existing practices around consideration of the interests of, and engagement with, their stakeholders meet their legal obligations, as well as the expectations of their stakeholders and the public more broadly.

³ Section 414CZA of the Companies Act 2006.

⁴ See Schedule 7, Part 4 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended), which requires directors of certain large companies to make statements detailing how they have engaged with (among others) their employees, suppliers and customers.

Audit Reform

The audit profession and the framework within which it operates has come under sustained attack in the UK, driven by a number of high-profile corporate collapses and scandals, where critics have alleged that the auditors did not adequately identify or flag to stakeholders frauds or underlying financial difficulties in the businesses in question.

In response, three related reviews were completed over the last year:

- The independent review of the FRC,⁵ led by Sir John Kingman (the current Chairman of Legal & General and former senior civil servant at H.M. Treasury), which proposes the replacement of the FRC with a new independent regulator—the Audit, Reporting, and Governance Authority (ARGA)—with a broader remit and stronger enforcement powers.
- The independent review into the quality and effectiveness of audits,⁶ led by Sir Donald Brydon (the former Chairman of the London Stock Exchange), which proposes a large number of significant reforms, including:
 - a refreshed statement of purpose for audits, recognizing its role as a public interest function, and several other proposals around the interests that the company’s stakeholders (beyond shareholders) have in the quality and effectiveness of audits;
 - proposals to enable shareholders to influence the scope of audits and to hold the audit committee and auditor accountable;
 - the creation of a new audit profession, distinct from the accounting profession and regulated by the new ARGA;

⁵ Sir John Kingman, Independent Review of the Financial Reporting Council (December 2018), available [here](#).

⁶ Sir Donald Brydon CBE, Independent Review into the Quality and Effectiveness of Audit (December 2019), available [here](#).

Boards will need to reassess whether their existing practices around consideration of the interests of, and engagement with, their stakeholders meet their legal obligations, as well as the expectations of their stakeholders and the public more broadly.

- proposals to facilitate fraud prevention and detection by directors and auditors;
- the replacement of the core audit opinion from “true and fair” to “present fairly, in all material respects,” given the difficulty in using the former term when corporate reporting increasingly involves more subjective matters, such as the significant use of estimates and judgements; and
- requiring a new section in the audit report in which the auditor confirms whether the directors’ section 172(1) statement reflects observed reality, based on the auditor’s knowledge of the company and its processes.

— The statutory audit services market study⁷ undertaken by the UK antitrust regulator (the Competition and Markets Authority), which highlighted competition concerns in the audit market driven by the dominance of the “Big Four” and made the following key recommendations to address these concerns:

- Mandatory joint audit (with very large companies exempt, as well as those choosing a sole challenger auditor).
- An operational separation between the Big Four’s audit and non-audit businesses.

It is not yet clear which of these proposals will actually make it into law, but the UK government has recently reaffirmed its commitment to enacting reforms to rebuild trust and confidence in audits, and plans to announce the reforms it will adopt early in 2020. Given the significant impact that these reforms will have on financial reporting processes, boards will need to closely monitor developments in this area throughout 2020.

⁷ Competition and Markets Authority, Statutory Audit Services Market Study – Final Report (April 2019), available [here](#).