



Rt Hon Kwasi Kwarteng MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H 0ET

Wednesday 14th July 2021

Dear Dr Kwarteng,

‘Restoring trust in audit and corporate governance’ consultation – R3 response

I write as President of the insolvency and restructuring trade body R3 to share our views on the Government’s proposals to strengthen the UK’s corporate governance framework, as outlined in the “Restoring trust in audit and corporate governance” consultation.

As you know, R3 is the trade association for the UK’s insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround and restructuring experts, students, and others in the profession. Our members work across the spectrum of the profession, from global legal and accountancy firms through to smaller, local practices. Our members have direct experience of insolvencies and their impact on individuals and businesses across the UK.

Although the consultation’s remit does not include insolvency, corporate governance shortcomings are often a significant factor in situations of corporate financial distress and, ultimately, insolvencies. Our members therefore have a unique perspective on a number of the issues raised in the consultation. Indeed, an effective corporate governance framework is as important to the insolvency and restructuring profession as it is to debtors, creditors, and other stakeholders.

In light of this context, we have focussed our comments on those areas of the consultation relating more specifically to the corporate governance framework, rather than the audit-specific reform proposals. In particular, we believe the consultation would benefit from giving greater consideration to two key issues that could help to significantly improve the integrity and efficacy of the UK’s corporate governance framework:

1. Encouraging greater awareness of directors’ duties and supporting directors to fulfil them, as well as improving access to the resources they need to make informed decisions;
2. Ensuring a more comprehensive approach to improving the integrity of the UK’s corporate governance framework.

R3 recognises the importance of ensuring public and stakeholder confidence in the UK’s audit and corporate governance framework. This confidence and trust plays an important role in maintaining the attractiveness of the UK as a place to do business, and crucially underpins the financial security of many tens of thousands of people. We broadly accept the rationale for many of the specific changes proposed in the consultation, but believe further consideration should be given to the points we raise under the two themes above.

Encouraging greater awareness of directors’ duties and supporting directors to fulfil them

Despite focusing predominantly on audit, the consultation also sets out substantial changes to the UK’s corporate governance framework. The consultation outlines proposals to introduce new statutory requirements for corporate reporting, creates additional responsibilities for directors over internal controls, and expands the scope for civil action against directors found to be in breach of their duties. While these reforms would apply exclusively to directors of the largest companies, the consultation sets out plans to revise the definition of public interest entity (PIE) to expand the number of firms that would fall within the remit of these reforms.

The reform plans revolve around the creation of the Audit, Reporting and Governance Authority (ARGA) to replace the Financial Regulatory Council (FRC). Although the Insolvency Service would retain responsibility over directors' disqualification proceedings, ARGA will have powers to investigate and sanction directors for breaches of corporate reporting duties and internal control duties, as well as exiting responsibilities. While we do not object to this specific reform, we do stress the importance of close engagement and collaboration between these two bodies so as to prevent a fragmented and confused approach to the monitoring and enforcement of directors' adherence to their duties and responsibilities.

R3 recognises the Government's desire to restore public trust in the corporate governance framework by bringing about a more robust regulatory regime and greater transparency in corporate reporting. Increasing directors' accountability may well encourage more of them to seek earlier, qualified advice when facing situations of corporate financial distress, which is likely to increase the range of options available to companies to resolve this financial distress and reduce the likelihood of significant corporate failures. At the same time, the greater transparency encouraged by the Resilience Statement could be helpful to insolvency professionals looking to trace the source of a company's financial troubles.

While the focus of this consultation is on the larger end of the corporate spectrum, it remains unclear whether these proposed reforms will lead to increased awareness of directors' responsibilities across the board, especially for directors of SMEs. Although we recognise the Government's focus in this consultation on directors of larger entities, we would suggest a more comprehensive approach to reform of directors' duties and responsibilities would be more effective, given the proportion of SMEs in the business population.

While R3 would argue for such a comprehensive approach, the consultation does draw attention to the links between director conduct and director understanding of duties and responsibilities, and corporate governance and corporate failure.

The insolvency and restructuring profession's experience of director capabilities – across the corporate spectrum – is mixed. While there are some very capable directors, there are others who are ill-equipped to run companies or who do not fully understand the extent of directors' responsibilities and duties.

While developing policies to encourage closer adherence to directors' duties from the offset as set out above is one approach, attention must be paid to the root causes of misconduct – or simple failure to meet these duties – and the Government should also consider ways to improve the skills and knowledge of UK directors. This more rounded approach, which supports directors to carry out their roles more effectively, while also increasing sanctions where their duties are not met, we believe would be a more effective way of dealing with this issue. Doing so would limit the damage done to UK plc by corporate governance failures in a way that would not impair entrepreneurialism.

Director duties in the context of insolvency

R3 believes that directors' knowledge of their duties can be poor, and that while directors are expected to be aware of limitations in their knowledge and to seek professional advice where appropriate, many do not. This is particularly true where a company enters the 'zone of insolvency'.

The insolvency and restructuring profession recognises that there needs to be a trade-off between promoting entrepreneurialism and imposing controls on directors and how they run a company. In the profession's experience, however, the balance struck is not always the right one.

Limited liability affords individuals significant protections from the financial risks and other liabilities a company may incur. This protection comes at a very low cost: a limited company can be created for as little as £12, with no requirement (at present) for new directors to provide identification, and little requirement for new directors to show their responsibilities are understood – until it is too late and those responsibilities are breached. The protection on offer to entrepreneurs is welcome, but there is a question about whether this protection is too easy to obtain – and therefore too easy to abuse.

Where a company's financial problems have been long in the making, R3's members often report that company directors seek advice from an insolvency professional too late, or that advice isn't sought at all. In the profession's experience, the earlier advice is sought, the more options a company has and the more likely it is that it can avoid insolvency and the consequent creditor losses and negative impact on the company's supply chain, employees, and other stakeholders in the approximately 17,000 corporate insolvencies that take place annually.

Directors are already expected to consider whether they need to use professional advice, but they may not be aware of this expectation or they may not be aware they are at a point where advice is needed. The Government must explore ways to improve director awareness and education, and R3 would be happy to work with the Government to do this. One option could be to use directors' regular statutory interactions with Companies House as an opportunity to provide directors with information and reminders of their duties.

R3 believes that closer engagement between the Government and the insolvency and restructuring profession on these issues could play an important role in helping to improving the UK's corporate governance framework and ensuring that directors, regardless of company size, are aware of their responsibilities and are able to access the resources they need to make informed decisions – for the benefit of all stakeholders.

By way of example, as part of R3's 'Back to Business' campaign, we have recently launched a comprehensive resource for company directors that explains how to spot signs of financial distress, the options open to them for resolving it, and where to find sources of regulated advice. The resource:

- provides a one-stop guide to the main options that are available to resolve corporate financial distress;
- explains how the insolvency and restructuring framework and profession can help to rescue viable businesses, save jobs, and repay creditors;
- helps to point directors to qualified and regulated sources of this advice;
- sets out the duties and responsibilities of company directors and the importance of meeting them.

Ensuring a more comprehensive approach to strengthening the UK's corporate governance framework

We welcome the Government's renewed focus on improving the robustness of the UK's corporate governance framework in this consultation. A number of high-profile corporate failures over recent years has damaged public confidence and trust in the UK's audit and corporate governance framework. Increasing directors' responsibilities over internal controls and introducing new corporate reporting standards, coupled with a more active enforcement of this statutory duties through ARGA, could help to bring about greater rigour and transparency to the system. As we have noted, however, such an approach also needs to be matched by a greater emphasis in supporting directors to improve their skills and knowledge.

That said, we would note that this is another consultation that proposes to make significant and wide-ranging reforms to the UK's corporate architecture that comes after a series of other consultations over recent years. In 2018, the Government published its 'Insolvency and Corporate Governance' consultation which focussed on dealing with the aftermath of corporate governance failures. More recently, there have been a total of four consultations on reform of Companies House and the Companies Register, focussed on the operation of the corporate governance framework. This does not include the various audit-specific consultations and reviews that have also taken place over the same period.

Only in recent weeks, the Government has also published the *Rating (Coronavirus) and Directors Disqualification (Dissolved Companies) Bill 2021-22* which, based on proposals in the aforementioned 2018 consultation, makes a targeted but nevertheless important change to the framework, in an attempt to prevent abuse of the company dissolution process by giving the Insolvency Service the power to investigate directors of dissolved companies.

While there are aspects of all of these consultation proposals that we have welcomed, in particular the reforms to Companies House and the introduction of director ID verification, this somewhat ad hoc approach to policy development in this crucially important part of UK plc, risks leading to a disjointed and ineffective framework. Looking at the considerable amount of work undertaken by the Government on this issue in recent years, as well as the range of departments and agencies with a stake in this policy area, we believe that the Government's objective of improving the UK's corporate governance framework would greatly benefit from a more joined-up and holistic approach.

Indeed, and as R3 advised the House of Commons Public Bill Committee which considered the Rating (Coronavirus) and Directors Disqualification (Dissolved Companies) Bill on 7th July, the Government has introduced this legislation to prevent abuse of the dissolution process, while still allowing Companies House to effectively automatically strike-off and dissolve around 94% of the approximate total of 418,000 companies that are dissolved annually, simply for directors' failures to file accounts or confirmation statements. The sheer number of companies struck-off on this way, with little to no examination, points to a potentially wider fraud issue than the Government's limited legislative measure can resolve by itself. While we appreciate that the legislative timetable is particularly busy, a more comprehensive approach would lead to a more complete closure of this loophole.

Given our members' unique perspective on the current efficacy of the UK's corporate governance framework, and their experience in supporting the integrity of that framework by resolving the aftermath of corporate governance failures, we would be keen to discuss with your department the ways in which this expertise can be used to support the Government's efforts in this area.

If you or your officials require any further information, please do not hesitate to get in contact with R3's Public Affairs Manager, Giorgio Buttironi, on 020 7566 4227 or at giorgio.buttironi@r3.org.uk.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Colin Haig'.

Colin Haig
R3 President