# Audit Developments in the UK

by Philip Johnson

**In this article, Philip Johnson looks at the details of the UK audit reviews, what changes can be expected following these reviews and how some changes may bring about new opportunities for audit firms.**

## Background

There has been considerable focus over the last 22 months on the audit profession in the UK. Corporate collapses such as Carillion and more recently Thomas Cook have led to the inevitable question in the media as to where were the auditors? That of course conveniently forgets that the primary focus should be on those responsible for running the companies in question and in particular, the executive directors.

The UK is not alone in putting audit under the microscope. A review into the audit profession is ongoing in the Netherlands and a series of audit related reviews are taking place in Australia. The EU has also commenced its review of the 2014 Audit Directive and Regulation that took effect in 2016.

## UK Audit Reviews

The main audit related reviews in the UK that have recently completed or are still in progress are:

1. The Kingman Review of the Financial Reporting Council (FRC);

2. The Competition and Markets Authority (CMA) Market Study of the Audit Market;

3. The Brydon Review; and

4. The Department for Business, Energy and Industrial Strategy (BEIS) Parliamentary Committee 'Future of Audit' review

### 1. The Kingman Review

Sir John Kingman was tasked in April 2018 by the then Secretary of State for Business, Energy and Industrial Strategy (BEIS), to lead a root-and-branch review of the FRC. Sir John's report to government was published in December 2018 and he recommended that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers and that it should be called the Audit, Reporting and Governance Authority (ARGA). Additionally, he recommended that:

- The new regulator's proposed strategic objective should be "To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards."

- It should comprise a new (significantly smaller) board with some, but limited, continuity with the existing board and its sub-board structure should be simplified.

- It should not seek to be "representative" of stakeholder interests.

- It should publicly report Corporate Reporting Review findings and should develop a new capability to offer pre-clearance on interpretation of accounting standards.

- It should develop a robust market intelligence function to identify emerging risks at an early stage.

- It needs to be able to act quickly where potentially serious problems are indicated and take further action if necessary.

- It should work towards publishing individual audit quality inspection reports, including gradings in full.

- It needs to engage at more senior level in a much wider and deeper dialogue with UK investors.

- It must be able to recruit staff of the calibre, expertise and seniority necessary to hold those regulated to account.

- It should develop a pool of 'grey panthers' whose expertise could be drawn on when needed.

- Government should review the definition of a Public Interest Entity (PIE) and working with

the new regulator, develop detailed proposals for an effective enforcement regime for PIEs that holds all relevant directors, not just members of professional bodies, to account for their duties to prepare and approve financial statements and to deal openly and honestly with auditors.

- Government should introduce a duty of alert for auditors to report viability or other serious concerns.
- BEIS should put in place a statutory levy (increased funding will be required).
- BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from the US Sarbanes-Oxley regime (Proportionality is key).

Some of these recommendations are already being taken forward by the FRC. Others require the introduction of primary legislation. The first Government consultation on certain of these proposals ended on 11 June 2019 and more consultations are expected. The envisaged impact is a much more powerful regulator that will seek to exercise greater powers over both corporate UK and also the larger audit firms. The FRC's new leadership team: Chief Executive, Sir Jon Thompson (formerly the CEO of HMRC), and Chairperson, Simon Dingemans (formerly Chief Financial Officer at GlaxoSmithKline plc), are now in post. They will lead the transition to ARGA.

## 2. CMA Market Study into the UK Audit Market

The CMA issued its final report on its market study into the audit market in April 2019. It decided not to undertake another full market investigation (as it had in 2011-13). As a direct consequence of this decision the CMA cannot utilise its powers to enact legislation but rather only make recommendations to Government.

The CMA reported that it had identified the following problems with the audit market:

- Issues of a regulatory nature;
- companies select their own auditors and audit committees are only a partial solution to this problem;
- a high level of concentration among the Big Four, resulting in limited choice and a market that is not resilient; and
- audits being carried out by firms whose main business is not in audit.

To seek to address these problems the CMA proposed the following primary remedies:

### i. Robust regulatory oversight of audit committees.

Greater scrutiny by the new regulator is intended to increase accountability of audit committees. This recommendation consists of three elements that would require the regulator to have the power to:

a. mandate minimum standards for both the appointment and oversight of auditors;

b. monitor compliance with the minimum standards; and

c. take remedial action where necessary.

It is intended that this remedy would initially apply to all FTSE 350 companies, although the CMA envisages that at a later date consideration could be given to expanding its scope.

### ii. a. The introduction of Mandatory joint audit

This would apply to FTSE 350 companies and one of the joint auditors should be a non-Big Four firm. There should be initial limited exceptions, based on criteria set by the regulator – mainly the largest and most complex companies would be exempt.

Any company choosing a sole challenger auditor would also be exempt. The introduction of joint audit is intended to be gradual and no proposed change to the UK auditor liability regime is proposed. Additionally, audits of companies exempted from the joint audit requirement may be subject to real-time peer reviews from a non-Big Four firm (except in rare circumstances where a Big Four firm may be used) commissioned by and reporting to the regulator.

Companies should make the transition to joint audit no later than when their next tenders arise.

**ii. b. The regulator should monitor the health of the audit firms.**

It should work with the firms' management to keep abreast of developments. If it became apparent that a Big Four firm was in distress or likely to fail, with audit contracts and staff moving to the remaining Big Three, the regulator should use additional powers and/or take executive control of the distressed Big Four audit firm to limit the movement of clients to the other Big Three, while maintaining audit quality. This remedy aims to preserve choice if a Big Four firm were in distress or approaching failure and ensure that as many as possible of the audit clients of a distressed Big Four firm were transferred to a new firm, a challenger firm, or remain within the same firm while a turnaround was implemented.

**iii. Operational split between the Big Four's audit and non-audit businesses**

This remedy would require the Big Four (other firms might be included at a later date) to put in place a strong strategic and operational split between their audit and non-audit services practices.

The regulator should be given the powers to design the specific details of the remedy and refine it over time. The key elements of the operational split are likely to be as follows:

- No profit-sharing between the audit practice and the non-audit practice, with audit partner remuneration linked to the profits of the audit practice only.
- Separate financial statements for the audit practice, consisting of a profit and loss statement for the audit practice.
- Transparent transfer pricing, checked by the regulator, particularly for the use of non-audit specialists on audits.
- The audit practice should also include audit-related services, such as various regulatory reporting requirements that regulators regard as being best carried out by companies' auditors.
- A separate CEO and board for the audit practice, populated by a majority of independent non-executives, who should be answerable to investors in audited companies, and to the public interest via the regulator.
- The audit board should be responsible for all remuneration and career progression decisions within the audit practice.

If it proves impossible to complete an operational split that delivers the expected improvements, the CMA has stated that a re-examination of the merits of a full structural split in the UK would be necessary. Additionally, the CMA proposed that the government and the regulator could consider introducing a deferred compensation and clawback regime for senior audit staff and partners.

**iv. A five-year review of progress by the regulator.**

The regulator should be required to review and assess the effectiveness of the remedies over this horizon. The CMA appreciates that the assessment of the effectiveness of joint audit would take longer.

It must be emphasised that many in the corporate sector do not support the measures proposed. The UK Government has yet to respond to the recommendations, but some aspects are being considered by the BEIS Parliamentary Committee – see below.

## 3. Brydon Review

Sir Donald Brydon, Chair of the Sage Group is currently leading an independent review, looking at audit as a product and what audit should be in the future. The review was commissioned in response to the perceived widening of the "audit expectations gap" - the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail. Recent company failures have brought this gap into greater focus.

### Objectives

The Independent Review is examining the existing purpose, scope and quality of statutory audit in the UK, in order to determine:

a. the needs and expectations of users of financial and non-financial corporate reporting;

b. how far the audit process and product may need to improve and evolve to meet the needs of users and to serve the wider public interest;

c. what specific changes to the statutory audit model and wider regulatory framework for audit may be needed to deliver this, including any changes to company law; and

d. whether other forms of business assurance should be developed or enhanced to enable shareholders and other stakeholders to assess better the future financial prospects and sustainability of companies.

The primary focus of the review is on PIEs, but it intends to be mindful of the impact of any recommendations on smaller and non-listed entities. It will also consider how the audit product should be developed to take account of changing business models, new technology and stronger public expectations.

To assist his review, Sir Donald established advisory panels on business, audit and technology. A consultation was launched in April 2019 which ended in June 2019.

This explored a range of matters that included:

- Who are the stakeholders?
- Is the scope of audit still appropriate and is it meeting existing requirements?
- Should the UK consider introducing something similar to the US Sarbox regime on internal controls?
- Should auditors be providing assurance over more areas of the annual report?
- Is more required of auditors in relation to their assessment of whether an entity is a going concern or indeed an entity's viability statement?
- What impact is technology having and indeed what further impact will it have?
- Is there a need for reform of the Auditor liability regime?
- Are more informative audit reports required (graduated auditor reports)?
- What is the auditor's role in relation to a company's capital maintenance?
- Should external auditors make greater use of the work of internal auditors?
- What is the auditor's role in relation to the detection of fraud?

Sir Donald Brydon will report to the BEIS Secretary of State by the end of the year. It is not yet clear whether that report will be made public or indeed whether it will be his final report. Recently he specifically highlighted that he hopes his review will address concerns about IFRS and capital maintenance.

## 4. BEIS Parliamentary Committee – Future of Audit

The BEIS Parliamentary Committee undertook an inquiry into the future of audit and its main recommendations published in April 2019 were:

- Consideration should be given to how the scope of audit might be widened to give the auditor more opportunities to express forward-looking opinions.
- To support the CMA's proposal to increase regulatory oversight of audit committees to ensure that audits are independent, robust and free of bias towards the Big Four. If this does not work, independent appointment of auditors by the regulator should be considered.
- To propose the introduction of a segmented market cap and the use of joint audits, on a pilot basis, for the most complex audits to enable the so called challenger firms to step up.
- All company directors, regardless of their professional qualification, should be accountable for their performance and liable to the regulator's sanctions, including if company reporting falls short of the required standards.
- To welcome the Government's commitment to consider and consult on the possible introduction of a strengthened framework around internal controls on a similar basis to Sarbanes-Oxley.
- Companies should be required to disclose the balance of distributable reserves in the annual accounts and break down profits between realised and unrealised.

The Committee continues to monitor developments.

## 5. FRC – Other Developments – Changes to Auditing and Ethical Standards

The FRC has also been consulting on proposed revisions to its Ethical Standard and certain of its International Standards on Auditing (ISAs) (UK). The FRC has already strengthened ISA 570 'Going Concern'. These revisions include requiring greater work on the part of the auditor to more robustly challenge management's assessment of going concern, as well as a new reporting requirement for the auditor of PIEs, listed and large private companies to provide a clear, positive conclusion on whether management's assessment is appropriate, and to set out the work they have done in this respect. The changes to the FRC's Ethical Standards and other ISAs (UK) have yet to be announced but it is expected that auditors will be prohibited from providing non-audit services (subject to a small list of permitted services) to certain audit clients (scope to be determined).

## 6. Conclusion

In conclusion, the audit review situation remains very fluid in the UK. However, hopefully by next year there will be more clarity as to what changes one can expect to be introduced. It has to be hoped that a holistic assessment will be made of all the proposed changes emanating from each of the respective reviews to ensure their compatibility and reduce the risk of any unintended consequences.

Whilst many might see challenges ahead, some of the revisions may offer new opportunities for audit firms and encourage persons to remain within the profession or indeed to join it. Furthermore, the impact of technology will have an even greater impact in the years ahead.

**Philip Johnson ,**

*ICAS Council Member and Past President of Accountancy Europe*