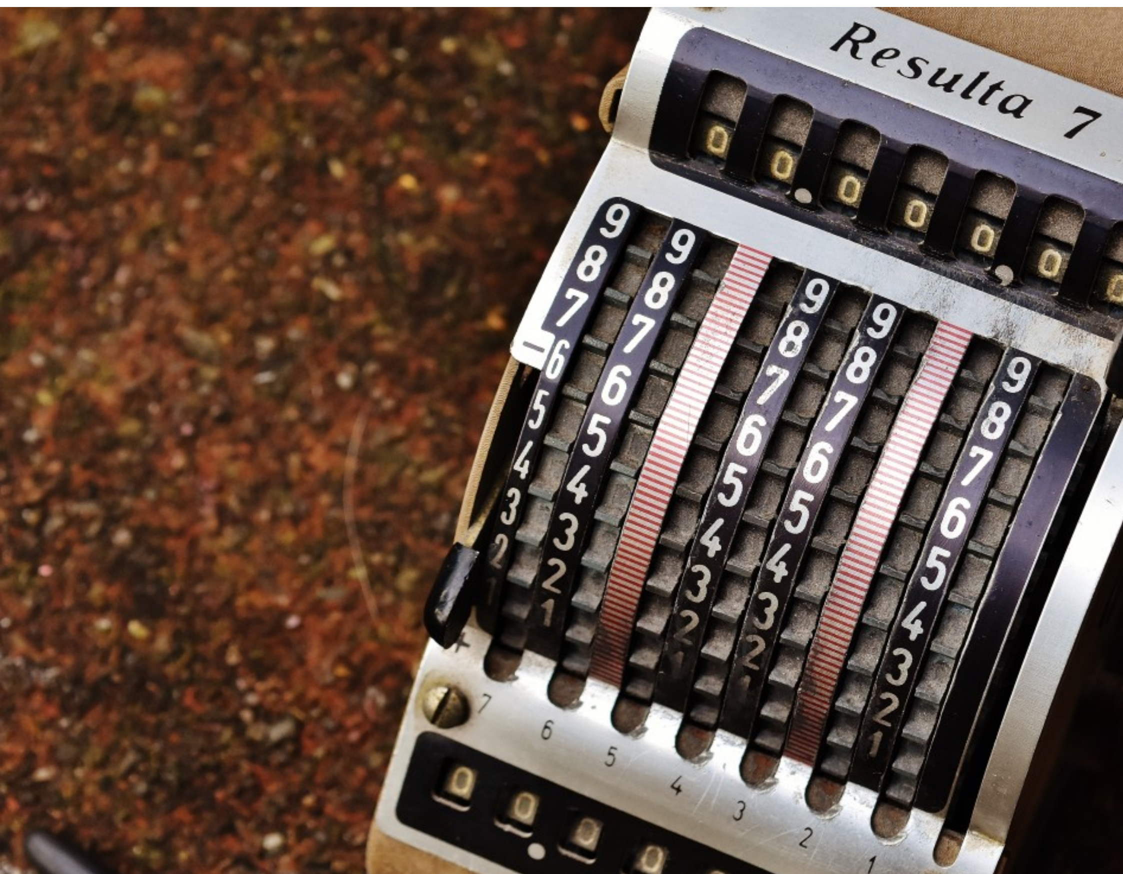
HOUSE OF COMMONS
LIBRARY

BRIEFING PAPER

Number 8385, 10 January 2019

Company audits: problems and solutions

By Federico Mor



Contents:

1. Audit basics
2. Problems and solutions
3. Reform

Contents

Summary **3**

1. Audit basics **4**
1.1 Why are accounts wrong? 4
1.2 What does the law require? 5
1.3 What are audits for? 5
Audit expectation gap 7
1.4 Who must be audited? 7
1.5 Who regulates the auditors? 8
1.6 What standards and who sets them? 8
1.7 The Big Four 9

2. Problems and solutions **10**
2.1 Lack of competition 11
2.2 Conflicts of interest 13
2.3 Quality and supervision 16
2.4 Accounting standards 20

3. Reform **23**
3.1 BEIS insolvency and corporate governance consultation 23
3.2 CMA audit market study 23
3.3 Kingman Review of the FRC and audit procurement 25
3.4 Future of audit – Brydon Review 26
3.5 BEIS Committee inquiry 28

Cover page image: CC0 Creative Commons, no attribution required

Summary

An annual audit is a statutory requirement for all listed and large companies. The purpose of the audit is to provide **assurance to shareholders that the financial statements give a true and fair view** of the company. Good audit, though, doesn't just protect shareholders, but also employees, pensioners, suppliers, customers and the wider community. At the broadest level, it serves the public interest by underpinning transparency and integrity in business.

Accounting and audit failures periodically turn the spotlight on a range of problems with the industry, and the audit of large companies in particular. Key problems include:

- **Lack of competition**: the 'Big Four' accountancy firms dominate the market and they are 'too few to fail'.
- **Conflicts of interest**: auditors can be caught between the interests of the company's management, their own interest, that of their firm and their duties as auditors.
- **Poor quality and inadequate purpose**: too many audits are found to be wanting by the regulator, and fail to meet wider expectations.
- **Weak regulation and supervision**: the regulator lacks resources, power and independence.
- **Lack of prudence in the accounts**: accounting standards have evolved in a direction that permits or encourages less prudent accounting.

There are different solutions to these problems, but there is no one silver bullet that can solve them all.

Momentum for reform has gathered pace. The following strands of work are discussed in this briefing:

- Measures by the Competition and Markets Authority (CMA) to increase competition and focus competition on quality rather than price.
- The creation of an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers (Kingman Review).
- Strengthening the UK's framework in relation to capital protection and dividend payments (government consultation).
- An independent review of the purpose and future of audit (Brydon Review).

1. Audit basics

The **company prepares** the accounts. The **auditor** expresses an **informed opinion** on whether the accounts are true and fair.

Directors are responsible for the accounts of their company. The accounts are usually signed by the Finance Director (or CFO), but they are normally prepared by specialised financial reporting teams with input from managers across the company. Accounts must give a true and fair view, and companies must also follow suitable accounting standards.

It is the job of the auditor to verify that the accounts are true and fair, and that the standards have been applied properly. To do so, auditors work closely with the company's managers (hereafter "management"), who supply them with evidence and explanations. The closeness of this relationship is both a strength (enabling an efficient and effective audit) and a weakness (diminishing the auditor's ability and willingness to challenge management).

Most company accounts are assumed to be reliable, but sometimes they are revealed to be spectacularly wrong or misleading. A famous case is that of Enron, the US energy giant that collapsed in 2001 on the back of large-scale accounting fraud.

1.1 Why are accounts wrong?

The reasons behind accounting "misstatements" range from simple error to serious fraud and anything in between. The reasons in between are mostly to do with incentives on management to achieve certain targets or pressure to hide problems.

Many areas of accounting involve a degree of judgement. Often, there will be a range of acceptable views, for example, on the value of a company's stock or the likelihood of recouping money from debtors. These judgements can have a significant impact on the final profit figure of the company. And so, the temptation to "massage" the accounts can be strong, and judgement can conceal a fine line between bending the rules a little and breaking them.

Accountancy firm EY's 12th Global Fraud Survey (2012) asked 372 Chief Financial Officers (CFO) whether they thought certain actions could be justified if they helped a business survive an economic downturn. The result was:

- 47% of CFOs felt one or more of these questionable actions could be justified to help the business survive
- 15% would be willing to make cash payments to win or retain business
- 4% viewed misstating a company's financial performance as justifiable to help a business survive

Asked whether they thought that company management was likely to cut corners to meet targets, 52% of CFOs agreed.[1]

[1] EY, 12th Global Fraud Survey, 2012, pp12-3

1.2 What does the law require?

Directors must ensure that the accounts **give a true and fair view**.

Auditors must state whether the accounts give a true and fair view.

Section 393 of the *Companies Act 2006* requires accounts to "**give a true and fair view** of the assets, liabilities, financial position and profit or loss" of the company. The company directors must not approve the accounts unless they are satisfied that they give a true and fair view.

Part 16 of the *Companies Act 2006* sets out requirements for audited accounts, the appointment and removal of auditors, their functions and their liability. Section 495 says that the auditor's report on the accounts "must state clearly whether, in the auditor's opinion, the annual accounts give a true and fair view" and "have been prepared in accordance with the requirements of this Act".

An important requirement of the Act is known as the '**capital maintenance regime**' (Part 23 Distributions). Companies can only pay dividends out of past, realised profits available for distribution in the company's 'distributable' reserves (section 830 and 831). Distributions to shareholders must be justified by reference to 'relevant accounts' (sections 836 - 839). The relevant accounts are normally the company's last annual accounts (836(2)).

The accounts are used to justify paying out dividends.

A company can only rely on its annual accounts to make a distribution if they have been "properly prepared" in accordance with the provisions of the *Companies Act 2006* (section 837(2)). Unless the company is exempt from audit (see 'Who must be audited'), the auditors must have made their report on the accounts (837(3)).

If the auditor expresses a negative opinion on the accounts, a company cannot rely on its annual accounts to justify a distribution without a further opinion from the auditor on the effect of the matters at issue on the ability of the company to make a distribution (837(4)(a)).

Distributions also need to be compatible with the fiduciary and other duties of directors:

> Thus, directors should consider both the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due. In reaching their decision they must take into account any change in the financial position of the company after the balance sheet date of the relevant accounts and the future cash needs of the company.[2]

1.3 What are audits for?

The main principles and objectives of audit are laid out in International Standard on Auditing (ISA) 200:

> The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the

[2] ICAEW, Guidance on realised and distributable profits under the Companies Act 2006, April 2017, para. 2.3A

> financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.[3]

Two key words are worth unpacking, 'material' and 'opinion'.

Materiality

The concept of materiality means that accounts do not have to be 100% true and accurate. In fact, most sets of accounts are likely to contain small errors considered to be immaterial. An error is material if it is likely to matter to the users of the accounts (e.g. shareholders and lenders):

> In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.[4]

Auditors set materiality thresholds for the companies they audit. These thresholds are used both in planning the scope of the audit work (the aim is to have a good chance of finding errors above the threshold) and in evaluating results (errors below the threshold will normally not affect the auditor's opinion).

To give an example, Tesco's auditor, Deloitte, set materiality at £50 million for Tesco's 2017/18 group accounts:

> The materiality that we used for the Group financial statements was £50m (2016/17: £50m) which equates to 4.4% of profit before tax before exceptional items.[5]

Opinion

Second, note that the auditor provides an opinion, not a guarantee or a fact. It is an informed opinion, but it is not expected to be infallible:

> As the basis for the auditor's opinion, ISAs (UK) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.[6]

---

[3] FRC, ISA 200, June 2016, p2
[4] FRC, ISA 200, June 2016, p3
[5] Deloitte, Independent auditor's report to the members of Tesco PLC, in: Tesco, Annual Report and Financial Statements 2018, 10 April 2018, p68
[6] FRC, ISA 200, June 2016, p3

Audit expectation gap

It has been shown that the public expects a lot more of auditors than what they are officially tasked with and can reasonably achieve at an affordable cost. This difference is known as the "**audit expectation gap**".[7] A well-documented expectation gap relates to fraud detection.[8] Auditors do not and cannot prevent or stop all fraud in a company; rather, they must stand a good chance of detecting major fraud of a material amount.

The public expects more of auditors than what they are tasked with and can reasonably achieve at an affordable cost.

The expectation gap might in part stem from the value and importance of audit to wider stakeholders. Good audit doesn't just protect shareholders, but also employees, pensioners, suppliers, customers and the wider community. At the broadest level, it serves the public interest by underpinning transparency and integrity in business, as put by the Financial Reporting Council itself:

> Narrowly defined, audit provides assurance to shareholders on the truth and fairness of an entity's reported performance and position set out in its financial statements. The societal purpose of audit goes beyond this and serves the public interest. Audit facilitates investors and other stakeholders, including the general public, in forming views about an audited entity based on trustworthy information. Accordingly, audit underpins transparency and integrity in business.[9]

1.4 Who must be audited?

The *Statutory Audit Directive 2006/43/EC* requires 'public-interest entities' (PIEs) in EU member states to have their annual accounts audited. Public-interest entities are broadly defined as listed companies, credit institutions and insurance undertakings. Member states are free to make audit mandatory for other entities too, for example, large private companies.

Listed companies and large private companies must be audited annually.

The Directive is implemented in the UK by the *Companies Act 2006*. Section 475 requires all companies to have their annual accounts audited unless the company can and does avail itself of one of these exemptions:

- Small companies (section 477)
- Subsidiary companies (section 479)
- Dormant companies (section 480)

The auditor's opinion is published in the company's annual report and accounts. For example, here is the Independent auditor's report to the members of Tesco PLC.

[7] Brenda Porter et al., Report On Research Conducted In The United Kingdom And New Zealand In 2008 Investigating The Audit Expectation-Performance Gap, September 2009
[8] Ibid., p15
[9] FRC, Audit Culture Thematic Review, May 2018, p4

1.5 Who regulates the auditors?

As the competent authority for audit in the UK, the **Financial Reporting Council** (FRC) is responsible for, among other things:

- Public oversight of statutory auditors
- Setting criteria for determining the eligibility of persons for appointment as statutory auditors
- Monitoring of statutory auditors and audit work by means of inspections
- Investigations of statutory auditors and audit work; and imposing and enforcing sanctions[10]

The FRC carries out regular audit quality reviews, and publishes lists of its enforcement sanctions against auditors.

A Government-commissioned review of the FRC has recommended that the FRC be replaced with an independent statutory regulator called the Audit, Reporting and Governance Authority. The review and recommendations are discussed in section 3.

1.6 What standards and who sets them?

There are two sets of standards that are fundamental to the work of auditors: **accounting standards** and **auditing standards**.

Accounting standards prescribe how particular types of transactions and events should be reflected in company accounts. Companies must follow suitable accounting standards, and auditors verify that the standards have been applied properly. A key goal of accounting standards is to ensure that financial reporting "reflects economic reality and hence provides a true and fair view".[11] Another is to increase consistency across companies.

The FRC is responsible for issuing accounting standards in the UK[12], but the international financial reporting standards ("IAS" and "IFRS") that most large and all listed UK companies adopt are set by the International Accounting Standards Board (IASB) of the IFRS Foundation. As of April 2018, 144 jurisdictions require IFRS Standards for all or most listed companies, including all EU countries. The major exception is the United States, which uses its own national standards.[13]

Although international standards do not have any direct impact on national accounting requirements, they often influence their development and result in a convergence of national rules.

Similarly, the International Auditing and Assurance Standards Board is the independent body that sets international standards for auditing. Their International Standards on Auditing (ISAs) are adopted with minor modifications by the FRC.

---

[10] FRC, Roles and Responsibilities, June 2017, p1
[11] FRC, Foreword to Accounting Standards, March 2018, p1
[12] FRC, Roles and Responsibilities, June 2017, p4
[13] IFRS, Analysis of the IFRS jurisdiction profiles, updated 25 April 2018

1.7 The Big Four

The "Big Four" refers to the four largest accountancy firms in the world: **PwC**, **Deloitte**, **EY** and **KPMG**.

The table below shows the audit and non-audit income of the six largest accountancy firms in the UK. The income of the Big Four is multiple times that of the next two players, BDO and Grant Thornton. For example, the average audit income of the Big Four is almost four times BDO's, and total income is almost six times BDO's.

UK FEE INCOME OF LARGEST ACCOUNTANCY FIRMS, YEAR ENDED 2017

Firm	No of PIE Audit Clients	Audit (£m)	Non-Audit Work to Audit Clients (£m)	Non-Audit Clients (£m)	Total Fee Income (£m)
PwC	533	676	351	1,975	3,002
KPMG	464	548	221	1,403	2,172
EY	287	442	229	1,677	2,348
Deloitte	337	418	214	2,309	2,941
BDO	100	151	68	237	456
Grant Thornton UK	69	133	55	312	500

Source: FRC, Key Facts and Trends in the Accountancy Profession, Figure 33, July 2018

It is also worth noting that audit work only contributes a minor share of the total fee income of these firms – between 15% and 30%.

The dominance of the Big Four is almost total at the top end of the market. The Big Four audit 99% of FTSE 100 companies, and 97% of FTSE 250 companies.

FTSE 350 AUDIT CLIENTS BY ACCOUNTANCY FIRM, YEAR ENDED 2017

Firm	No of FTSE 100 Audit Clients	No of FTSE 250 Audit Clients	Total FTSE 350 Audit Clients
PwC	35	66	101
KPMG	26	59	85
Deloitte	21	68	89
EY	14	48	62
BDO	1	3	4
Grant Thornton UK	0	4	4

Source: FRC, Key Facts and Trends in the Accountancy Profession, Figure 38, July 2018

2. Problems and solutions

High-profile failures such as that of BHS in 2016 and Carillion in 2018 have drawn attention to various audit problems, some longstanding. PwC was fined £10 million (reduced to £6.5m for early settlement) in relation to its audit of BHS, and the partner in charge of the audit received a 15-year ban from auditing.[14] The FRC is investigating KPMG's audit of Carillion:

> The investigation […] will consider whether the auditor has breached any relevant requirements, in particular the ethical and technical standards for auditors. Several areas of KPMG's work will be examined including the audit of the company's use and disclosure of the going concern basis of accounting, estimates and recognition of revenue on significant contracts, and accounting for pensions.[15]

The Work and Pensions Select Committee and the Business, Energy and Industrial Strategy Select Committee worry that audit quality is too often too low.[16]

The FRC carries out annual audit quality inspections of statutory auditors. In its latest inspection of KPMG audits, it found that half of the firm's FTSE 350 audits required improvements, against an FRC target of no more than 10% in 2018/19. The FRC commented:

> The overall quality of the audits inspected in the year, and indeed the decline in quality over the past five years, is unacceptable and reflects badly on the action taken by the previous leadership, not just on the performance of front line teams. Our key concern is the extent of challenge of management and exercise of professional scepticism by audit teams, both being critical attributes of an effective audit […].[17]

As of 2018, none of the Big Four audit firms meet the 2018/19 target of no more than 10% of FTSE 350 audits requiring improvements, although PwC and EY are close.[18]

Below we look at the main problems that are thought to afflict auditors and the audit market. These problems can be grouped under four broad categories. Critics of the current state of affairs share the same end goal of raising the quality and robustness of audits, but don't always agree on the diagnosis or prescribe the same solutions.

---

14 FRC, Sanctions against PwC and former audit partner in relation to BHS, 12 June 2018

15 FRC, Investigation into the audit of the financial statements of Carillion plc, 29 January 2018

16 See for example: Carillion joint report, 16 May 2018

17 FRC, KPMG Audit Quality Inspection, June 2018, p4

18 See FRC's audit inspection public reports.

2.1 Lack of competition

The Big Four dominate the market and they are "too few to fail".

In the game of auditing very large companies, there really are only four players. 98% of FTSE 350 companies and 99% of S&P 500 companies are audited by the Big Four.[19]

If four seems to leave just about enough choice and competition, the reality is that the Big Four would rarely all compete for the same audit contract. Most often, a variety of conflicts of interest preclude one or more of the Big Four from tendering.

Article 5(1) of the *Audit Regulation* lists the services that firms are not allowed to provide to their audit clients, including internal audit, tax, accounting, payroll, legal, HR and valuation services. So, for example, it is not possible for an audit firm which currently provides internal audit or tax advice to bid for the external audit contract of the same company. The consequence is that **there aren't four to choose from, but often two or even just one**, as reported by the *Financial Times*:

> While situations where conflicts restrict large companies to considering at best two, or in some cases one, of the Big Four are rarely public knowledge, they are relatively routine. Last month, for instance, the building products supplier SIG appointed EY after its existing auditor Deloitte was unexpectedly ejected by the shareholders. EY was the only one of the Big Four eligible to compete.[20]

In such circumstances, the Big Four have all become systemically important – '**too few to fail**'. If one were to fold or withdraw from the audit market, it would spell all but the end of competition in the FTSE 350 audit market.

The dominance of the Big Four is a concern to many, and it is not new. In fact, the Big Four became so in 2002, when Arthur Andersen, one of the then Big Five, collapsed. But so far, policymakers and regulators have not been sure what to do about it. Most recently, two Select Committees raised the issue with the FRC as part of their joint Inquiry into Carillion. The FRC shares the Committees' concerns and is involving the regulator in charge of competition, the Competition and Markets Authority (CMA):

> We share many of the concerns expressed by the Committee about concentration in the audit market and, in particular, the dominance of the Big 4. The failure of a firm could have serious implications for confidence in the capital markets. It is also worth noting that at present the loss of an audit contract gives a firm an opportunity to pick up better remunerated consulting work. The market does not therefore fully incentivise high quality performance. We have a responsibility to monitor these risks but do not have powers to intervene. We have therefore raised the issue with the CMA who are considering the matter. Working with the CMA we will consider whether any of the audit regulations could be changed to reduce concentration in tandem with competition measures.[21]

[19] FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018
[20] FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018
[21] FRC, Response to Carillion Select Committee letter, 3 July 2018

But it wasn't very long ago (2013) that the CMA's predecessor, the Competition Commission (CC), published the final report of its Statutory audit services market investigation.

The Competition Commission had concluded that:

> […] companies are offered higher prices, lower quality (including less sceptical audits) and less innovation and differentiation of offering than would be the case in a well-functioning market.[22]

The main remedy the CC pursued was an obligation to put statutory audit engagement out to tender at least every ten years. Another was to prohibit "Big Four clauses" in loan agreements (where lenders make it a condition of the loan that the company be audited by one of the Big Four).[23] The CC's aim was to make it easier for mid-tier audit firms (e.g.: Grant Thornton, BDO) to win FTSE 350 contracts.

Increasing competition by breaking up the Big Four was not considered. But some want regulators to give it serious consideration now. In particular, the Business, Energy and Industrial Strategy Committee and the Work and Pensions Committee included a recommendation to that effect in their Carillion Inquiry report:

> We recommend that the Government refers the statutory audit market to the Competition and Markets Authority. The terms of reference of that review should explicitly include consideration of both breaking up the Big Four into more audit firms, and detaching audit arms from those providing other professional services. (Paragraph 213)

As the report makes clear, there are two ways in which these multidisciplinary accountancy firms can split: by separating the audit arm from the other services provided by the firm, or simply by splitting the whole firm into two. The latter would instantly create another four accountancy firms that could compete for audit work. The former, on the other hand, does not increase the number of audit firms. But even so, it could increase competition because the new audit-only Big Four would no longer be conflicted by their tax or consultancy arms. And so, more would be able to compete for any particular audit contract (as opposed to the situation described earlier where only one or two of the Big Four are actually eligible to compete).

Unsurprisingly, the Big Four like neither solution. They argue that a break-up would lower audit quality for these reasons:

- Smaller audit firms would be more dependent on their large clients, and so less able to challenge them
- Audit-only firms would find it harder to recruit and retain talent
- Audit-only firms would not benefit from the vast range of specialisms and resources available to multidisciplinary firms

In Deloitte's words:

> We do not believe that [break-up] is a viable solution to [increasing competition and ensuring audit quality] and would be concerned that it would damage both audit quality and the UK's position as an attractive capital market.

---

22 CC, Statutory audit services for large companies market investigation: Final report, 15 October 2013, p7

23 Id.

> Larger, more diverse firms are more financially independent and are therefore far better positioned to objectively and robustly challenge the largest companies that they audit and to make the significant investments required in systems and technology. […]
>
> Firms with a multi-disciplinary model – providing wider services beyond audit – have the best mechanisms to challenge large companies, attract specialist talent and develop the skills, expertise and global consistency needed for good quality audits. Such firms are also better positioned to offer a broad and varied range of career paths that ensure they attract and retain the best talent to the profession.[24]

And PwC's:

> The Committee's recommendation to break up the large firms would not solve the problems of audit effectiveness or the "expectation gap". A break up could also harm audit quality when it is imperative that any solution has this as a priority. The delivery of a high quality audit requires audit teams who are able to access a broad base of specialist knowledge (within the UK and internationally.
>
> Large complex audits need specialist skills beyond accountancy, often at short notice. For example, we can easily access valuation experts to provide audit support services, business recovery specialists to advise on going concern issues and tax specialists to consider whether companies have assessed their tax liabilities.[25]

One of the principal accountancy bodies in the UK, the Institute of Chartered Accountants in England and Wales (ICAEW), is also against break-up. Instead, they favour making the market more attractive to new entrants, and identify a number of regulatory barriers that could be eased:

> As much as the dominance of the Big Four, smaller audit firms have also cited the cost of regulation, the long time frame for reviewing audits and unlimited liability as some of the reasons they are reluctant to enter the market.[26]

2.2 Conflicts of interest

Auditors can be caught between the interests of management, the interests of their own firm and their duties as auditors.

There are variously described conflicts of interest that can affect auditors. The origin of all such conflicts is that, sometimes, the interests of the company's management are not aligned with the interests of shareholders (and other stakeholders) and the duties of auditors. The more influence that management holds over auditors, the more conflicted auditors may be between their duties and accommodating management. The Competition Commission's report on the audit market explains the problem:

> Audit originated as a way of providing assurance to shareholders that the management of the companies in which they held shares was accurately reporting the state of the company it managed. […]

[24] Deloitte's response in: Carillion: Responses from Interested Parties to the Joint Report, 12 July 2018, pp22-3
[25] PwC's response in: Carillion: Responses from Interested Parties to the Joint Report, 12 July 2018, pp34-5
[26] ICAEW's response in: Carillion: Responses from Interested Parties to the Joint Report, 12 July 2018, p56

> However, it is the company, via its management, that selects the auditor. This conflict (that auditors must win and retain engagements from companies in order to generate revenue, but simultaneously objectively scrutinize the company's reports) has been present since the introduction of audit in its modern form. This conflict may not be particularly apparent where the performance of a company is in line with expectations. However, where there is a gap between market expectations and company performance or a company is otherwise under financial pressure, this conflict may generate significant contradictory incentives.
>
> Auditors that we spoke to during the course of our case studies told us that this was a central challenge of their role: to establish sufficiently close and effective working relationships with the management of companies to enable efficient execution of the audit, yet to retain sufficient distance to be able to investigate thoroughly and to challenge accounting treatments that they considered incorrect.[27]

Management hold influence over the auditor because they can harm the auditor's interests. There are three 'weapons' available to management:

- **Not appointing or reappointing** the auditor
- Terminating or **not awarding contracts** to the other arms (e.g. consultancy) of the accountancy firm that the auditor works for
- Making the audit more difficult and costlier by **being less cooperative**

The second of these is the reason that some critics argue for audit-only firms, such as Cass Business School Professor Laura Empson:

> Prof Empson, for instance, argues that the creation of "audit-only" firms is the only viable solution. "It is not the oligopoly that troubles me. It is the conflicts of interest between the audit and consulting parts of the business".[28]

The Head of Audit at accountancy firm BDO argued instead that accountancy firms should simply be banned from providing any non-audit services to their audit client:

> The head of audit at the UK's sixth-largest accounting firm has called for tighter restrictions on the range of services auditors can offer their clients amid growing concerns about conflicts of interest in the audit market.
>
> Scott Knight, head of audit at BDO, said new European rules limiting the amount of non-audit work that accounting firms can offer to their listed audit clients have not gone far enough and called for harsher restrictions.
>
> These rules, which came into force in the UK in 2016, restricted non-audit fees to 70 per cent of the audit fees billed over the previous three years. The aim was to address the concern that auditors might gloss over client problems in their reports in order to protect the high fees earned from providing ancillary services such as tax advice to the same client.

---

[27] CC, Statutory audit services for large companies market investigation: Final report, 15 October 2013, p33

[28] FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018

> The rules banned auditors from doing certain activities for their audit clients altogether, including a range of tax services, the preparation of financial statements, valuation services and certain legal services. […]
>
> Mr Knight said: "The rules are too confusing and it's too easy to trip up. I would love there to be a really clear black line. The rule should be if you do the audit, you can only do audit and audit-related work."[29]

On the other hand, Deloitte pointed out that, thanks to the EU audit regulations and the FRC's ethical standards introduced in 2016, the nature and volume of non-audit services that firms can provide is now severely restricted, and that "fees for non-audit services to companies audited by the largest firms was just 11% of the firms' fee income in 2016, down from 35% in 2011".[30]

Be that as it may, audit-only firms or a ban on non-audit services only deals with one of the three sources of management influence over auditors. To protect auditors from the threat of not being reappointed, appointment rules and processes would have to be revisited.

The formal process for the appointment of auditors in listed companies is as follows. First, the audit committee (composed of independent non-executive directors) makes a recommendation to the board of directors. Following this recommendation, the directors make a decision, and the decision is voted on by shareholders at the AGM (see for example Tesco's Results of June 2018 AGM, with resolution 18 "To reappoint the auditors" passed with 95% of the votes).[31] The Secretary of State has power to appoint an auditor where the company has failed to do so.[32]

The FRC's Corporate Governance Code sets out the main duties of the audit committee, which include:

> - conducting the tender process and making recommendations to the board, about the appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor;
> - reviewing and monitoring the external auditor's independence and objectivity;
> - reviewing the effectiveness of the external audit process, taking into consideration relevant UK professional and regulatory requirements;[33]

In practice, however, the role of shareholders is minimal, while the opposite is true of executive directors, and in particular the CFO. That was the Competition Commission's finding:

> *Role of shareholders*

[29] FT, BDO calls for greater restrictions on non-audit work, 1 May 2018
[30] Deloitte's response in: Carillion: Responses from Interested Parties to the Joint Report, 12 July 2018, p23
[31] The law is found in Part 16, Chapter 2 of the *Companies Act 2006*
[32] Ibid., section 490
[33] FRC, UK Corporate Governance Code, June 2018, pp10-12

> As a matter of law, it is the shareholders as a body that appoint or reappoint the auditor by ordinary resolution in an AGM. However, given their lack of information we consider that shareholders are poorly placed to judge the performance of their auditors and, even where they do have a well-informed view on these matters, it may be hard in practice for shareholders to oppose the recommendations of the company's board, due to the coordination problem we identified in paragraph 5.25. We found that, in practice, shareholders almost always follow the recommendations of the board.
>
> *Role of board members (in particular FDs and ACs)*
>
> From our first survey, for FTSE 350 companies it appears that in selecting the auditor, the key individuals are the FD/CFO, the ACC [audit committee chair] and the other members of the AC [audit committee]. […]
>
> The case study evidence indicated that the external auditor recommended to shareholders by the board is generally a joint decision between the executive and non-executive management. We found that executive management often had a key role in recommending a particular audit firm for the ACC and AC to approve.[34]

To remove the influence of management over the appointment process, some commentators propose that auditors be selected by independent third parties such as a regulator or stock exchange.[35] Professor Prem Sikka of the Essex Business School goes further and argues that the regulator shouldn't just appoint auditors, but directly audit companies.[36]

As for the last source of management influence over auditors (i.e. making the auditor's life difficult), that is one that would probably remain under any system.

2.3 Quality and supervision

Reducing conflicts and ensuring that more than one or two firms can bid for an audit would certainly be positive developments. But it is unlikely that they would solve all problems. In particular, it is not at all clear that more competition would do much to raise audit quality. Worse, heightened competition could actually hurt audit quality.

More competition without strong checks could actually reduce audit quality.

Competition is generally assumed to lower prices and/or raise quality. This is true in certain markets with certain characteristics, but equally, other **types of markets are likely to see quality fall as competition becomes fierce**. There are reasons to believe that the audit market could fall in the latter category.

In blog called "The curious case of competition and quality" (based on a journal article of the same name), two competition academics identify the characteristics of markets where more competition can drive down quality:

34 CC, Statutory audit services for large companies market investigation: Final report, 15 October 2013, pp176-7
35 FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018
36 Quoted in: The Economist, The dozy watchdogs, 11 December 2014; and also: Parliamentary Commission for Banking Standards, Written evidence submitted by Professor Prem Sikka, 21 December 2012

> Why doesn't the pressure of competition always increase quality? Two underlying factors characterise these instances: first, it is prohibitively expensive or difficult to convey to consumers the inherent quality differences in the product offerings; second, consumers' ability to accurately assess quality differences is limited.[37]

These two key factors – difficulty in conveying and assessing quality differences – are present in the audit market. The end product of an audit (the auditor's report to shareholders) affords limited insight into the audit process and its quality or lack thereof. By and large, these reports are only a few pages long, and the bulk is generically worded. In most cases, the firm's name and logo are the only way to tell who the auditor was.

It is useful to illustrate how an increase in competition can reduce quality:

> A producer may choose unilaterally to degrade quality, when this represents the easiest (or only) path to successfully absorb the pressures of fierce competition. Quality erosion may lead to a competitive race to the bottom. Suppose several smaller suppliers are dealing with powerful retailers. One supplier decides to secretly lower its product's quality slightly in order to meet the retailers' pressures to lower price. Other sellers must now also degrade their products' quality in order to remain competitive. Absent consumer awareness, quality control or effective regulation, consumers are increasingly buying poorer quality goods. […]
>
> Take for example the horsemeat scandal which dominated the media in Europe in 2013. Following an investigation by the Irish Food Standards Agency, many prepared meals across the EU were found to contain horse meat despite the meat being advertised as 100% beef. […] Importantly, these markets exhibit fierce competition which normally would lead to higher quality at lower prices. Yet, here, the competitive downward pressure on price led to suppliers' attempts to secretly reduce quality and costs.
>
> Interestingly, quality erosion may also occur in heavily-regulated industries, such as air travel. The proliferation of budget airlines has increased the pressure on many airlines to provide services at lower costs. Some of the price reductions are accompanied with transparent changes to quality of service. Others, however, may involve disguised variants. Indeed, intense competition may induce airlines to exploit consumers' behavioural biases, involving less salient factors such as air-quality in airplanes, quality of frequent flyer programmes and other ancillary services.
>
> The competitive pressure may have also affected fuel supply levels and air delays. According to the regulatory framework, airlines should allow enough fuel to reach their destination, with an additional 30 minutes flying and a final approach before landing. Usually, low fuel incidents take place in the event of bad weather, where planes will likely spend more time in the air than originally planned. Reportedly, pilots can be under pressure from the airlines' needs to minimise costs and carry the lowest fuel intake permitted by the regulations. As one pilot reported: "I'm constantly under pressure to carry less fuel than I'm comfortable

---

[37] Ariel Ezrachi and Maurice E. Stucke, [The curious case of competition and quality](), OUP blog, 21 July 2015

> with … Sometimes if you carry just enough fuel and you hit thunderstorms or delays, then suddenly you're running out of gas and you have to go to an alternate airport." As passengers are often unaware of this quality dimension, it remains undetected.
>
> […] In such cases, competition can turn into a race to bottom, where the environment is despoiled, the planes lack sufficient fuel, our burgers feature something other than beef, and our online search engines provide less than objective search results, despite competition being one click away.[38]

So, when quality is not transparent, greater competition creates a greater incentive to bend rules, cut corners or cheat to get ahead of competitors. The other firms then face pressure to follow, with worse outcomes for everyone in the end.

It is worth quoting another article about competition in the credit ratings industry. The industry, composed of a few big firms, deserves an important share of the blame for the financial crisis of 2008.[39] There are many similarities with audit:

> The DOJ [US Department of Justice, whose responsibilities include antitrust] assumed that increasing competition in the ratings industry would benefit, not harm, investors and society.
>
> One cannot fault the DOJ for assuming that entry, in increasing competition, often benefits consumers. But under an issuer-pays model, increasing competition among the ratings agencies, the OECD found, 'is not an unambiguously positive development, as it can create a bias in favour of inflated ratings under certain circumstances'. This became evident after the financial crisis. […]
>
> With the expansion of Fitch Ratings, the competitive pressures on the ratings agencies increased. The ratings agencies' cultures changed. They placed greater emphasis on increasing market share and short-term profits. The novel financial instruments they rated, credit default swaps (CDS) and credit debt obligations (CDOs), were a growing and relatively more profitable sector. A competitive race to the bottom ensued.
>
> Consequently, increased competition among the ratings agencies, rather than improve ratings quality, reduced quality to society's detriment. It is now the subject of lawsuits—with allegations that the financial institutions, by 'play[ing] the [rating] agencies off one another' and choosing the agency offering the highest percentage of AAA certificates with the least amount of credit enhancements, 'engender[ed] a race to the bottom in terms of rating quality'. The authors of the ratings study concluded that 'competition most likely weakens reputational incentives for providing quality in the ratings industry and, thereby, undermines quality. The reputational mechanism appears to work best at modest levels of competition.'[40]

Once these dynamics are recognised, the more promising route to better audit quality lies in better regulation and supervision. To reiterate, this is not to say that policymakers should be comfortable with the

---

38 Ariel Ezrachi and Maurice E. Stucke, The curious case of competition and quality, OUP blog, 21 July 2015

39 See for example: FT, Ten years after Lehman collapse few lessons have been heeded, 22 August 2018

40 Maurice E. Stucke, Is competition always good?, *Journal of Antitrust Enforcement*, Vol. 1, No. 1 (2013), pp162–197

current number of players in the FTSE 350 audit market, but simply that increasing that number is a solution to another problem. In the words of the Competition and Markets Authority (CMA), "Competition and regulation should work hand in hand to ensure that audit firms and individuals within those audit firms have the maximum incentives to carry out high-quality audits". It is the "[s]election and oversight of auditors [that] would ensure that competition is focused on quality (more than price)".[41]

The FRC has a team (AQR) dedicated to reviewing the quality of audits and setting quality goals (some of the findings in their audit inspection reports were discussed briefly at the beginning of section 2):

> We identify areas where improvements are required to safeguard or enhance audit quality and/or comply with regulatory requirements. We seek to agree an action plan with each firm inspected to achieve the improvements needed. We assess periodically the adequacy of the progress made by the firm in addressing our findings. […]
>
> Our reporting arrangements are among the most transparent of any audit regulator in the world and we believe that they contribute to achieving continuous improvements in the quality of UK auditing.
>
> Each year we publish a number of individual firm and thematic inspections reports, which summarise the results of our inspection activities. We also contribute to the FRC's overall report on audit quality.

It may be that the FRC should demand more of the audit firms in order to raise quality across the board. Some indeed argued that the FRC is too close to those it regulates.[42] Equally, if audit firms don't live in fear of their regulator, it may be because the regulator lacks teeth. The FRC's budget and the fines it hands out are orders of magnitude smaller than those of the Financial Conduct Authority (FCA), for example.[43]

In May 2018, the Work and Pensions Committee and Business, Energy and Industrial Strategy Committee recommended that the FRC be given more resources and powers to discharge its duties:

> The Carillion collapse has exposed the toothlessness of the Financial Reporting Council and its reluctance to use aggressively the powers that it does have. […]
>
> At present, the mindset of the FRC is to be content with apportioning blame once disaster has struck rather than to proactively challenge companies and flag issues of concern to avert avoidable business failures in the first place. We welcome the Government's review of the FRC's powers and effectiveness. We believe that the Government should provide the FRC with the necessary powers to be a much more aggressive and proactive regulator: one that can publicly question companies about

---

[41] CMA, Audit update paper, December 2018, p85

[42] FT, Too close for comfort: the incestuous ties that bind auditors and watchdogs, 20 August 2018

[43] The FRC had revenue of £32 million in 2016/17 vs £575 million for the FCA. Total financial penalties imposed by the FCA in the last few years run to the billions of pounds vs the tens of millions for the FRC.

> dubious reporting, investigate allegations of poor practice from whistle-blowers and others, and can, through the judicious exercise of new powers, provide a sufficient deterrent against poor boardroom behaviour to drive up confidence in UK business standards over the long term.[44]

In April 2018, the Government launched an independent review of the FRC, which reported in December 2018. The review recommended that the FRC be replaced with an independent statutory regulator called the Audit, Reporting and Governance Authority. The review and recommendations are discussed in section 3.

2.4 Accounting standards

A final area of concern is that company accounts lack prudence. Synonymous descriptions for this sort of accounting include "overly optimistic" or "aggressive".

Key to making companies more resilient is to make accounting standards and their application more prudent.

Prudence is fundamental to good accounting, as explained by the European Financial Reporting Advisory Group:

> It has long been established that the idea of prudence (or 'conservatism') plays a major part in financial reporting. […] The origins of prudence may, in part, reflect the use of financial statements in showing the amount of profit that is available for distribution.
>
> The essence of prudence is that assets and income are not overstated and that liabilities and expenses are not understated. The application of prudence ensures that gains are reported only if they are highly probable or reasonably certain (often not until realised) but that (expected) losses are recognised as soon as they are identified. Prudence also causes an asymmetry in the accounting for assets and liabilities, as it requires a higher degree of certainty before recognition of assets than of liabilities. Prudence may affect the accounting policies that determine whether transactions and events are recognised; the measurement of assets and liabilities that are recognised; and the presentation of gains and losses. It may play a role both in the development of accounting standards and, in practice, the preparation of financial statements based on these standards.[45]

Can the auditor challenge management on the basis that their accounting is imprudent? Certainly, but it is much easier to do when prudence is embedded in an accounting standard that the auditor can point to. By contrast, when the letter of the standard permits over-optimistic accounting, the auditor can only challenge management on more subjective grounds. Without a clear breach of the rules, the auditor in practice will only object to decisions that are patently indefensible. Anything less egregious will probably get the benefit of the doubt.

Many areas of accounting involve a degree of judgement. As the accounts are the company's (not the auditor's), it is for the company to take a view. The auditor's role is simply to satisfy themselves that the

---

44 WP and BEIS Committees, Carillion joint report, 16 May 2018, p78
45 European Financial Reporting Advisory Group, Getting a Better Framework: Prudence, April 2013, p4

view taken by management is acceptable and compatible with the standards.

Two examples will illustrate the enormous **impact that accounting standards can have on the level of prudence** in the accounts.

According to the 2016 accounts, Capita's equity was a positive £483 million at the end of 2016. But according to the 2017 accounts, Capita's equity *as of the same date*, 31 December 2016, was a *negative* £553 million. What can explain the £1 billion difference in these two equally audited balance sheet figures that measure the same quantity as of the same date?

A new accounting standard, IFRS 15, requires companies to book **revenue** on contracts based on the flow of benefits received by the client, not the flow of costs incurred by the company. This change particularly affected companies that have long-run contracts as their standard business activity. IFRS 15 became mandatory for all listed companies on 1 January 2018, but companies were free to adopt it earlier.

And so, Capita went from booking revenue on a contract according to how much it had spent (known as 'percentage of completion'), to booking revenue according to how much benefit the client had received. In Capita's words:

> This reflects an important change in accounting policy as the Group moves from one based predominantly on percentage of completion revenue recognition to a methodology that is focused on aligning revenue recognition to the delivery of solutions and value to its customers.[46]

The result of booking revenue according to how much value is delivered to the customer was to make Capita £1 billion more cautious about how much money it had made. That £1 billion should not have been considered earned yet as of 31 December 2016.

Companies can only pay dividends out of past profits available for distribution in the company's 'distributable' reserves (section 830 and 831 of Companies Act 2006). After adopting IFRS 15, Capita had *minus* £1.1 billion of distributable reserves in its 2016 balance sheet. And so, had Capita adopted IFRS 15 in its 2016 accounts, it might have been unwilling or unable to make dividend payments in 2017.[47] That would

---

[46] Capita, 2017 half-year statements, 21 September 2017, p38

[47] Distributions to shareholders must be justified by reference to 'relevant accounts' (sections 836 - 839). The relevant accounts are normally the company's last official annual accounts (836(2)). For group companies, it is the *parent company* accounts that matter, not the *group* accounts. Group accounts are not relevant because distributions are made by individual companies and not by groups. So technically, Capita might still have been able to pay a dividend based on available reserves in its parent company balance sheet. But such a distribution also needs to be compatible with the fiduciary and other duties of directors, considering the fragility of the Capita group. "Thus, directors should consider both the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due. In reaching their decision they must take into account any change in the financial position of the company after the balance sheet date of the

have saved the company £217 million,[48] or almost a third of the £700 million rescue it then sought from shareholders in January 2018 (and received in May 2018).

The second example of the impact that accounting standards can have concerns **goodwill**. Goodwill is the amount a company pays for an acquisition over and above the fair net value of the assets acquired. For example, if a company bought an incredibly popular restaurant, it would pay a lot more than the value of the restaurant's assets (e.g. kitchenware, tables, chairs, etc), because the company is buying a popular brand with a large client base and the promise of future profits.

It used to be that goodwill had to be "amortised" every year.[49] In plain English, companies would gradually reduce the value of the goodwill by charging themselves a notional expense known as amortisation. The expense may be notional, but it has the real effect of reducing accounted profits, and so reducing the funds available for distributions.

When IAS 22 was superseded in 2005 by a new standard, IFRS 3, the requirement to amortise goodwill every year was dropped.[50] Instead, goodwill now has to be "tested for impairment", meaning that management checks whether goodwill is still worth what it was the year before. If it is, good; if it isn't, it is "impaired" (the value is reduced). This is the reason that Carillion was able to keep the value of its goodwill entirely unchanged in the five years to 2017 (despite evidence that it should have been impaired).[51] The auditor did not successfully challenge management's assessment of the value of goodwill, but they would have certainly reminded management to amortise goodwill, if that was still the requirement.

In both examples, what matters is that standards impact the amount of cash that can be extracted from the business in bonuses and dividends. More prudent standards leave companies better capitalised, and so more resilient to shocks.

Some argue that accounting standards have evolved in a direction that can be inconsistent with the *Companies Act 2006* requirements to give a true and fair view and to protect capital. These concerns are discussed in section 3.4.

relevant accounts and the future cash needs of the company." ICAEW, Guidance on realised and distributable profits under the Companies Act 2006, April 2017, para. 2.3A

48 Capita, Cash flow statement for the year ended 31 December 2017, in: Annual Report 2017, 23 April 2018, p95

49 IAS Plus, IAS 22 — Business Combinations (Superseded), visited 21 August 2018

50 See: IAS Plus, Goodwill and impairment project - Agenda paper 18, 16 February 2016

51 FT, Carillion's troubles were shrouded in a fog of goodwill, 18 June 2018

3. Reform

Momentum for reform has gathered pace, with several strands of work discussed in the sections below.

3.1 BEIS insolvency and corporate governance consultation

A BEIS consultation on Insolvency and Corporate Governance (launched 20 march 2018) included proposals to strengthen corporate governance in pre-insolvency situations. Of particular interest here were proposals to **strengthen the UK's framework in relation to dividend payments** (see capital maintenance regime in section 1.2 for background). BEIS was interested in views on whether the framework for determining lawful distributions and how directors exercise their judgement on this could be improved:

> The consultation sought views on whether the UK's current regime based on the concept of "distributable profits" remains fit for purpose. This was in the context of examples of companies in apparent financial difficulties and approaching insolvency, nonetheless continuing to pay significant dividends.[52]

The Government wants to tighten the UK dividend regime.

In its response to the consultation, the Government said it would consider taking the following actions:

- Explore the case for a comprehensive review of the UK's dividend regime;
- A requirement for companies to disclose the audited figure for available reserves and distributable profits in their annual report and accounts (FRC guidance is that there is currently no legal requirement to publish distributable reserves);
- Ways in which the definition of "net assets" (for the purpose of distributions) might be tightened such as a more critical look at the valuation of "goodwill";
- Legislation to require companies to disclose and explain their capital allocation decisions, if investor pressure and new section 172 reporting requirements do not deliver sufficient progress
- A requirement for listed companies that there be at least one shareholder vote on dividends each year.[53]

3.2 CMA audit market study

On 9 October 2018, the Competition and Markets Authority (CMA) launched a new market study into statutory audit. If the CMA finds that a market is not working well or may harm the interests of consumers, it can impose a wide range of 'remedies' to fix it.

The CMA is focussing on three key issues in the audit market:

[52] BEIS, Government response: Insolvency and Corporate Governance, August 2018, p17
[53] BEIS, Government response: Insolvency and Corporate Governance, August 2018, p22-3

- choice and switching (i.e. the dominance of the Big Four)
- the long-term resilience of the sector (i.e. the fact that the Big Four are 'too few to fail')
- the incentives between audited companies, audit firms and investors (in particular, the fact that companies pick their own auditor)

In his letter to the Government announcing the launch of the market study, CMA chairman Lord Andrew Tyrie listed three groups of remedies that "appear to merit attention":

1. **Reduce the barriers to non-Big Four firms auditing major companies;** for instance through a market share cap, mandated joint audit, or other measures.
2. **Maximise choice among the Big Four**; for instance by separating audit and non-audit services, creating audit-only firms.
3. **Address the incentive problems underlying the audit sector**; for instance by moving responsibility, in certain circumstances, for procuring audits away from audited companies to an independent body with a public interest mandate.[54]

The letter remarked that new legislation would be needed to implement many of these remedies.

On 18 December 2018, the CMA published an update paper for the statutory audit market study. The paper sets out a range of remedies that the CMA is considering. They include:

The CMA is considering a range of 'remedies' to improve competition and quality in the audit market.

- Measures to focus competition on quality rather than price;
- Mandated joint audits or market share caps;
- A split between audit and non-audit services.[55]

The CMA believes that the main reasons driving low-quality audits are:

- companies choose their own auditors, and as a result we have seen too much evidence of them picking those with whom they have the best 'cultural fit' or 'chemistry' rather than those who offer the toughest scrutiny
- choice is too limited, with the Big Four audit firms conducting 97% of the audits of the biggest companies
- auditors' focus on quality appears diluted by the fact that at least 75% of the revenue of the Big Four comes from other services like consulting.[56]

54 CMA, Operation of the audit market: letter from Lord Tyrie, CMA Chairman, to the Rt Hon Greg Clark, 9 October 2018
55 CMA, Audit update paper, December 2018, p86
56 CMA, CMA proposes reforms to improve competition in audit sector (press release), 18 December 2018

3.3 Kingman Review of the FRC and audit procurement

On 17 April 2018, the Government launched an independent review of the Financial Reporting Council (FRC section) led by Sir John Kingman. The review examined the role, governance and powers of the FRC.[57]

The consultation closed on 6 August 2018 and the report was published on 18 December 2018.

The independent review 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**. The new regulator would be called the "Audit, Reporting and Governance Authority". There are 83 specific recommendations in the report.

The Government intends to replace the FRC with a new, independent statutory regulator with stronger powers.

The Review's conclusions are summarised as follows:

> The Review believes that the FRC should be replaced with a new body which:
>
> - Has a clear and precise sense of purpose and mission;
> - Is firmly focused on the interests of consumers of financial information, not producers;
> - Is respected by those who depend on its work, and where necessary feared by those whom it regulates;
> - Has the right powers and resources it needs to do its job; and
> - Is able to attract the highest-quality people.
>
> These are not unrealistic aspirations for a regulator. Broadly speaking, all these things are now, after a decade of post-crisis reconstruction, true for both of the UK's two main financial regulators. At the FRC, by contrast, none of these things is consistently true.[58]

Business Secretary Greg Clark said the government would "take forward the recommendations set out in the Review to replace the FRC with a new independent statutory regulator with stronger powers".[59]

In a letter dated 8 October 2018, BEIS Secretary of State Greg Clark asked Sir John Kingman, in his capacity as FRC review lead, to also report on **audit procurement and scope**:

> I would find it very helpful, alongside the review you are currently undertaking of the Financial Reporting Council, if you could let me have your thoughts on whether there is any case for change in the way in which audits are currently procured, and audit fees and scope are set, particularly for major companies of public interest.

[57] BEIS, Government launches review of audit regulator (press release), 17 April 2018
[58] Sir John Kingman, Independent Review of the Financial Reporting Council, December 2018, p5
[59] BEIS, Independent review of the Financial Reporting Council (FRC) launches report (news story), 18 December 2018

> In particular, it would be useful to have your view on whether any change could better promote the interests of users of accounts – and ensure quality, rigour, independence and scepticism on auditors' part – whilst at the same time, of course, needing to be feasible and workable in practice.

Alongside the Review report, Sir John Kingman also published his letter to the Secretary of State, in response to that request. In summary, Sir John believes that there is a principled case for considering radical change, but that it would not be right to press ahead if investors (the main users of the accounts) are firmly opposed.[60]

Sir John nonetheless recommended two "more modest and focussed" changes to give the new regulator the power to appoint the auditor and approve audit fees in certain circumstances:

> First, I suggest you should give the new regulator the right to appoint an auditor, in the case of PIEs, in three very specific circumstances. One would be where quality issues (to a threshold to be defined) have been identified around the company's audit. The second would be where a company has parted company with its auditor, other than as part of the normal rotating cycle. The third would be where there has been a meaningful shareholder vote, even one well short of 50%, against an auditor appointment. In all these cases, I suggest it would be demonstrably in the interests of investors, other stakeholders and ultimately the company for the regulator to have the ability (not the obligation) to intervene. […]
>
> Second, I suggest you should give the new regulator the right, again in the case of PIEs, to approve audit fees, where it sees a case for doing so in the interests of quality. This would ensure that the new regulator's market-based work on audit fees, and implications for quality, could be put to practical use.[61]

3.4 Future of audit – Brydon Review

On 18 December 2018, Business Secretary Greg Clark announced an independent review of the future of audit, chaired by Donald Brydon. The Brydon Review into UK Audit Standards will consider:

- How far audit can and should evolve to meet the needs of investors and other stakeholders, putting the UK at the forefront;
- How auditors verify information they are signing off;
- How to manage any residual gap between what audit can and should deliver; and
- What are the public's expectations from audit.[62]

One group of issues the CMA highlighted in their invitation to comment to the audit market study was the audit framework and the 'expectation gap'. These are fundamental questions that go beyond the remit and expertise of the CMA. Accordingly, the CMA summarised the views they

60 Sir John Kingman, Operation of the audit market: letter to Rt Hon Greg Clark, December 2018, p6-7

61 Sir John Kingman, Operation of the audit market: letter to Rt Hon Greg Clark, December 2018, p7

62 Greg Clark, Update on Audit Industry: Written statement - HCWS1193, 18 December 2018

received on these subjects for the benefit of the Brydon Review, in Appendix C to audit market study update paper (December 2018).

In view of the issues identified in that appendix, the CMA proposed some high-level questions that the Brydon Review should address:

> (a) What is the purpose of an audit as it currently stands?
>
> (b) What should the purpose of an audit be? Put another way, what do stakeholders require from an audit?
>
> (c) Does the scope of audit need to change to achieve the desired purpose? If yes, how?
>
> (d) Do the Companies Act, IAS, ISAs UK, or corporate governance roles need to change to achieve this purpose?
>
> (e) Who should auditors owe duties to? Should auditors' duties and liabilities be expanded? Do directors need to bear more responsibility for financial reporting?
>
> (f) Does audit need to align better with the capital distributions regime in Companies Act 2006?[63]

Question (f) relates to the capital maintenance regime discussed earlier in sections 1.2 and 3.1 (see also earlier discussion on accounting standards). The CMA received views that:

Some argue that audit is failing to deliver a key purpose: assessing whether the company's capital is properly protected.

> the current audit framework, particularly the accounting standards, is failing to deliver a key purpose of audit: assessing whether the company's capital is properly protected.
>
> […] Because accounts are prepared in accordance with accounting standards, and auditors review the accounts against these standards, the Companies Act 2006 requirements are not necessarily met—a case of company law following the standards, rather than the other way around. As a result, a key purpose of the audit report is lost.
>
> These respondents concluded that the expectations gap is a result of the industry's misinterpretation of the existing legal framework. One described the expectations gap as a red herring. They said that if the existing regime was applied properly, the expectation gap would disappear because the statutory framework is robust enough to produce the outcomes stakeholders expect.
>
> This particular submission on the purpose of audit has been subject to significant legal analysis in recent years. It seems unsatisfactory that what appears to be quite a fundamental question about the purpose of an audit as required by the Companies Act 2006 can be subject to such debate and difference in legal opinion. We are supportive of a review which examines this debate in detail and resolves in certain terms what the purpose of audit is.[64]

63 CMA, Appendix C to audit market study update paper: the 'expectations gap'; the purpose and scope of audit, December 2018, p10-11

64 CMA, Appendix C to audit market study update paper: the 'expectations gap'; the purpose and scope of audit, December 2018, p5-6

Sarasin & Partners LLP argued that 'true and fair view' requirement has been watered down to fit with IFRS:

> The upshot of this watering down of the true and fair requirement has been that most auditors assume that as long as financial statements have been prepared in accordance with prevailing accounting standards (the first opinion provided by auditors), then the true and fair standard will have been met. […]
>
> The practice of equating compliance with IFRS with meeting the statutory true and fair standard is a serious matter. The audit has evolved into a "tick-box" model of checking compliance with IFRS, rather than applying judgement to determine whether or not capital and performance has been overstated.[65]

Compliance with accounting standards does not necessarily deliver 'true and fair' accounts.

3.5 BEIS Committee inquiry

On 12 November 2018, the BEIS Select Committee launched an inquiry into the Future of audit. The Inquiry focuses on the work of the CMA and the FRC review in improving quality and competition in the audit market. The Committee intends to feed into the CMA study and ensure that audit reform is linked to the wider agenda of corporate governance reform.

65 Sarasin & Partners LLP, Submission to CMA market study on Audit, November 2018, p4

About the Library

The House of Commons Library research service provides MPs and their staff with the impartial briefing and evidence base they need to do their work in scrutinising Government, proposing legislation, and supporting constituents.

As well as providing MPs with a confidential service we publish open briefing papers, which are available on the Parliament website.

Every effort is made to ensure that the information contained in these publicly available research briefings is correct at the time of publication. Readers should be aware however that briefings are not necessarily updated or otherwise amended to reflect subsequent changes.

If you have any comments on our briefings please email papers@parliament.uk. Authors are available to discuss the content of this briefing only with Members and their staff.

If you have any general questions about the work of the House of Commons you can email hcenquiries@parliament.uk.

Disclaimer

This information is provided to Members of Parliament in support of their parliamentary duties. It is a general briefing only and should not be relied on as a substitute for specific advice. The House of Commons or the author(s) shall not be liable for any errors or omissions, or for any loss or damage of any kind arising from its use, and may remove, vary or amend any information at any time without prior notice.

The House of Commons accepts no responsibility for any references or links to, or the content of, information maintained by third parties. This information is provided subject to the conditions of the Open Parliament Licence.

BRIEFING PAPER
Number 8385
10 January 2019