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Company audits: problems and solutions

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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, pension holders, 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 arguably '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, powers and independence.
- **Lack of prudence in the accounts**: accounting standards have evolved in a direction that permits or encourages less prudent accounting. At the same time, compliance with the laws that demand prudence in the payment of dividends and protect the company's capital is patchy.

There were several major reviews of how the audit industry works – and how it might be improved – in 2018 and 2019, each recommending significant reform. After considering these, in March 2021 the Department for Business, Energy and Industrial Strategy published a White Paper setting out proposals to make wide-reaching changes to the roles and responsibilities of directors, shareholders, auditors and the audit regulator, in an attempt to drive up standards.

The reforms include increased accountability for directors, a new audit regulator, requiring a clearer operational separation of the audit and non-audit activities of firms, and mandatory shared audits for FTSE 350 companies between the Big Four and smaller competitors. A consultation on these proposals closes in July 2021.

The Financial Times has stated that the proposals have been "broadly welcomed by audit executives and business groups", though concerns have been raised by some industry participants, politicians and academics over the costs of the reforms on businesses, on whether they are likely to successfully deal with the problems in the audit industry, and on whether increased accountability for directors might hamper attempts to boost diversity in boardrooms.

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.

Consultancy and accountancy firm EY's Global Integrity Report 2020 surveyed over 3500 board members, managers and employees across 33 countries and territories, finding that:

- 90% of respondents believed that COVID-19 posed a risk to ethical business conduct at their organisation;
- 15% of senior managers would be prepared to mislead external parties such as auditors or regulators to improve their own career progression or pay package; and
- 17% of respondents saw accounting manipulation or misstatements as one of the three most significant risks when acquiring, partnering with or investing in other organisations.[1]

[1] EY, Global Integrity Report 2020, pp3, 9 and 13

1.2 What does the law require?

Section 393 of the *Companies Act 2006* states company directors must not approve company accounts unless they are satisfied that they "**give a true and fair view**".

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

Auditors must state whether the accounts 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".

Part 23 (Distributions) of the Act sets out rules on 'capital maintenance'. Companies can only pay dividends out of past, realised profits available for distribution in the company's 'distributable' reserves (sections 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 'qualifies' the accounts (meaning the auditor does not state that in their view the accounts have been properly prepared in accordance with the Act)[2], 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 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.[3]

1.3 What are audits for?

The main principles and objectives of audit are laid out in the 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 See section 474
3 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.[4]

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.[5]

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 £80 million for Tesco's 2018/19 group accounts:

> The materiality that we used for the Group financial statements was £80m (2017/18: £50m) which equates to 4.7% (2017/18: 4.4%) of profit before tax before exceptional items and amortisation.[6]

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.[7]

4 FRC, ISA 200, January 2020, p2
5 FRC, ISA 200, January 2020, p3
6 Deloitte, Independent auditor's report to the members of Tesco PLC, 9 April 2019, p84
7 FRC, ISA 200, January 2020, p3

Audit expectation gap

It has been argued that stakeholders and the general public expect 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**".[8] An oft-cited example of expectation gap relates to fraud detection.[9] Auditors do not and cannot prevent or stop all fraud in a company; rather, they must stand a good chance of detecting fraud of a material amount.

It is said that 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, pension holders, 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.[10]

However, not everyone agrees that widespread disappointment with audit is the result of mistaken expectations. The Business Committee of the House of Commons found that too many audits "are falling short of what audits are for within the current framework", and that "the delivery gap [i.e. audits failing to deliver what they are supposed to] is far wider than the expectation gap".[11]

1.4 Who must be audited?

The EU *Statutory Audit Directive 2006/43/EC* required '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 was 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 479A)
- Dormant companies (section 480)

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[8] 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

[9] Ibid., p15

[10] FRC, Audit Culture Thematic Review, May 2018, p4

[11] BEIS Committee, The Future of Audit, HC 1718, 2 April 2019, para 25, 56

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.

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.[12]

The FRC is funded by the audit profession and carries out regular audit quality reviews, and publishes lists of its enforcement sanctions against auditors.

The Government has announced proposals to replace the FRC be with an independent statutory regulator called the Audit, Reporting and Governance Authority. The proposals are discussed in section 4.

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".[13] Another is to increase consistency across companies.

The FRC is responsible for issuing accounting standards in the UK,[14] 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 the UK and all EU countries. The major exception is the United States, which uses its own national standards.[15]

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.

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

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.

1.7 The Big Four

The "Big Four" refers to the four largest accountancy firms in the world: **PwC**, **Deloitte**, **EY** and **KPMG**. All are legally based in, or have strong connections to, the UK.[16]

The table below shows the audit and non-audit income of the six largest accountancy firms in the UK. The total income of the Big Four is multiple times that of the next two players, BDO and Grant Thornton. The audit income of EY, the fourth biggest player, is more than double that of the next biggest player, BDO.

UK FEE INCOME OF LARGEST ACCOUNTANCY FIRMS, YEAR ENDED 2019

Firm	No of PIE Audit Clients	Audit (£m)	Non-Audit Work to Audit Clients (£m)	Non-Audit Clients (£m)	Total Fee Income (£m)
PwC	444	713	239	2,508	3,460
KPMG	438	631	185	1,582	2,398
Deloitte	321	469	195	2,763	3,427
EY UK	252	453	118	1,876	2,447
BDO	140	200	92	285	577
Grant Thornton UK	52	132	60	310	502

Source: FRC, Key Facts and Trends in the Accountancy Profession, Figure 33, October 2020

Notably, audit work only contributes a minor share of the total fee income of the Big Four – between around 13% and 26%.

As at the end of 2019, the Big Four enjoyed virtually complete dominance at the top end of the audit market, auditing all FTSE 100 companies and almost all of the FTSE 250.[17]

[16] See relevant sections of the websites of PwC, Deloitte, KPMG and EY

[17] FRC, Key Facts and Trends in the Accountancy Profession, Figure 38, October 2020

2. Problems

High-profile failures such as that of BHS (2016), Carillion (2018), Patisserie Valerie and Thomas Cook (both 2019) have drawn attention to alleged poor auditing practices.

PwC was fined £10m (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.[18] KPMG is expected to be fined up to £25m for deficiencies in its auditing of Carillion.[19] The FRC's list of enforcement sanctions imposed shows that fines have also recently been imposed against other big players, including Deloitte (September 2020), EY (October 2017), Grant Thornton (March 2020) and BDO (June 2020).[20]

The Work and Pensions Select Committee and the Business, Energy and Industrial Strategy Select Committee have expressed concern that audit quality is too often too low.[21]

The FRC carries out annual audit quality inspections of several statutory audit firms, as well as a more general "Developments in Audit Report". In its latest Developments in Audit report (November 2019) it found that "Audits are not consistently reaching the necessary, high standards required to provide confidence in financial reporting," commenting that:

> In July 2019 we reported that the overall inspection results of the biggest seven firms were unsatisfactory, with only 75% of the FTSE 350 audits we reviewed being classified as good or requiring no more than limited improvements. These results fell significantly short of our target set three years ago that by 2019 at least 90% of FTSE 350 audits would be assessed in this category. The results at Grant Thornton and those for the FTSE 350 audits at PwC were particularly poor.[22]

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 situation share the same end goal of raising the quality and robustness of audits, but don't always agree on the diagnosis or solutions.

2.1 Lack of competition

In the game of auditing very large companies, there are only four real players. 97% of FTSE 350 companies and 99% of S&P 500 companies are audited by the Big Four.[23]

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

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

[18] FRC, Sanctions against PwC and former audit partner in relation to BHS, 12 June 2018
[19] Sky News, KPMG inches towards settlement with audit regulator over Carillion collapse, 18 March 2021
[20] FRC, Recent Enforcement sanctions imposed against Audit firms and Audit partners, unclear when last updated
[21] See for example criticism of KPMG in the Carillion joint report, 16 May 2018, p4
[22] FRC, Executive Summary, Developments in Audit Report 2019, November 2019
[23] FT, A shake-up of audit's oligopoly is long overdue, 2 September 2018

contract. Most often, a variety of conflicts of interest preclude one or more of the Big Four from tendering.

Article 5(1) of the EU *Audit Regulation*[24] lists the services that statutory auditors 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 auditor currently providing 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.[25]

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 choice in the FTSE 100 audit market. So, this uncomfortable situation is about more than a lack of competition – it is about the fragility of the audit market at the top, and therefore a need to make that market more **resilient**.

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 policymakers and regulators have not been sure what to do about it. In 2018 two Parliamentary Select Committees raised the issue with the FRC as part of their joint Inquiry into Carillion. The FRC shared the Committees' concerns and said it would involve 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.[26]

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.

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[24] which, following the UK's departure from the EU and the end of the transition period, now forms part of UK law subject to amends made by The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019

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

[26] FRC, Response to Carillion Select Committee letter, 3 July 2018

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.[27]

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).[28] The CC's aim was to make it easier for mid-tier audit firms (e.g. Grant Thornton and BDO) to win FTSE 350 contracts.

Increasing competition by breaking up the Big Four[29] was not considered. But in 2018, some wanted regulators to give it serious consideration. 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)

On 8 October 2018, the Business Secretary Greg Clark wrote to the competition regulator (the Competition and Markets Authority referred to above) to ask it to look into the audit market, encouraging the CMA "to be ambitious in its thinking and move swiftly".[30] The CMA launched a review the following day, which is discussed in section 3, CMA audit market study.

2.2 Conflicts of interest

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 2013 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. […]
>
> 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

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

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

[28] Ibid.

[29] Separating audit from non-audit services can increase choice by reducing or eliminating the conflicts of interest that disqualify firms from auditing companies they supply other services to.

[30] Letter from Rt Hon Greg Clark to Lord Tyrie, CMA Chair, 9 October 2018

> 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.[31]

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 costly 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".[32]

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.
>
> 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

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

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

> should be if you do the audit, you can only do audit and audit-related work."[33]

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".[34]

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 2020 AGM, with resolution 18 "To reappoint the auditors" passing with over 99% of the votes).[35] The Secretary of State has power to appoint an auditor where the company has failed to do so.[36]

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;[37]

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*
>
> 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

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

> 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.[38]

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.[39] Professor (now Lord) Prem Sikka of the Essex Business School goes further and argues that the regulator shouldn't just appoint auditors, but directly audit companies.[40] The Business, Energy and Industrial Strategy (BEIS) Select Committee recommended instead that auditors be appointed for fixed-term, non-renewable contracts of seven years, so that auditors need not worry about being reappointed or fired for doing their job.[41]

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. There may however be measures that could mitigate that risk to some extent. For example, the BEIS Committee made several recommendations that might tilt the balance of power between management and auditors, such as greater public reporting by the auditor of the issues encountered in the audit (including when the auditor had to perform extra work which the company refused to pay for)[42], more regulatory scrutiny of audit committees[43], and powers for the regulator to intervene in the interest of quality[44]. The Committee's inquiry into audit is discussed in section 3, BEIS Committee inquiry.

2.3 Quality and supervision

Reducing conflicts and ensuring that more than one or two firms can bid for an audit might be positive developments, but it is unlikely that this 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,

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[38] CC, Statutory audit services for large companies market investigation: Final report, 15 October 2013, pp176-7
[39] FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018
[40] 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
[41] BEIS Committee, The Future of Audit, HC 1718, 2 April 2019, para 179
[42] Id., paras 40-45, 150-153
[43] Id., para 166
[44] Id., para 153

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 a 2015 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:

> 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.[45]

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.

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.

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

> 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 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.[46]

So, when quality is not transparent, greater competition can create a greater incentive to bend rules, cut corners or cheat to get ahead of competitors. 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, is often partly blamed for the financial crisis of 2008.[47] 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

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

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

> reputational mechanism appears to work best at modest levels of competition.'[48]

Once these dynamics are recognised, the more promising route to better audit quality arguably lies in better regulation and supervision. To reiterate, this is not to say that policymakers should be comfortable with the current number of players in the FTSE 350 audit market, but simply that increasing that number would not necessarily increase audit quality. 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)".[49]

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.[50] Equally, if audit firms don't live in fear of their regulator, it may be because the regulator lacks teeth. The FRC imposed total fines of £16.5 in 2019/20.[51] By contrast, the UK's financial services regulator, the Financial Conduct Authority (FCA), imposed total fines of £192.5m in the calendar year 2020.[52]

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. […]

48 Maurice E. Stucke, Is competition always good?, *Journal of Antitrust Enforcement*, Vol. 1, No. 1 (2013), pp162–197
49 CMA, Audit update paper, December 2018, p85
50 FT, Too close for comfort: the incestuous ties that bind auditors and watchdogs, 20 August 2018
51 FRC, Annual Enforcement Review, July 2020, p2
52 FCA, 2020 fines, last updated 3 March 2021

> 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 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.[53]

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, Kingman Review of the FRC.

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.[54]

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

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[53] WP and BEIS Committees, Carillion joint report, 16 May 2018, p78

[54] European Financial Reporting Advisory Group, Getting a Better Framework: Prudence, April 2013, p4

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 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, services company Capita plc's net assets was a positive £483 million at the end of 2016. But according to the 2017 accounts, Capita's net assets *as of the same date*, 31 December 2016, was a *negative* £553 million. What can explain the over £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.[55]

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.[56] And so, had Capita adopted IFRS 15 in its 2016 accounts, it might have been unwilling or unable to make dividend payments in 2017.[57] That would have saved the company £217 million,[58] or almost a third of the £700 million rescue it then sought from shareholders and received in May 2018).

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55 Capita, 2017 half-year statements, 21 September 2017, p38
56 See Commons Library Insight, Capita: where did the capital go? 6 February 2018
57 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))
58 Capita, Cash flow statement for the year ended 31 December 2017, in: Annual Report 2017, 23 April 2018, p95

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 a very 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.[59] 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.[60] 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, no change is needed; 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).[61] 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.

Reforming the international accounting standards that most large companies use may be long and difficult, but the standards are not the only means to achieve prudence. Individual countries can also legislate as they see fit to require more accounting disclosures and impose prudence in the payment of dividends. IFRS, the purpose of which is to provide international comparability, does not and cannot replace national rules and regulations.[62]

The **law** can demand prudence regardless of what the accounting standards allow.

In the UK, some argue that compliance with the accounting standards has eclipsed the requirements in company law to give a true and fair view and to protect capital. One of the central purposes of keeping accounts is to determine a company's profits and how much of these are distributable in the form of dividends to shareholders. The laws that foster prudence in the payment of dividends and protect the company's capital form what is known as the capital maintenance regime (see section 1.2). Inadequate compliance with the capital maintenance

59 IAS Plus, IAS 22 — Business Combinations (Superseded), visited 8 April 2021

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

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

62 Nick Anderson (IFRS Board Member), Feature: Returns, reinvestment opportunities and dividend distribution, 8 February 2019

regime and related issues are discussed in sections 3.1, 3.3 and 3.5 below.

3. Reform

Government, regulator, independent reviews and the Business Committee of the House of Commons have explored and recommended sweeping reforms. The following strands of work are discussed in the sections below:

- The Department for Business, Energy and Industrial Strategy (BEIS), looking at **tightening rules on the payment of dividends**, and implementing recommendations from the other parties;
- The Kingman Review, recommending the **creation of an independent audit regulator**, accountable to Parliament, with a new mandate and new powers;
- The BEIS Select Committee, looking at audit in the round, including the **role, culture and independence of auditors**;
- The Competition and Markets Authority, looking at the audit market to **increase choice and resilience**, and focus competition on quality rather than price; and
- The Brydon Review, looking at the **purpose, scope, quality and effectiveness** of the audit product.

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.[63]

The Government is minded 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);

[63] BEIS, Government response: Insolvency and Corporate Governance, August 2018, p17

- Explore ways in which the definition of "net assets" (for the purpose of distributions) might be tightened such as by taking 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 reporting requirements do not deliver sufficient progress; and
- A requirement for listed companies that there be at least one shareholder vote on dividends each year.[64]

3.2 Kingman Review of the FRC and audit procurement

On 17 April 2018, the Government launched an independent review of the Financial Reporting Council (FRC) led by businessperson Sir John Kingman. The review examined the role, governance and powers of the FRC.[65] 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 plans 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.[66]

Business Secretary Greg Clark said the government would "take forward the recommendations set out in the Review to replace

64 BEIS, Government response: Insolvency and Corporate Governance, August 2018, p22-3
65 BEIS, Government launches review of audit regulator (press release), 17 April 2018
66 Sir John Kingman, Independent Review of the Financial Reporting Council, December 2018, p5

the FRC with a new independent statutory regulator with stronger powers".[67]

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.
>
> 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 believed that there is a principled case for considering radical change (i.e. the independent appointment of auditors), but that it would not be right to press ahead if investors (the main users of the accounts) are firmly opposed.[68]

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.[69]

The Government published a formal response to the Review on 11 March 2019, which also included a consultation on some of the recommendations, as suggested by the Review itself. Chapter 7 of the consultation document sets out how the Government is taking forward each of the 83 recommendations that Sir John made.

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[67] BEIS, Independent review of the Financial Reporting Council (FRC) launches report (news story), 18 December 2018

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

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

3.3 BEIS Committee inquiry into the future of audit

The Business, Energy and Industrial Strategy Select Committee launched an inquiry into The Future of audit on 12 November 2018, and published its report on 2 April 2019. The inquiry sought to look at audit in the round and respond or feed into the other reviews and work happening in this area, and to link audit reform to the wider agenda of corporate governance reform. The report summary reads:

> ***The effectiveness of audit***
>
> We examined one of the core reporting and audit failures that brought down Carillion—the imprudent payment of dividends out of optimistically booked, and in hindsight unrealised, profits. We recommend that the Government and the Financial Reporting Council urgently produce a clear, simple and prudent definition of what counts as realised profits, and make further recommendations to tighten the UK dividend regime. To make audits more transparent and useful, we recommend the use of graduated findings and several measures to improve engagement with shareholders. We are clear that the detection of fraud should be a priority within an audit and audits must demonstrate how potential fraud has been investigated. We fully support the fundamental rethink of audit that Sir Donald Brydon is undertaking. We encourage him to consider how the scope of audit might be widened to give the auditor more opportunities to express forward-looking opinions and to report on more issues affecting stakeholders such as suppliers, employees and pension holders. This will make audit a more useful, informative product and a more varied, interesting career.
>
> ***Conflicts of interest and auditor independence***
>
> There are still fears that auditors are conflicted by the commercial culture in which they operate. The culture of advisory services does not sit easily with the culture of challenge required by audit. We recommend that the CMA aims for a structural split or at the very least implements its proposed operational split between audit and non-audit. If operational separation does not end cross-subsidies and fails to produce improvements in culture, independence and transparency, we recommend that the CMA implements a full structural break-up of the Big Four into audit and non-audit businesses.
>
> Many audit committees are placing an auditors' 'cultural fit' and 'chemistry' above their professional scepticism and some committees are spending too little time on audit. We welcome 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. We recommend that if this does not work, independent appointment of auditors by the regulator should be considered.
>
> ***Competition and resilience***
>
> The Big Four dominate the FTSE 100 and FTSE 250 audit markets. The obstacles facing challenger firms have led to a lack of competition and choice for some of our most important companies when they change auditors. Choice would all but disappear if one of the Big Four failed. This precarious situation must be addressed before it is too late. To improve resilience and choice, the challengers need to gain a secure foothold in FTSE 350

> audits. We therefore recommend a segmented market cap and the use of joint audits, on a pilot basis, for the most complex audits to enable the challengers to step up.
>
> ***Regulation***
>
> The Financial Reporting Council's (FRC) weak response to several audit scandals contributed to the current crisis of trust in audit. We agree with the Kingman Review and the Government that the FRC, with its voluntary base, needs replacing with a new statutory body, the Audit, Reporting and Governance Authority (ARGA). We also agree it needs more powers. We welcome the decision to replace the FRC's leadership and recommend that the Government introduces the necessary legislation to establish ARGA in the next session of Parliament. We also recommend stronger audit quality reviews to be published in full, greater responsibility for non-financial directors for financial reporting and further consideration to be given regarding greater internal controls and enhanced audit checks for banks.[70]

3.4 CMA audit market study

The Competition and Markets Authority (CMA) launched a market study into statutory audit on 9 October 2018. 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 focussed on three key issues in the audit market:

- 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 based on 'cultural fit' or 'chemistry' rather than those who offer the toughest scrutiny).[71]

On 18 December 2018, the CMA published an update paper for the statutory audit market study. The paper set out a range of remedies that the CMA was considering, including joint audits, market share caps and a split between audit and non-audit services.[72]

On 18 April 2019, the CMA published its final report. The CMA recommended:

- An operational separation of audit from consulting services, where the audit practice has its own leadership, separate remuneration and no longer shares in the profits of the consultancy arm. This remedy is to mitigate conflicts of interest and reduce cultural tensions between audit (challenging management) and consulting services (helping management).
- Mandatory joint audits for most large companies involving at least one auditor from outside the Big Four, or the appointment of a single non-Big Four auditor if a company does not want joint

The CMA recommended that **audit be separated** from consulting services, and that most large companies be required to **appoint an auditor from outside the Big Four** (either jointly with a Big Four or alone).

[70] BEIS Committee, The Future of Audit, HC 1718, 2 April 2019, pp3-4
[71] CMA, CMA proposes reforms to improve competition in audit sector (press release), 18 December 2018
[72] CMA, Audit update paper, December 2018, p86

auditors. This remedy is to enable firms outside the Big Four to develop the capacity and skills to audit the UK's biggest companies. Building up the 'Challenger' firms will increase choice for companies and make the market more resilient (to address the systemic risk that a Big Four failure poses of falling 'from four to three' by going 'from four to more').

- The introduction of statutory powers to enable the regulator to closely scrutinise the work and decisions of companies' audit committees, and hold them to account. This remedy is to ensure that audit committees choose auditors that are likely to provide the most robust and constructive challenge to the accounting practices of the company, instead of auditors who show 'cultural fit' or appear accommodating.[73]

In July 2019 the Government said it "agreed with [the CMA's] conclusion that more can be done to strengthen quality, competition and resilience in the audit market", and launched a consultation paper on the CMA's recommendations.[74] A summary of responses to the consultation was published in March 2021 alongside the White Paper discussed in section 4.

3.5 Brydon Review into the quality and effectiveness of audit

On 18 December 2018, Business Secretary Greg Clark announced an independent review of the future of audit, chaired by businessperson Sir Donald Brydon. Greg Clark wrote that the Review would consider the following questions:

- 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.[75]

The Review's terms of reference were published on 14 February 2019, and a call for views on 10 April 2019 (with the responses published in December 2019). This consultation invited views, information and evidence on, in particular:

- the purpose of audit and for whom it should be carried out
- whether its scope and purpose should be widened and strengthened to meet changing expectations of audit
- how the quality of the audit process and product could be improved
- whether audit findings could be better communicated

73 CMA, CMA recommends shake-up of UK audit market (press release), 18 April 2019
74 CMA, Market Study on Statutory Audit Services, July 2019
75 Greg Clark, Update on Audit Industry: Written statement - HCWS1193, 18 December 2018

- the role of audit within wider business assurance and in relation to directors' legal responsibilities
- the role of audit in detecting fraud
- auditor liability[76]

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

Included within these topics is the issue of capital maintenance, discussed in earlier sections (1.2, 2.4, 3.1 and 3.3). The CMA and the BEIS Committee both asked Brydon to focus on it.[77] The CMA received views that "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."[78]

The Brydon Review report was published in December 2019, making 64 recommendations. In summary the recommendations entail:

- A redefinition of audit and its purpose;
- The creation of a corporate auditing profession governed by principles;
- The introduction of suspicion into the qualities of auditing
- The extension of the concept of auditing to areas beyond financial statements;
- Mechanisms to encourage greater engagement of shareholders with audit and auditors;
- A change to the language of the opinion given by auditors;
- The introduction of a corporate Audit and Assurance Policy, a Resilience Statement and a Public Interest Statement;
- Suggestions to inform the work of BEIS on internal controls and improve clarity on capital maintenance;
- Greater clarity around the role of the audit committee;
- A package of measures around fraud detection and prevention;
- Improved auditor communication and transparency;
- Obligations to acknowledge external signals of concern;
- Extension of audit to new areas including Alternative Performance Measures; and
- The increased use of technology.[79]

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76 Brydon Review, The quality and effectiveness of audit: call for view, 10 April 2019

77 CMA, Appendix C to audit market study update paper: the 'expectations gap'; the purpose and scope of audit, December 2018, p11; and: BEIS Committee, Oral evidence: Future of Audit, HC 1718, 4 February 2019, Q524

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

79 Sir Donald Brydon, Report of the Independent Review into the Quality and Effectiveness of Audit, December 2019, p6

4. White Paper

In March 2021 the Department for BEIS released its White Paper on audit and corporate governance, together with a consultation on its proposals. Responses to the consultation are due by 8 July 2021, and will "inform draft legislation that the Government will introduce to Parliament when Parliamentary time allows".[80] The reforms comprise a "holistic approach" which reform the roles of directors, auditors, shareholder and the audit regulator. The reforms for each are summarised below.[81]

Its proposals are described as "firmly based" on the findings of the Kingman, Brydon and CMA investigations.[82] Together with the White Paper, the Government published a document describing the steps it is taken in relation to each of the recommendations made by these investigations.[83]

Directors

Currently, the FRC has limited powers to enforce action against directors for breaches of their duties. The Government also considers current reporting requirements on directors to be weak.

The proposals therefore include new reporting requirements for directors, covering internal controls, dividend, capital maintenance decisions, and resilience planning. The regulator will also be given powers of investigation and enforcement in relation to large businesses which are considered to be of public importance. Currently, auditors of PIEs (being mainly publicly listed companies) are subject to additional requirements. The proposals involve expanding the definition of a PIE to include the largest private companies.

The Government is considering options for bolstering internal controls. The current preferred option is to require directors to make a statement about the effectiveness of the company's internal controls, but leaving directors, shareholders and audit committees to decide on whether such a statement should be assured by an external auditor.

Proposals are also being explored by the Government on whether and how companies calculate their distributable reserves, from which they can grant dividends. Options include requiring companies to disclose the amount of their distributable reserves or simply requiring directors to state that any proposed dividend is within known distributable reserves and will not in their expectation threaten the solvency of the company over the next two years.

Directors of PIEs may also be required to make an annual Resilience Statement, setting out their assessment of the company's prospects (including risks posed by climate change), and to have an Audit and

80 Ibid, p28
81 Ibid, pp 15-23, 121. See here for the proposals' impact assessment
82 BEIS, Restoring trust in audit and corporate governance, March 2021, p5
83 BEIS, Supplementary Publication on Review Recommendations, March 2021

Assurance Policy describing how the directors seek assurance of the information they report to shareholders.

The Government is seeking to give the regulator enforcement powers for wrongdoing by directors of PIEs, including though clawbacks of executive directors' remuneration.

Auditors

The audit product has not changed significantly in decades, and recent high-profile corporate failures have called into question the effectiveness of audits. The Government therefore plans to introduce a new "audit profession". There will also be new measures to increase competition and reduce conflicts of interest, requirements to separate audit and non-audit work, and new opportunities for smaller or challenger firms to audit larger companies.

The new "audit profession" would operate independently of current professional bodies, with a new body potentially set up to regulate corporate auditors. There will be separate principles for auditors to follow, new obligations on detecting fraud, and a new duty for auditors to take a wider range of information into account when reaching judgements.

Powers will be given to the regulator to monitor the resilience of the audit markets and of auditors. ARGA, once set up, will be given rule-making powers to help create and maintain the regime surrounding shared audits with challenger firms and the operational separation between the audit and non-audit activities of firms.

Shareholders

The Government says that are concerns that shareholders do not take enough of an interest in audit quality. The proposes therefore require companies to set out their approach to audit by having an Audit and Assurance Policy, on which the shareholders would have an advisory vote. Shareholders would also be given the chance to propose areas of emphasis to audit committee which the auditor could focus on. Better communication between shareholders and directors would be required following the dismissal or resignation of the auditor of a PIE.

The audit regulator

The FRC is argued to lack a meaningful statutory base, clear statutory objectives, and adequate enforcement powers. The Government is proposing legislation to replace the FRC with a new body, the Audit, Reporting and Governance Authority (ARGA). ARGA would be funded by a new statutory levy from market participants rather than the existing voluntary levy which funds the FRC. It would be set up as a company limited by guarantee, with objectives to promote and protect the interests of investors, other users of corporate reporting, and the wider public interest.

ARGA would also be given new powers of oversight, enforcement and approval. It would be accountable to Parliament with "strategic direction" from the Government.

ARGA would have powers to direct changes to company reports and accounts, rather than having to seek a court order as the FRC must currently do. The whole of a company's annual report will also be brought within the scope of the review of the regulator, meaning that areas like corporate governance and directors' remuneration statements could also be considered. ARGA will be able to publish its summary findings after such reviews.

The regulator would be given powers to set additional requirements for how audit committees appoint and supervise auditors. These are intended to apply to FTSE 350 companies. The regulator would be able to step in and appoint the auditor itself when serious problems are identified with a company's audits.

ARGA would be responsible for approving statutory auditors of PIEs, rather than professional bodies. The transparency of the regulator's current Audit Quality Review reports will also be enhanced.

In addition to auditors, ARGA would also have a statutory role in supervising accountants and actuaries. Its information-gathering and investigatory powers will be enhanced to enable it to better identify and assess issues with companies' corporate reporting or audits.

Commentary

The proposals have received both support and criticism.

A *Financial Times* article noted that the Government's proposals have been "broadly welcomed by audit executives and business groups" but noted there will be significant "extra cost and red tape". Their analysis of the Government's Impact Assessment concludes that more than £430m could be added to business costs under the Government's preferred options. The proposal to encourage competition by requiring shared audits between the Big Four and a small rival could cost around £23m per year, and the establishment of ARGA would cost around £39m per year.[84] An article from the FT editorial board described the reforms as a "sensible framework".[85]

Former Conservative Party leader Ian Duncan Smith MP, who now heads a Government deregulatory taskforce, said he would find it "difficult to see why we would be adding to the regulatory burden on businesses" at the present time "when we should be looking to ease the regulatory burden".[86]

An FT article also criticised the Government for not adopting the recommendation of the CMA to require joint audits of FTSE 350 companies, and instead use a "managed shared audit model" under which companies must use a challenger firm to conduct a "meaningful portion" of audits.[87] It argues that the Government's proposal is a halfway house that "probably pleases no one", stating that according

84 FT, UK audit reform set to cost businesses more than £430m a year, 18 March 2021
85 FT, Restoring confidence in UK plc, 18 March 2021
86 Ibid
87 FT, Restoring confidence in UK plc, 18 March 2021

to the CMA joint audits were successfully trialled in France. Proposals on director accountability were also criticised as a "tad flimsy".[88]

Writing in the FT, Karthik Ramanna, professor of business and public policy at Oxford University's Blavatnik School of Government, said that the Government's proposals have "not been worth the wait". He criticised the proposals for focusing on fixing rules rather than rebuilding norms. The problem (he says) is not the rules in themselves, but the lack of a culture within auditors and corporates to challenge malpractice. The proposal to require shared audits of companies using small auditors alongside the Big Four was deemed "misplaced" because it would lead to such smaller firms underinvesting in quality, making the UK "less entrepreneurial and markets less safe for investors". Proposals to replace the FRC with ARGA were deemed to "[miss] the point", which is not that the FRC has a lack of powers but instead that it is too close to the audit industry.[89]

A number of figures including Anne Richards, chief executive of Fidelity International, have raised concerns that increase the accountability of non-executive directors for accounts risks putting off some high-quality candidates and may harm efforts to increase diversity at boardroom level.[90]

The interim chief of the FRC, Keith Skoech, has said that ARGA would probably not be established until 2023 because of the need for primary legislation, but that the FRC was working on "areas that did not require legislation, such as pushing through the separation of the audit and advisory function of the Big Four audit firms". He warned that the FRC would use new powers to be granted to it by the Government to rebuild trust in the corporate sector, which he said is relatively low.[91]

[88] FT, Long road to audit reform is littered with questions, 18 March 2021
[89] FT, UK audit reforms fail to address the real problem behind scandals, 20 March 2021
[90] See FT, City of London bosses warn against 'gold plating' new governance rules, and Letter: Audit reform may stall boards' diversity drive, 24 March 2021
[91] FT, Trust in UK corporate sector is low, admits chief of audit watchdog, 26 March 2021

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