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By Peter Brook

Company audits: issues and proposed reforms

Summary
1 Audit basics
2 Audit failures and industry challenges
3 Reviews and recommendations
4 White Paper and proposed reforms

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Summary

Audit basics

The Companies Act 2006 sets out the main responsibilities of directors and auditors. Directors have an obligation to give a "true and fair view" in the annual accounts. The auditor must verify whether, in their opinion, the accounts give a "true and fair view" of the company's situation. Large companies can only pay dividends from "properly prepared" audited accounts. According to the Financial Reporting Council (FRC), the UK audit regulator, audit serves the public interest by underpinning transparency and integrity in business.

Issues

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. FRC fines for audit failures reached a record high in 2022 of £33.3m.

Lack of competition

The audit industry is dominated by the "Big Four" accountancy firms: PWC, Deloitte, EY and KPMG. The FRC confirm that between them, the Big Four audit almost the entire FTSE 350. Although four companies allows some competition in the market, the reality is that the Big Four would rarely all compete for the same audit contract.

Most often, a variety of conflicts of interest, including a prohibition on auditors also providing certain accounting services to clients, preclude one or more of the Big Four from tendering. 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 for companies seeking audit, there often aren't four to choose from, but often two or even just one.

Conflicts of interest

Sometimes, management of the company and the auditor have contradicting interests, such as when there is a gap between market expectations and company performance. In such circumstances, there is a risk that management's incentive is to overstate the performance of the company, whereas the auditor's role is to objectively verify that the accounts are materially true and fair.

Management have the ability to make the audit more difficult by being less cooperative, the ability to not reappoint the auditor and the threat of not awarding contracts to other arms of the accountancy firm. Some have argued that the creation of audit-only firms is the solution, whereas others argue that accountancy firms should be banned from providing non-audit services to audit clients. Neither has been taken forward in the proposed Government reforms.

Quality and supervision

Many audits are found to be substandard by the regulator.

In 2023, KPMG was fined a record £26.5m (reduced to £18.6m for co-operation) and a further £3.5m (reduced to £2.5m) for deficiencies in its auditing of Carillion.

In recent years, 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. The FRC's list of imposed enforcement sanctions shows that fines have also recently been imposed against other big players too, including Deloitte (October 2022), EY (June 2021), Grant Thornton (November 2021) and BDO (June 2020).

Despite record FRC fines in 2022 of £33.3m, these are still relatively low in the context of comparable industries. In the same year, the UK's financial services regulator, the Financial Conduct Authority (FCA), imposed total fines of £215.8m.

Proposed reforms

The Government has been exploring options to reform the audit industry for a number of years. It published a consultation and white paper in March 2021 outlining proposals for reform. The consultation received over 600 responses which the Government said, "helped fine-tune the package of measures". The Government published its response including its final reform proposals on 31 May 2022.

Some of the key proposals from the Government's response to the consultation include:

Audit Reporting and Governance Authority (ARGA)

- the creation of a new statutory regulator (the Audit, Reporting and Governance Authority – ARGA) with new responsibilities and powers, including "overseeing the accounting and actuarial professions, a stronger role in auditor registration, and new powers to tackle breaches of company directors' duties relating to corporate reporting and audit."

- a package of measures intended to increase choice, improve resilience, and enhance professional scepticism: notably giving challenger audit firms a meaningful proportion of subsidiary audits conducted for FTSE 350 companies; giving ARGA the ability to operate a 'market share cap'; and powers for ARGA to require 'operational separation' of the largest firms and to monitor the health of audit firms.
- enabling ARGA to direct changes to company reports and accounts, rather than having to seek a court order, along with powers to publish summary findings following a review.
- giving ARGA powers to investigate and sanction directors for breaches of corporate reporting and audit-related duties.
- giving ARGA responsibility for registration of auditors within scope, and ask professional bodies to improve auditor qualifications, skills, and training.

Other reforms

- expanding "the scope of regulation to large private companies" – those with both 750+ employees and an annual turnover of £750m+.
- inviting the current regulator (the Financial Reporting Council) to strengthen the UK Corporate Governance Code to provide for an explicit directors' statement about the effectiveness of a company's internal controls and the basis for that assessment).
- changing reporting requirements to "introduce a new statutory Resilience Statement and a new statutory Audit and Assurance Policy" for companies within scope.
- a new statutory regime for the oversight of accountancy professional bodies and powers to investigate and sanction accountants.

The proposed reforms were met with a mixed response. Some stakeholders referred to the "watering down" of initial plans to overhaul audit rules, whereas others welcomed the "most radical shake-up" in years.

Implementation

A number of stakeholders have urged the Government to implement its proposals for reform more quickly. Despite being announced in the May 2022 Queen's Speech, the Government did not publish a Draft Audit Reform Bill. Audit reform was not included in the November 2023 King's Speech.

In October 2023, responding to a parliamentary question the Minister for Enterprise, Markets and Small Business, Kevin Hollinrake stated that:

> the Government has carried out significant work towards audit and corporate governance reform legislation but has not set a date for publication of a draft Audit Reform Bill. The Government is committed to legislating when Parliamentary time allows.

1 Audit basics

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

The Companies Act 2006 sets out the main financial reporting responsibilities of directors and auditors.[1] Directors are responsible for the accounts of their company, made up of the financial statements and the annual report. The accounts must be signed by a director, which could be the CEO, CFO or Finance Director, on behalf of the board, but they are normally prepared by specialised financial reporting teams with input from managers across the company.[2] Accounts must give a "true and fair view", and companies must also follow suitable accounting standards.[3]

It is the job of the auditor to verify that the accounts give a "true and fair view", and that the accounting standards have been applied properly.[4] The auditor must give an "opinion" as to whether the accounts have been prepared in accordance with the Act. The auditor can "qualify" their opinion if the accounts have not been properly prepared.[5]

To carry out an audit, auditors work closely with the company's managers (hereafter "management"), who supply them with evidence and explanations. The closeness of this relationship can be both a strength (for example by enabling an efficient and effective audit) and a weakness (for example by diminishing the auditor's ability and willingness to challenge management).

Companies can only pay dividends out of past, realised profits classified as "distributable reserves".[6] Dividends must be justified by reference to "relevant accounts", usually be the company's latest audited accounts, which must have been "properly prepared".[7]

If the auditor 'qualifies' the accounts, a company cannot rely on them to justify a dividend. The company would have to seek a further opinion from the auditor on the effect of the matters at issue on the ability of the company to make a distribution.[8]

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

1 Part 15 of the Companies Act 2006 sets out the responsibilities of directors, and part 16 sets out the requirements for audited accounts, the appointment and removal of auditors, their functions and their liability.
2 Companies Act 2006, 414
3 Companies Act 2006, 393-395
4 Companies Act 2006, 495
5 Companies Act 2006, 474
6 Companies Act 2006, 830-831
7 Companies Act 2006, 836-839
8 Companies Act 2006, 837 (4)

The accounts are used to justify paying dividends.

Dividends can only be paid when the auditor finds the accounts to be "true and fair".

> 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.[9]

1.1 Why can accounts be wrong?

The reasons behind accounting errors (or "misstatements") can range from simple errors to serious fraud and anything in between. There can be incentives for 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 valuation of a company's stock, the value of an uncertain future liability, or the likelihood of recouping money from debtors. These judgements can have a significant impact on the company's final profit figure, creating an incentive for the company to favour certain accounting judgements.

Consultancy and accountancy firm EY's Global Integrity Report 2022 surveyed 4,762 board members, managers and employees across 54 countries and territories, finding that:

- 55% of respondents believe that standards of integrity have either stayed the same or worsened over the last 18 months;
- 18% of all surveyed board members would be prepared to mislead external parties such as auditors or regulators to improve their own career progression or remuneration. This is six times that of employees; and
- 42% of surveyed board members agree that unethical behaviour in senior or high performers is tolerated in their organization (up from 34% in 2020).[10]

1.2 What are audits for?

The main principles and objectives of audit are laid out in the International Standard on Auditing (ISA) 200. It describes the purpose of the audit as

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

10 EY, Global Integrity Report 2022 (PDF), pp3 and 22

increasing confidence in the financial statements, through the auditor's work, set out in the auditor's opinion:

> 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 financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.[11]

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 described by the Financial Reporting Council:

> 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.[12]

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 impact the decisions of users of the accounts (for example 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.[13]

Auditors set materiality thresholds for the companies they audit using their judgement. These thresholds are used both in planning the scope of the audit work (the aim is to provide reasonable assurance that there are no errors above the threshold) and in evaluating results (errors below the threshold will normally not affect the auditor's opinion). Auditors calculate materiality by using their judgement to determine the level at which errors would influence user decisions. Usually, it is calculated as a percentage of a key value in the accounts, such as profit, or revenue. ISA 320 provides guidance and representative examples for auditors.[14]

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11 Financial Reporting Council, International Standard on Auditing (UK) 200 (PDF), updated May 2022, p2

12 Financing Reporting Council, Audit Culture Thematic Review, May 2018, p4

13 As above, p3

14 Financial Reporting Council, International Standard on Auditing (UK) 320, updated May 2022, p6

To give an example, Tesco's auditor, Deloitte, set materiality at £100 million for Tesco's 2021/22 group accounts, which was determined as 4.6% of Tesco's adjusted profit before tax.[15]

Although the auditor sets a financial threshold over which errors are considered material, some errors are considered material by nature. This means that for certain errors in the accounts, auditors would give a qualified opinion regardless of the error value. Examples would include errors in disclosing management remuneration, errors due to management fraud, or reporting incorrect cash balances.

Opinion

The auditor provides an opinion, not a guarantee or a fact. It is an informed opinion, whereby the auditor can take reasonable assurance that the accounts are free from material misstatement, 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.[16]

The auditor's opinion is published in the company's annual report and accounts.[17]

Audit expectation gap

It has been argued that public and stakeholder expectations of audit exceed the level required by the auditing standards, and the level that can be reasonably achieved at an affordable cost.[18] This mismatch is known as the "audit expectation gap". [19]

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15 Tesco, Annual Report 2022 (PDF), p106

16 Financial Reporting Council, International Standard on Auditing (UK) 200, updated May 2022, p3

17 For example, here is the Independent auditor's report to the members of Tesco PLC

18 Mengyan Gao, The Cause of Auditing Expectation Gap, Journal of Finance Research, October 2020, p51

19 Brenda Porter et al., Report On Research Conducted In The United Kingdom And New Zealand In 2008 Investigating The Audit Expectation-Performance Gap (PDF), September 2009

An oft-cited example of the expectation gap relates to fraud detection.[20] Auditors do not and cannot prevent or stop all fraud in a company; rather, they must stand a good chance of detecting fraud with a material impact. Stakeholders and the general public often expect auditors to prevent fraud, and can be left disappointed with audit's actual more limited role, solely in detection.[21]

The expectation gap might in part stem from the value and importance of audit to wider stakeholders, as it underpins transparency and integrity in business.[22]

However, disappointment with audit is not only caused by mistaken expectations. In 2019, the then Business, Energy and Industrial Strategy Committee of the House of Commons found that too many audits were "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" They recommended that this "must be fixed as soon as possible".[23] The Government responded by highlighting that they had commissioned the then ongoing Brydon review into audit quality [see section 3.5] and that the FRC will continue to monitor audit performance and take action where appropriate.[24]

1.3 Who must be audited?

The EU Statutory Audit Directive 2006/43/EC required 'public-interest entities' (PIEs) to have their annual accounts audited. PIEs are broadly defined as listed companies, credit institutions and insurance undertakings. The UK Companies Act 2006 implemented the directive in the UK and extended the obligation to audit accounts further.

Section 475 of the Companies Act 2006 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); defined as holding turnover of below £10.2 million per year, a balance sheet total of below £5.1 million, and not more than 50 employees.[25]
- Subsidiary companies where the company's results are consolidated (included in) the group accounts, with certain exceptions (section 479A);

20 As above, p15
21 As above, p15
22 Financing Reporting Council, Audit Culture Thematic Review, May 2018, p4
23 BEIS Committee, The Future of Audit (PDF), HC 1718, 2 April 2019, para 25-56
24 Future of Audit: Government Response (PDF), HC2296, 7 June 2019, p3
25 Companies Act 2006, Section 382

1.4 Who regulates the auditors?

Dormant companies (section 480); companies which are not trading or active (defined as having no significant accounting transactions in the period),[26] Listed companies and large private companies must be audited annually.

The **Financial Reporting Council** (FRC) is the competent authority for audit in the UK. It 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.[27]

The FRC is funded by the audit profession and carries out regular audit quality reviews, and publishes lists of its enforcement sanctions against auditors.[28][29][30]

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

The FRC delegates some responsibilities for oversight to the six chartered accountancy bodies, known as recognised supervisory bodies.[31]

They delegate the power to award recognised professional qualifications to auditors.[32]

1.5 What are the standards and who sets them?

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

[26] Companies Act 2006, Section 1169

[27] FRC, Roles and Responsibilities (PDF), December 2022, pp2-3

[28] FRC, Funding, 5 October 2023

[29] FRC, Audit Quality Reviews, 25 September 2023

[30] FRC, Enforcement Cases, accessed 10 November 2023

[31] The six chartered accountancy bodies are: Association of Chartered Certified Accountants, Chartered Accountants Ireland, Chartered Institute of Management Accountants, Chartered Institute of Public Finance and Accountancy, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland.

[32] FRC, Oversight of Audit, accessed 10 November 2023

Accounting 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".[33] Another is to increase consistency across companies.

UK accounting standards derive from two main sources. The first, issued by the FRC[34] and based on the requirements of Part 16 of the Companies Act 2006, is known as UK GAAP (Generally Accepted Accounting Practice)[35] and is used by most UK companies that need to have audited accounts. The second are international financial reporting standards set by the International Accounting Standards Board (IASB) of the IFRS Foundation, which is headquartered in London,[36] and which are adopted for use in the UK ("**UK-adopted international accounting standards**").[37]

Since leaving the EU and the end of the transition period (31 December 2020), new standards are considered by a body called the UK Endorsement Board (the **UKEB**). UKEB is independent of the FRC in its technical decision-making, although the FRC oversees the UKEB's adherence to its due process and governance.[38] The UKEB reports on the performance of its functions annually to the Secretary of State, who must lay that report in Parliament.[39] So far, the UKEB has not made any decision to diverge from standards set by the IASB.

Publicly listed companies in the UK must use UK-adopted international accounting standards for their group accounts, and other companies can choose to do so if they wish (for example, for the sake of easier international comparability). As of January 2022, around 1,500 listed companies in the UK prepared their accounts using UK-adopted international accounting standards, and around 14,000 UK companies voluntarily chose to report under UK-adopted international accounting standards.[40] For context, as at March 2023 there were over 5.1 million UK companies on the UK company register.[41]

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. UK GAAP itself is based on international financial reporting standards and can generally be seen as a less complex version of UK-adopted international accounting standards. As of 2018, 144

33 FRC, Foreword to Accounting Standards (PDF), March 2018, p1
34 FRC, Roles and Responsibilities (PDF), December 2022, p2
35 See ICAEW, UK GAAP [accessed 3 November 2023]
36 IFRS Foundation, Who we are [accessed 3 November 2023]
37 FRC, Overview of the Financial Reporting Framework (PDF), January 2022, p4
38 UK Endorsement Board, Structure [accessed 3 May 2023]
39 As above
40 Letter from Pauline Wallace (UKEB) to Andreas Barckow (IASB), 28 January 2022 (PDF), p1
41 Companies House, Official Statistics, section 2, 27 April 2023 [accessed 3 November 2023]

jurisdictions required IFRS-based Standards for all or most companies, including the UK and all EU countries. The major exception is the United States, which uses its own national standards.[42]

Auditing standards

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 in the UK with minor additions by the FRC. The FRC describes these additions as:

> Where necessary, the international standards have been augmented with additional requirements and application and other explanatory material that is appropriate in the UK national legislative, cultural, and business context.[43]

The FRC confirms that the UK ISAs remain compliant with the ISAs issued by the IAASB:

> ISAs (UK) are consistent with International Standards on Auditing as issued by the IAASB and the requirements of ISAs (UK) do not conflict with the requirements in ISAs. An audit conducted in accordance with ISAs (UK) does not therefore preclude the auditor from being able to assert compliance with International Standards on Auditing issued by the IAASB.[44]

1.6 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.[45]

The table below shows the audit and non-audit income of the six largest accountancy firms in the UK in 2022. Income for both audit and non-audit work for each of the Big Four is significantly larger than the nearest challengers, BDO and Grant Thornton. The audit income of EY, the fourth biggest player, is almost double that of the next biggest player, BDO.

UK FEE INCOME OF LARGEST ACCOUNTACY FIRMS, 2022

Firm	No. of PIE Audit Clients	Audit (£m)	Non-Audit Work to Audit Clients (£m)	Non-Audit Clients (£m)	Total Fee Income (£m)
PwC	297	818	195	2862	3875

[42] IFRS, Use of IFRS Standards around the world 2018, p2

[43] FRC, Scope and Authority of Audit and Assurance Pronouncements, March 2023, para 18-20

[44] As above, para 18

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

KPMG	192	709	98	1916	2723
Deloitte	255	649	209	3425	4283
EY UK	225	626	163	2440	3229
BDO	217	324	73	411	808
Grant Thornton UK	20	167	52	428	648

Source: FRC: Key Facts and Trends in the Accountancy Profession, Figure 33 (PDF), August 2023

Notably, audit work only contributes a minority share of the total fee income of the Big Four – between around 19% and 26%. Nonetheless, in 2022 the Big Four dominated the top end of the audit market, auditing 98 of the FTSE 100 companies and 202 of the FTSE 250.[46] The Big Four's dominance has reduced slightly compared to previous years. By comparison, in 2020, the Big Four audited the entire FTSE 100, and 208 of the FTSE 250.[47]

[46] FRC, Key Facts and Trends in the Accountancy Profession, Figure 38 (PDF), August 2023

[47] FRC, Key Facts and Trends in the Accountancy Profession, Figure 38 (PDF), July 2021

2 Audit failures and industry challenges

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. The FRC fines for audit failures reached a record high in 2022 of £33.3m.[48]

In 2023, KPMG was fined a record £26.5m (reduced to £18.6m for co-operation) and a further £3.5m (reduced to £2.5m) for deficiencies in its auditing of Carillion.[49]

In recent years, 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.[50] The FRC's list of imposed enforcement sanctions shows that fines have also recently been imposed against other big players too, including Deloitte (October 2022), EY (June 2021), Grant Thornton (November 2021) and BDO (June 2020).[51]

The Work and Pensions Select Committee and the Business and Trade Select Committee have expressed concern that audit quality is too often too low.[52] '

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 2021) it found that "audit quality remains mixed and inconsistent across the firms and in some instances, between audits at the same firms" commenting that:

> The results of our Audit Quality Reviews and recent enforcement cases once again highlight deficiencies relating to lack of professional scepticism by auditors, including failures to sufficiently challenge management's assumptions, as well as evidence of the poor application of professional judgement. The persistence of these issues over time is disappointing given that they are fundamental to the mindset required to deliver effective audits.[53]

Below the main problems affecting the audit market are examined. These problems can be grouped under four broad categories. Critics of the current

48 City AM, FRC fines hit record highs as watchdog sends 'clear message' to UK's audit sector, 14 November 2022

49 FRC, Sanctions against KPMG LLP, KPMG Audit PLC and two former partners, 12 October 2023

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

51 FRC, Enforcement Cases, updated 12 October 2023

52 See for example criticism of the audit of Wilko in the Business and Trade Committee, Oral evidence: The collapse of Wilko (PDF), HC 316, 28 November 2023

53 FRC, Developments in Audit 2021, pp3-4

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

The Big Four dominate the audit market for very large companies. Almost all S&P 500 companies and the vast majority of FTSE 100 and FTSE 250 companies are audited by the Big Four. [54]

Although four companies allows some competition in the market, 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.

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

Article 5(1) of the EU Audit Regulation[55] which also forms part of UK law in The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019, sets out services which auditors cannot perform for their audit clients.

These services include 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 for companies seeking audit, there often aren't four to choose from, but often two or even just one, as reported by the Financial Times in 2018:

> 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.[56]

In such circumstances, if one were to fold or withdraw from the audit market, it could leave large companies with no choice over who performs their audit.

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. 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

54 See FT, A shake-up of audit's oligopoly is long overdue, 2 September 2018; FRC, Challenger firms increase their share of the FTSE 250 audit market, 14 July 2021; and FRC, Key Facts and Trends in the Accountancy Profession, Figure 38 (PDF), August 2023

55 The Statutory Auditors and Third Country Auditors (Amendment) (EU Exit) Regulations 2019

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

> 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.[57]

In 2013, 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.[58]

There have been suggestions that audit services are treated as a "loss leader", whereby audits are performed for below cost in order to sell more profitable services.[59] Menzies LLP (a mid tier UK accountancy practice), outlined their view of the practice:

> We believe that competitive forces are pushing prices down. This disincentivises the audit firm from doing any more work than the minimum and, as a result, means that fraud is less likely to be detected by the auditor and that issues surrounding the entity's ability to continue as a going concern may not be considered sufficiently.
>
> Audit work is sometimes treated as a "loss leader", i.e. the work itself does not make a profit but leads to the audit firm cross selling other services which are profitable. We recognise that this approach is changing and welcome the separation of audit from other business areas. Where an audit firm provides advice outside of the audit to an entity, there is a risk that the firm finds itself advising on a fraudulent matter which the audit is designed to detect.[60]

The main remedy the CC pursued in 2013 was an obligation to put statutory audit engagements 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).[61] The CC's aim was to make it easier for mid-tier audit firms (for example Grant Thornton and BDO) to win FTSE 350 contracts.

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57 FRC, Response to Carillion Select Committee letter, 3 July 2018

58 CC, Statutory audit services for large companies market investigation: Final report (PDF), 15 October 2013, p7

59 ACCA, Rising technology costs, heavier regulatory burden and greater auditor rotation are all starting to bite as the Big Four look to shake off the loss-leader suspicions around audit, October 2019

60 Menzies LLP, Submission to Accountancy Europe about going concern and fraud (PDF), 30 April 2021

61 As above

Although there is some competition in the FTSE 350, the Big Four remain overwhelmingly dominant at the top end (see chapter 1.6).

Increasing competition by breaking up the Big Fourwas not considered. [62] But in 2018, some wanted regulators to give it serious consideration. In particular, the then Business, Energy and Industrial Strategy Committee and the Work and Pensions Committee, who 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)[63]

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".[64] 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 explained the problem:

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

> 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 performance or a company is otherwise under financial pressure, this conflict may generate significant contradictory incentives.

62 Breaking off audit from non-audit services amongst the Big Four could arguably increase choice by reducing or eliminating the conflicts of interest that disqualify firms from auditing companies they supply other services to.

63 Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion (PDF), May 2018

64 Letter from Rt Hon Greg Clark to Lord Tyrie, CMA Chair, 9 October 2018

> 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.[65]

Management hold influence over the auditor because they can harm the auditor's interests. Management are able to exercise power over the auditor by:

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

The first 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".[66]

The Head of Audit at accountancy firm BDO, Scott Knight, argued instead that accountancy firms should simply be banned from providing any non-audit services to their audit clients as the current rules were too vague:

> 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."[67]

On the other hand, Deloitte pointed out that, thanks to the EU audit regulations and the FRC's ethical standards revised 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".[68]

The FRC's ethical standards were revised again in 2019 to further limit the level of non-audit services that firms can provide to audit clients. The rules were also extended to include previously excluded smaller engagements, rather than solely PIEs. Certain non-audit services were banned entirely for

65 CC, Statutory audit services for large companies market investigation: Final report (PDF), 15 October 2013, p33

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

67 FT, BDO calls for greater restrictions on non-audit work, 1 May 2018

68 Deloitte's response in: Carillion: Responses from Interested Parties to the Joint Report, 12 July 2018, p23

firms providing statutory audits, including valuation services, relevant IT systems implementation and internal audit.[69]

The revised standards set a lower bar at which audit firms must either refuse to provide non-audit services, or resign from the engagement, namely they must resign where:

> For an engagement, where it is probable that an objective, reasonable and informed third party would conclude that the proposed non-audit / additional service would impair integrity or objectivity and compromise the independence of the firm or covered persons.[70]

The proposals to create audit-only firms or a ban on non-audit services only deals with one of the 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 involves the audit committee (composed of independent non-executive directors) making 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 Annual General Meeting (see for example Tesco's Results of June 2020 AGM, with resolution 18 "To reappoint the auditors" passing with over 99% of the votes).[71] The Secretary of State has power to appoint an auditor if a company fails to do so.[72]

Despite their ability to vote on the directors' decision, the Competition Commission found the role of shareholders to be minimal. They found the opposite to be true of executive directors, in particular the CFO.They found that due to a lack of available information, and a lack of coordination, shareholders almost always follow the recommendations of the board:

> 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.[73]

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.[74] Professor (now Lord) Prem Sikka of

69 FRC, Revised Ethical Standard 2019 (PDF), December 2019, Section 5
70 As above, Section 5.17
71 The law is found in Part 16, Chapter 2 of the *Companies Act 2006*
72 As above, section 490
73 CC, Statutory audit services for large companies market investigation: Final report, 15 October 2013, pp176-7
74 FT, An illusion of choice: the conflicts that mire the audit world, 9 August 2018

the Essex Business School goes further and argues that the regulator shouldn't just appoint auditors, but directly audit companies.[75] The Business, Energy and Industrial Strategy (BEIS) Select Committee (now Business and Trade 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.[76]

The Government responded by including the suggestion in the CMA consultation on the audit market (see section 3.4). The CMA included the suggestion as a proposal which 'might merit further consideration' in its March 2021 summary of responses to the consultation on the audit market.[77] The proposal was not included in the Government's audit reform White Paper.[78]

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 to some extent under any system. It is tempered somewhat by the statutory requirement for the company's accounts to be audited. If an audit firm is hampered by management, or does not get cooperation, the audit opinion can be qualified or modified whereby an auditor can withhold their opinion due to a 'limitation of scope'.[79] A qualified audit opinion can have serious consequences for the company, including reputational damage and a loss of investor confidence. Audit firms can also negotiate additional fees to cover extra work, although increases rarely fully cover cost overruns.[80]

The then BEIS Committee made several recommendations aiming to balance the 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)[81], more regulatory scrutiny of audit committees,[82] and powers for the regulator to intervene in the interest of quality.[83] The Committee's inquiry into audit is discussed in section 3, BEIS Committee inquiry.

75 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
76 BEIS Committee, The Future of Audit (PDF), HC 1718, 2 April 2019, para 179
77 BEIS, Market Study on Statutory Audit Services (PDF), March 2021, p20
78 BEIS, Restoring trust in audit and corporate governance, March 2021
79 ICAEW, Limitation on the scope of the audit (PDF), updated August 2021
80 BEIS Committee, The Future of Audit (PDF), HC 1718, 2 April 2019, para 146
81 As above, paras 40-45, 150-153
82 As above, para 166
83 As above, para 153

2.3 Quality, regulation and supervision

Reducing conflicts and ensuring that more than one or two firms could bid for an audit might be positive developments, but it is unlikely that this would solve all problems.

More competition without strong checks won't necessarily improve audit quality.

Competition is generally assumed to lower prices and/or raise quality. This is true in many markets, but the inverse can be true in some markets, where quality falls as competition becomes fierce. [84] The audit market is heavily influenced by the regulator, so regulation is crucial to improving quality.

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.[85]

These two key factors – difficulty in conveying and assessing quality differences – are arguably 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. The academics argue that the supplier can reduce quality and reduce their prices without significantly affecting the customer, in this case still certifying the accounts. [86]

They argue that when quality is not clearly rewarded, 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.

Competition within the credit ratings industry exemplifies this, according to Maurice E. Stucke, a competition academic. The industry, composed of a few big firms, is often partly blamed for the financial crisis of 2008.[87] There are similarities with audit:

> 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

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

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

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

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

> obligations (CDOs), were a growing and relatively more profitable sector. A competitive race to the bottom ensued. [88]

These dynamics highlight the importance of good regulation and supervision in ensuring competition in the audit market is focused on raising 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)".[89]

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.[90] 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 £16.5m in 2019/20, and a record £33.3m in 2022.[91] By contrast, the UK's financial services regulator, the Financial Conduct Authority (FCA), imposed total fines of £215.8m in the calendar year 2022.[92]

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:

> 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

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

89 CMA, Audit update paper (PDF), December 2018, p85

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

91 FRC, Annual Enforcement Review, July 2020, p2; and City AM, FRC fines hit record highs as watchdog sends 'clear message' to UK's audit sector, 14 November 2022

92 FCA, 2022 fines, last updated 4 January 2023

> boardroom behaviour to drive up confidence in UK business standards over the long term.[93]

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 a more powerful, independent statutory regulator called the Audit, Reporting and Governance Authority. This recommendation was carried forward into the Government White Paper proposals for audit reform.[94] The review and recommendations are discussed in section 3, Kingman Review of the FRC.

2.4 Accounting standards

A lack of prudence in company accounts can cause financial results to look more positive than reality. Synonymous descriptions for this sort of accounting include “overly optimistic” or “aggressive”.

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

> 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.[95]

Auditors can challenge management (formally or informally) on the basis that their accounting is imprudent, but it is much easier to do when prudence is embedded in an accounting standard that the auditor can point to.

Many areas of accounting involve a degree of judgement. As the accounts belong to the company,(not the auditor), 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 illustrate the significant impact that accounting standards can have on prudence in the accounts.

93 WP and BEIS Committees, Carillion joint report, 16 May 2018, p78

94 BEIS, Restoring trust in audit and corporate governance, March 2021, p18

95 European Financial Reporting Advisory Group, Getting a Better Framework: Prudence, April 2013, p4

IFRS 15

IFRS 15, introduced in 2018, required more prudent treatment of revenue.

According to the 2016 accounts, services company Capita plc's net assets[96] were 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 recognise revenue on contracts based on the flow of benefits received by the client, rather than the flow of costs incurred by the company. This change particularly affected companies that rely on long-run contracts for their standard business activity. IFRS 15 became mandatory for all listed companies on 1 January 2018, but companies were free to adopt it earlier.

Upon implementing the revised standard, Capita went from booking revenue on a contract according to costs incurred (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.[97]

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.[98] And so, had Capita adopted IFRS 15 in its 2016 accounts, it might have been unwilling or unable to make dividend payments in 2017.[99] That would have saved the company £217 million,[100] or almost a third of the £700 million rescue it then sought from shareholders and received in May 2018).

Goodwill

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 market value of the assets owned by the acquired company. For example, if a company bought a very popular restaurant, it would pay a lot more than the value of the restaurant's assets (for example

96 Net assets are the total assets owned by a company less the total liabilities.

97 Capita, 2017 half-year statements, 21 September 2017, p38

98 See Commons Library Insight, Capita: where did the capital go? 6 February 2018

99 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))

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

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.[101] 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 had the real effect of reducing accounting profits, and so reducing the funds available for distribution.

When IAS 22 was superseded in 2005 by a new standard, IFRS 3, the requirement to amortise goodwill every year was dropped.[102] 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).[103] The new standard allowed companies to be less prudent in their accounting by avoiding impairment of their goodwill assets.

The auditor did not successfully challenge Carillion's management's conclusion that goodwill was worth the same as the year before, or unimpaired. Under pre-2005 requirement, which required no judgement, it would have been far clearer to the auditor had management not reduced the value of their goodwill.

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 as they hand out less money in dividends, thus leaving companies more resilient to shocks.

Prudence in national standards

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 replace national rules and regulations.[104]

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

101 IAS Plus, IAS 22 — Business Combinations (Superseded), visited 8 April 2021
102 See: IAS Plus, Goodwill and impairment project - Agenda paper 18, 16 February 2016
103 FT, Carillion's troubles were shrouded in a fog of goodwill, 18 June 2018
104 Nick Anderson (IFRS Board Member), Feature: Returns, reinvestment opportunities and dividend distribution, 8 February 2019

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

3 Reviews and recommendations

Government, regulator, independent reviews and the then Business, Energy and Industrial Strategy Committee of the House of Commons have explored and recommended sweeping reforms through a series of reviews. This section will discuss these reviews and their recommendations.

Following the various reviews, the Government released its White Paper in March 2021 outlining their proposed reforms.[105] The Government published its response to the consultation accompanying its White Paper on 31 May 2022 detailing the Government's final proposals for an audit reform bill. [106]

The White Paper, consultation response and latest proposals are discussed in section 4.

The following reviews are discussed in the sections below:

- 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**; and
- 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 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.

105 BEIS, Restoring trust in audit and corporate governance, March 2021, p28

106 Department for BEIS, Restoring trust in audit and corporate governance: proposals on reform, 31 May 2022

The review examined the role, governance and powers of the FRC.[107] 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 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.[108]

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".[109]

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,

107 BEIS, Government launches review of audit regulator (press release), 17 April 2018

108 Sir John Kingman, Independent Review of the Financial Reporting Council, December 2018, p5

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

> 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.[110]

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.[111]

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.

3.2 BEIS Committee inquiry into the future of audit

The then 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 echoes the reforms suggested in the Kingman, CMA and Bryden reviews, predominantly around splitting audit and non-audit services, introducing mandatory joint audits and improving the regulator.[112]

110 Sir John Kingman, Operation of the audit market: letter to Rt Hon Greg Clark, December 2018, p6-7
111 Sir John Kingman, Operation of the audit market: letter to Rt Hon Greg Clark, December 2018, p7
112 BEIS Committee, The Future of Audit, HC 1718, 2 April 2019, pp 85-91

The report contain a summary of its key findings and recommendations:

- Audit quality, by stronger regulation and much-needed clarity on the interaction between accounting standards and the law;
- Resilience, by increasing the capability of challenger firms through segmented market share caps and the piloting of joint audits;
- Conflicts of interest, by splitting audit and non-audit services, ending the renewal of contracts and introducing cooling off periods. This will help the culture to be tilted away from one of facilitation by a service provider to one of challenge by an inspector;
- Product usefulness, by encouraging the broadening of the scope of audits to provide more useful information to assist the efficient allocation of capital in the economy[113]

3.3 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).[114]

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.[115]

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

113 BEIS Committee, The Future of Audit, HC 1718, 2 April 2019, para 262

114 CMA, CMA proposes reforms to improve competition in audit sector (press release), 18 December 2018

115 CMA, Audit update paper, December 2018, p86

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).

- 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 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.[116]

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.[117] A summary of responses to the consultation was published in March 2021 alongside the White Paper discussed in section 4.

3.4 Brydon review into the quality and effectiveness of audit

On 18 December 2018, then-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

116 CMA, CMA recommends shake-up of UK audit market (press release), 18 April 2019
117 CMA, Market Study on Statutory Audit Services, July 2019

- What are the public's expectations from audit.[118]

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
- the role of audit within wider business assurance and in relation to directors' legal responsibilities
- the role of audit in detecting fraud
- auditor liability[119]

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.[120] 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."[121]

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;

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

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

120 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

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

- 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.[122]

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

4 White Paper and proposed reforms

4.1 White Paper

In March 2021 the Department for BEIS published its White Paper on audit and corporate governance, together with a consultation on its proposals. Responses to the consultation were due by 8 July 2021, and would "inform draft legislation that the Government will introduce to Parliament when Parliamentary time allows".[123] The reforms comprise a "holistic approach" which reform the roles of directors, auditors, shareholder and the audit regulator. The White Paper initial proposals for each are summarised below.[124]

Its proposals were described as "firmly based" on the findings of the Kingman, Brydon and CMA investigations.[125] Together with the White Paper, the Government published a supplementary document describing the steps it was taking in relation to each of the recommendations made by these investigations.[126]

Directors[127]

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

The White Paper considered options for bolstering internal controls. The preferred option was to require directors to make a statement about the effectiveness of the company's internal controls, but leaving directors,

123 BEIS, Restoring trust in audit and corporate governance, March 2021, p28
124 As above, pp 15-23, 121. See here for the proposals' impact assessment
125 BEIS, Restoring trust in audit and corporate governance, March 2021, p5
126 BEIS, Supplementary Publication on Review Recommendations, March 2021
127 BEIS, Restoring trust in audit and corporate governance, March 2021, chapter 2

shareholders and audit committees to decide on whether such a statement should be assured by an external auditor.

Proposals were also being explored by the Government on whether and how companies calculate their distributable reserves, from which they can grant dividends. Options included 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 have been 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 Assurance Policy describing how the directors seek assurance of the information they report to shareholders.

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

Auditors[128]

The audit product has not changed significantly in decades, and high-profile corporate failures have called into question the effectiveness of audits. The Government therefore planned to introduce a new "audit profession". There would 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 would 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 would be given to the regulator to monitor the resilience of the audit markets and of auditors. ARGA (the new regulator), 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[129]

The Government said there are concerns that shareholders do not take enough of an interest in audit quality. The White Paper therefore proposes to 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.

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128 BEIS, Restoring trust in audit and corporate governance, March 2021, chapter 6

129 BEIS, Restoring trust in audit and corporate governance, March 2021, p17

Shareholders would also be given the chance to propose areas of emphasis to audit committees 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[130]

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.

Initial commentary

The White Paper proposals 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

130 BEIS, Restoring trust in audit and corporate governance, March 2021, chapter 9

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.[131] An article from the FT editorial board described the reforms as a "sensible framework".[132]

Former Conservative Party leader Iain Duncan Smith MP, who headed 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".[133]

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.[134]

The Financial Times reported in September 2023 that the FRC has been planning on the basis that ARGA would not be set up until 2026 or 2027.[135]

4.2 Consultation response and final proposals

The Government published its response to the consultation accompanying its White Paper on 31 May 2022.[136] The consultation received over 600 responses which the Government said "helped fine-tune the package of measures" but "received a positive response, confirming our belief that changes are needed to rebuild trust in audit and corporate reporting".[137]

The consultation response noted that the reforms would be implemented in several ways, including work by professional bodies, ministerial directions, and primary legislation.

On primary legislation, the Government said it is "preparing initially to publish [it] in draft, for subsequent introduction when Parliamentary time allows".[138] As of December 2023, no draft bill has been published, and no ministerial directions have implemented reforms.

131 FT, UK audit reform set to cost businesses more than £430m a year, 18 March 2021
132 FT, Restoring confidence in UK plc, 18 March 2021
133 As above
134 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
135 FT, Labour vows to push through UK audit and corporate governance reforms, 25 September 2023
136 Department for BEIS, Restoring trust in audit and corporate governance: proposals on reform, 31 May 2022
137 As above, see landing page
138 As above, p8

The Government confirmed its intention to implement the key reforms set out in the White Paper. See section 4.1.

4.3 Commentary on final proposals

In response to the Government's final proposals, the FRC published its own position paper in July 2022. The paper sets out the FRC will 'support the Government's reforms as they transition into the ARGA' in five areas:

- Revisions to existing guidance and standards;
- Introduction of pre-legislative new standards to allow voluntary adoption, for example new standards for Audit Committees;
- Proactively engaging with regulated markets to encourage behavioural change ahead of the introduction of new statutory powers;
- The development of new guidance;
- Creation of new documents and expectation setting for future supervision and monitoring.[139]

After publication of the consultation response, the Financial Times reported that the Government had

> watered down plans for an overhaul of audit and boardroom rules in the UK, dropping a proposal to require directors to sign off on companies' internal controls and scaling back an expansion of the number of companies falling under the most stringent requirements.[140]

The article quoted the chief executives of the Financial Reporting Council and the Institute of Chartered Accounts in England and Wales as expressing concern about some of the final proposals, although a representative of the Institute of Directors was quoted as saying some of the changes were understandable, given the need to minimise regulatory burdens on businesses.[141]

The FRC position paper confirms that they do not expect the fundamentals of audit to change as a result of proposed reforms:

> Audit has been the subject of significant regulatory activity and intense political and public scrutiny in recent years. The fundamentals of what an

139 FRC, Position Paper, Restoring Trust in Audit and Corporate Governance (PDF), July 2022, para 10
140 Financial Times, UK ministers bow to pressure to water down audit and boardroom reforms, 31 May 2022
141 As above

> audit is will remain unchanged, as the Government has chosen not to expand the scope of an audit.[142]

A position paper published by the Chartered Institute of Internal Auditors noted that:

> Despite media reports that many of the proposals had been watered down or diluted, the government's proposed approach and the key proposals arguably do still represent the biggest and most radical shake-up of the UK's audit and corporate governance framework in years.[143]

4.4 Other corporate reporting reforms

The Government published draft regulations to reform corporate reporting requirements for large companies in July 2023.[144] Following consultation with companies raised concerns, the Government withdrew the proposed regulations in October 2023, describing them as 'burdensome'.[145]

These draft regulations would not have directly impacted the audit industry but would have increased disclosure requirements for large companies. In particular, the regulations would have required large companies to disclose more detail around how they are managing risks to the business and provide more assurances over the reliability of corporate reporting.

The main proposed legislative changes would have required very large companies (with at least 750 employees and an annual turnover of £750 million or more) to:

- explain how they are managing significant risks, and building or maintaining resilience;
- demonstrate that they have enough realised profits to pay any dividend (or make any other distribution of profit), and explain the company's approach to making dividends and other profit distributions over the short and medium term;
- describe the actions taken by the directors to prevent or detect major fraud;

142 FRC, Position Paper, Restoring Trust in Audit and Corporate Governance (PDF), July 2022, para 24
143 Chartered Institute of Internal Auditors, Position paper: Government response to White Paper Consultation 'Restoring Trust in Audit and Corporate Governance', undated
144 Department for Business and Trade, Corporate reporting: The Draft Companies (Strategic Report and Directors' Report) (Amendment) Regulations 2023, July 2023
145 Department for Business and Trade, 'Burdensome legislation withdrawn', 16 October 2023

- explain how the company assures the quality and reliability of its corporate reporting.[146]

The Institute for Chartered Accountants of England and Wales (ICAEW) welcomed the draft regulations, but highlighted the need for further progress on audit reform:

> While we're pleased to finally see progress, this draft legislation and the Financial Reporting Council's (FRC's) current consultation on the UK Corporate Governance Code are only two pieces of the audit and corporate governance reform jigsaw. For effective reform, the Auditing, Reporting and Governance Authority must be established without further delay, alongside clarity on which entities will meet the future definition of a Public Interest Entity.[147]

The withdrawal of the proposed reform has received a mixed response from the industry. The ICAEW were critical:

> Iain Wright, ICAEW Managing Director, Reputation and Influence, described the decision as "a major blow to those seeking to drive improved transparency and trust in UK corporate reporting".
>
> "Ensuring the UK's legislative framework is fit for purpose and sufficiently clear and robust to allow for future developments is vital if the UK is to retain its reputation for corporate transparency," he said. "So it is a surprise and disappointment that the government is abandoning needed new statements to boost corporate transparency on resilience and other key matters.
>
> "The measures set out in the draft regulations, while not perfect, were the product of extensive due process and consultation. Their withdrawal appears to signal an end to the UK process of audit and corporate governance reform initiated after the demise of Carillion, and it is to be regretted."[148]

Quoted in the Financial Times, Roger Barker, the director of policy and governance at the Institute of Directors was also critical of the Government withdrawal:

> [The withdrawal of the draft regulation] places the government's longstanding reforms of audit and corporate governance in disarray.
>
> (…) a further sign that the government is pulling back from reforms announced in the wake of the collapses of Carillion, BHS and Patisserie Valerie.[149]

The Financial Times reported praise from some industry figures for the shelving of the reforms:

> The shelving of the draft legislation was welcomed by London Stock Exchange chief executive Julia Hoggett, who said that "ever-increasing corporate

146 Department for Business and Trade, New transparency over resilience and assurance for big business, July 2023
147 "Proposals strengthen big business assurance and resilience claims", ICAEW, July 2023
148 "Government withdraws draft corporate reporting regulations", ICAEW, 18 October 2023
149 "UK government shelves stricter company disclosure rules", FT, 16 October 2023

> governance processes" had "impacted the effectiveness of listed companies and the standing of the UK over other capital markets".[150]
>
> The move was also backed by insurance market Lloyd's of London and financial services lobby groups UK Finance and TheCityUK.

Industry led reformThe FRC regulates the audit market and interprets the ISAs in the UK (see section 1.6). Although audit reform legislation and the introduction of ARGA have not yet been implemented, the ISA auditing standards have been changed aiming to improve performance and scrutiny.

The FRC updated UK ISA 315: Identifying and Assessing the Risks of Material Misstatement, in July 2020.[151] The updated ISA came into force in December 2021.

The new standard re-focussed the audit process to better identify risks, and increased the level of work required to identify and challenge companies' internal controls preventing fraud or error.

The ICAEW summarised the new requirements under ISA 315, which introduce significantly greater auditor scrutiny of controls, alongside greater risk assessment in the audit process:

- The introduction of five new inherent risk factors to aid in risk assessment; subjectivity, complexity, uncertainty, change and susceptibility to misstatement due to management bias or fraud.
- Requiring "sufficient, appropriate" evidence to be obtained from risk assessment procedures as the basis for the risk assessment.
- A great deal more on IT, particularly IT general controls. [152]

The ICAEW described the changes as aiming "to drive better quality and more consistent risk assessments, as well as promote the exercise of professional scepticism".[153]

In addition, industry has taken some steps towards a greater use of technology, although the extent to which this was a response to the Brydon review is unclear.

Technology and Artificial Intelligence research company *Emerj* published an article looking at the increasing use of AI in audit at the Big Four in 2020. He found that all of the Big Four were using AI to automate and improve audit, concluding that:

> AI is being integrated into the core of the business and its use is showing a gradual increase.

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150 "UK government shelves stricter company disclosure rules", FT, 16 October 2023

151 FRC, ISA_UK_315_Jul_2020 [pdf],

152 ICAEW, Revised ISA 315 for 2022 audits, December 2021

153 As above

> (…) Second, the Four also purport to see AI as a critical factor to give them an edge over others and are in some sense competing with each other to gain AI supremacy.[154]

4.5 Pace of reform

A number of stakeholders have urged the Government to be quicker in implementing its proposals for reform of the audit industry. Despite being announced in the May 2022 Queen's Speech, the Government did not publish a Draft Audit Reform Bill. Audit reform was not included in the November 2023 King's Speech.[155]

The May 2022 Queen's Speech – delivered over a year after the Government's White Paper was published, and shortly before the consultation response was published – included proposals to publish a "Draft Audit Reform Bill".[156] In a debate on the Queen's Speech in the House of Lords, Liberal Democrat peer Baroness Bowles noted that "Legislation on audit reform has been relegated to draft".[157]

The Financial Times reported on criticism by accounting and industry groups on the Government's decision to "to ditch a bill from its next legislative programme that would have implemented long-delayed reform of audit and corporate governance", and instead replace it with a draft bill owing to other priorities related to climate change and illicit finance.[158] The Chartered Institute of Internal Auditors (CIIA) said it was "concerned that there is no detailed timetable as to when the government plans on publishing a draft Audit Reform Bill, or when legislation will be passed".[159]

In November 2022, the CIIA wrote letters to Prime Minister Rishi Sunak, Chancellor Jeremy Hunt and then-Business Secretary Grant Shapps, requesting "a "clear timeframe" for the Audit Reform Bill to be published and the legislation officially passed through parliament".[160] In January 2023, Labour MP Darren Jones (then Chair of the House of Commons BEIS committee) called on the government to "hurry up with its planned reforms". Business Minister Lord Callanan noted that primary legislation was not the only route through which the Government is implementing its proposed reforms, saying "reform is already underway" and that the Government had

[154] Daniel Faggella, "AI in the Accounting Big Four – Comparing Deloitte, PwC, KPMG, and EY", *Emerj*: 3 April 2020

[155] HL Deb 16 May 2022, vol 822

[156] Prime Minister's Office, The Queen's Speech 2022, 10 May 2022, p49 (PDF)

[157] HL Deb 16 May 2022, vol 822

[158] Financial Times, Dropping of UK audit bill from Queen's Speech comes under fire, 28 April 2022

[159] Chartered Institute of Internal Auditors, Position paper: Government response to White Paper Consultation 'Restoring Trust in Audit and Corporate Governance', May 2022

[160] Accountancy Age, UK government must 'get on' with audit reform, industry body says, 8 November 2022

given the FRC "more powers to ban auditors from reviewing large companies' accounts where necessary."[161]

In January 2023, the ICAEW published an article criticising the slow progress of audit reform:

> A lack of progress on audit reform is in danger of stalling economic growth and injecting much-needed confidence in the UK economy. Half a decade since the failure of the outsourcer and despite a series of investigations and Ministerial pledges for an overhaul of audit regulation, actual reform is yet to emerge.[162]

In February 2023, responding to a parliamentary question from Green party peer Baroness Bennett on publication of the Draft Audit Reform Bill, Lord Callanan said that "the reforms [to the audit industry] will be delivered by a variety of mechanisms. This includes changes already made by the regulator and by Ministerial Direction." He did not commit to a specific date for publication of the draft Bill, noting only that "The Government is committed to legislating when Parliamentary time allows."[163] Government Minister the Earl of Minto noted in May 2023 that the Government had not yet "set a date for publication of a draft Audit Reform Bill."[164]

In October 2023, responding to a parliamentary question from Darren Jones, Shadow Chief Secretary to the Treasury, the Minster for Enterprise, Markets and Small Business, Kevin Hollinrake confirmed that:

> The Government has carried out significant work towards audit and corporate governance reform legislation but has not set a date for publication of a draft Audit Reform Bill. The Government is committed to legislating when Parliamentary time allows. [165]

Kevin Hollinrake also wrote to the Business and Trade Select Committee in October 2023, confirming that he was "unable at this stage to set out a definite timetable for primary legislation on audit reform."[166]

There was no announcement of the Draft Audit Reform Bill in the King's Speech on 7 November 2023.[167]Following its omission from the King's Speech, The Financial Times highlighted the poor progress of audit reform:

> Five years after the collapse of contractor Carillion, much of the agenda has been delayed or watered down.

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161 City A.M., Carillion: Five years on, MPs and industry leaders demand audit reform to ensure scandal is not repeated, 18 January 2023

162 ICAEW, Carillion anniversary prompts calls for audit reform push, 19 January 2023
163 Question UIN HL5292, tabled on 1 February 2023
164 Question UIN HL6926, tabled on 28 March 2023
165 Question UIN 201002, tabled on 13 October 2023
166 Kevin Hollinrake, Letter to Business and Trade Committee (PDF), 16 October 2023
167 Prime Minister's Office, The King's Speech 2023 (PDF), 7 November 2023

> (…) Anne Kiem, chief executive of the Chartered Institute of Internal Auditors, said legislation was “urgently needed” to create Arga and give it “the legal powers it needs to hold company directors and audit firms to account”.[168]

The ICAEW responded with ‘concern’:

ICAEW is concerned that without primary legislation for proposed reforms – which were to include establishing a new regulator… the ability of the existing Financial Reporting Council (FRC) to properly oversee company directors will be severely compromised.[169]Bruce Cartwright, CEO of the Institute of Chartered Accountants of Scotland (ICAS) was also critical of the delay:

Again, we see lack of action by a government apparently committed to reform but again backtracking on those commitments. The result is to potentially undermine public trust in that as a business community, we demonstrate transparency in business and do the right thing. Dropping audit and corporate governance reform from the King’s Speech is a huge blow to the interests of UK businesses and the public.[170]

168 “What’s left of the UK’s once ambitious corporate governance reforms?”, FT, 9 November 2023

169 “King’s Speech audit reform omission very disappointing”, ICAEW, 7 November 2023

170 “Lost opportunity – no audit reform will have negative impact on public trust”, ICAS, 7 November 2023