



Department for  
Business, Energy  
& Industrial Strategy

Extract of Operational Separation requirements being  
proposed by UK Government

For information and discussion purposes only

# Restoring trust in audit and corporate governance

Consultation on the government's proposals

March 2021

Closing date: 8 July 2021

## 8.2 Operational separation between audit and non-audit practices

*Independence and professional scepticism are key attributes when completing a statutory audit that provides investors and shareholders with the information they need to take an informed view of a company's accounts. In its Market Study, however, the CMA concluded that the multidisciplinary structure within large firms has resulted in behavioural and financial incentives that undermine both attributes and sometimes lead to poor quality audits. The Government shares these concerns and – while it recognises that a multidisciplinary structure brings advantages – has decided to take forward the CMA's central recommendation to strengthen the oversight of audit practice through an 'operational separation' between the audit and non-audit sides of the firm.*

### Review recommendations and consultation responses

#### CMA Review

8.2.1 In its Market Study, the CMA considered whether the organisational structure of firms conducting both audit and non-audit work had an impact on the quality of audit engagements. They concluded that tensions can arise between a firm's non-audit and audit functions, with the result that the greater revenue and profits accruing from non-audit work may have a detrimental impact on auditor incentives and working culture. In particular, the CMA concluded that there is a 'one firm' culture in multidisciplinary firms, diluting the culture of objectivity and challenge required by auditors performing a public interest function.<sup>244</sup>

8.2.2 In response to these issues, the CMA recommended an operational split of firms, with the regulator responsible for designing specific elements of the separation and refining it over time. The CMA recommended that this proposal would initially apply to the 'Big Four' firms and that the regulator should consider extending elements of the operational separation principles to the challengers. The key features of this recommendation included:

- **the creation of a new board for the audit practice**, which would be responsible for remuneration decisions and developing and maintaining audit quality standards;
- a requirement to produce **separate financial statements** that would reflect the costs of services provided by the non-audit part of the firm<sup>245</sup>; and
- a requirement that profits should not be shared between the audit and non-audit practice.<sup>246</sup>

8.2.3 In making these recommendations, the CMA decided against an alternative proposal that would have mandated a full structural separation between audit and non-audit functions.

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<sup>244</sup> Statutory audit services market study, pages 187-293

<sup>245</sup> Statutory audit services market study, page 192

<sup>246</sup> Statutory audit services market study, page 187

However, it also noted that a re-examination of the merits of a full structural split may be necessary if an operational separation does not deliver the expected improvements.<sup>247</sup>

8.2.4 The Government consulted on the CMA's proposals in relation to operational separation in 2019 and respondents broadly agreed with the CMA's suggestion to create separate governance structures within firms. However, respondents disagreed with specific aspects of the CMA's proposals, including its proposal to prevent profit sharing, which some stakeholders suggested would erode the multidisciplinary culture within firms and result in a loss of access to expert non-audit staff. Thirty-four respondents also opposed or expressed concern about the CMA's proposal to revisit the merits of a full structural split at a later stage, while a further 19 supported it.

## Government response and proposals

8.2.5 The Government has taken account of the CMA's recommendations alongside responses to the 2019 consultation and has reached the view that there is merit in taking steps to reform the balance of incentives and working culture within audit firms while maintaining their multidisciplinary structure. The Government proposes to require:

- the strengthening of governance within audit practices through the creation of independent Audit Boards within firms;
- Audit Boards to have oversight of audit partner remuneration and ensure it is linked to audit quality;
- the publication of a separate profit and loss account for the audit practice, accounting for cross subsidies between the audit practice and the rest of the firm through arm's-length transfer pricing; and
- regulatory oversight of the remuneration of audit partners, with a view to supporting policies and practices that reward high-quality audits.

8.2.6 As described in more detail below, these proposals share many of the key elements of the CMA's recommendations and will be implemented through a combination of primary and secondary legislation and by the new regulator, which will be given an appropriate statutory framework to ensure effective delivery and to make regulatory rules. The Government notes that the largest audit firms are already working with the Financial Reporting Council to implement these measures on a voluntary basis by 2024. The Government supports this work and welcomes the weight it places on openness, professional scepticism and judgment, and independence from influences that might divert attention away from audit quality.

8.2.7 In terms of scope, **the Government envisages that the measures described below will apply initially to audit firms who carry out statutory audits of 15% or more of the FTSE 350 by audit fees.** This percentage could be reduced in future to create a level playing field for all audit practices in the market. However, it will ultimately be for the new regulator to determine the initial scope of these measures and then adjust it over time to reflect future

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<sup>247</sup> Statutory audit services market study, page 188

changes to the structure of the market. The Government also recognises that a threshold of this kind may produce unintended market distortions and would be interested in views on whether this approach might disincentivise challenger firms from scaling up operations in the FTSE 350 market. Comment on these initial proposals and alternative suggestions would be welcomed.

8.2.8 In line with the CMA's recommendations, **the Government's central proposal is to give ARGAs powers to strengthen the governance of audit practices**, building on the Financial Reporting Council's principles published in July 2020. The Government supports the CMA's vision of an independent Audit Board (consisting of an independent Chair, and majority of independent non-executives with appropriate skills and seniority) focused on creating a culture that supports audit quality and encourages ethical behaviour, openness, teamwork, challenge and professional scepticism. The board would be responsible for providing independent oversight of the audit practice, its audit strategy and the approval of the CEO of audit.

8.2.9 As part of these proposals, it is envisaged that the Audit Board will have delegated authority to link remuneration and career progression with audit quality, through clear quality metrics. This is in line with the CMA's recommendations and under these proposals audit partner remuneration would be determined above all by contribution to audit quality. As a result, it is expected that auditors would stand to lose more from poor audit quality than they would gain by prioritising or assisting non-audit work.

8.2.10 Alongside these proposals, **the Government intends to require the publication of separate financial profit and loss financial statements for audit practices**. The accounts would be required to account for material cross-subsidies by transfer pricing when the audit practice transacts with services and expertise in the rest of the firm. Such accounts would enable stakeholders to understand the true costs and profits of the audit business, and would also enable the regulator to draw on reliable published data when assessing the impact of any further regulatory interventions.

8.2.11 The final strand of the Government's proposals is to **provide powers for the regulatory oversight of audit partners' remuneration structures** to ensure that partners' incentives are effectively aligned to audit quality. The regulator would work with audit firms and their new audit boards to set the principles of what constitutes high audit quality and how it can be measured, and then provide guidance or rules on quality metrics and audit partner appraisals. The regulator would review how these principles are translated into policies by the firm's management with oversight from the audit boards and monitor their application on an ongoing basis. The regulator will have the powers to require the provision of relevant information and make recommendations to audit boards in this regard. This is a new measure that was not part of the CMA's recommendations, but one that the Government considers will assist in achieving the goals of the proposed remedies.

8.2.12 In coming to these proposals, the Government has considered carefully related recommendations from Sir Donald Brydon's review. For instance, the Government is implementing his broad proposal to require the publication of separate financial statements and

disclosure of remuneration policies<sup>248</sup>, but has opted to apply this proposal initially to firms within scope of the remedy rather than extend it to all firms conducting statutory audits of Public Interest Entities. The Government has not seen evidence that the measures need widening at this stage and has concerns that this would create additional burdens for smaller firms. The Government expects the regulator to monitor this question closely and to review whether it may be necessary for all auditors of Public Interest Entities to be subject to further transparency measures in future.

8.2.13 In addition, the Government considered Brydon's recommendation for audit firms to establish an independent fee setting function separated from those conducting the audit<sup>249</sup>. It is not minded to take this recommendation forward at this time, given that the operational separation of the audit function and publication of its accounts should address the underlying rationale for this recommendation. However, the Government will keep this recommendation under review as part of the efficacy and implementation review discussed in Chapter 1<sup>250</sup>.

### Future options

8.2.14 At this stage, **the Government has decided not to take forward the CMA's proposal to introduce audit-practice profit pools**. During the consultation, respondents raised a wide range of concerns about this proposal, with several noting that it may precipitate a separation of the larger firms by undermining their partnership model, which would in turn have negative implications for the stability of the market. The Government shares this concern and, without further evidence of the internal economics within firms, does not view this element of the CMA's proposal as proportionate at this time. Additionally, the CMA's rationale for this remedy was that if audit partners were remunerated from the wider firm profit pool their decisions would not be solely focused on audit quality. The Government considers that the measures to allow the regulator to supervise partner remuneration structures within firms will be more effective in ensuring that audit partners' incentives are focused on audit quality. However, it will revisit this proposal at a later stage if further evidence becomes available to suggest this is needed. As a result, this element of the CMA's proposals will fall within the scope of the implementation and efficacy review discussed in Chapter 1.<sup>251</sup>

8.2.15 Finally, the Government has noted the CMA's proposal to revisit the option to require a full structural split once its recommendations have been implemented and had time to take effect. It also shares the CMA's view that a full separation is not the correct option at this time and have noted the important concerns raised in the consultation about the effects that a full separation may have in raising costs, duplicating functions and creating barriers to accessing specialist expertise during 'busy seasons'. However, other respondents supported the CMA's proposal and **the Government intends to take appropriate powers to enable the regulator to deliver a full structural separation in future, subject to consultation and Parliamentary scrutiny**. While it is recognised that a full split would pose significant challenges, these powers

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<sup>248</sup> Independent review into the quality and effectiveness of audit, paragraph 25.2.3

<sup>249</sup> Independent review into the quality and effectiveness of audit, paragraph 9.4.14

<sup>250</sup> See page 25, above.

<sup>251</sup> See page 25, above.

will provide the policy flexibility to act once the Government and regulator have gained further evidence on the efficacy of the proposed suite of measures.

- 64. Do you have any further comments on how the operational separation proposals should be designed, codified (in legislation and regulatory rules), and enforced in order to achieve the intended outcome of incentivising higher audit quality?**
- 65. The Government proposes to require that all audit firms provide annual reports on their partner remuneration to the regulator. This will include pay, split of profits, and which audited entities they worked on. Do you have any comments on this approach?**
- 66. In the event that the Government wishes to go further than the existing operational split proposals in future and implement split profit pools in line with the CMA recommendation, do you have any comments on how these can be made to work effectively?**
- 67. The Government believes these proposals will meet its objectives. In the event that they prove insufficient to improve audit quality, and full separation of professional services firms is required, do you have any comments on how to make this work most effectively?**