Financial Regulations Landscape in the UK

Background

The UK Financial Reporting Council (FRC) is responsible for setting governance standards for UK companies, as well as inspection of financial reports and audit quality. However, it has faced significant scrutiny since one of the UK's largest companies, Carillion plc, collapsed in January 2018.

Carillion was the second largest construction and facilities management company in the UK. On January 15, 2018, it was placed into compulsory liquidation by the UK High Court, appointing PwC as the liquidator. Rachel Reeves, chair of the Business, Energy & Industrial Strategy (BEIS) committee, a parliamentary select committee, viewed PwC's appointment as a potential conflict of interest, stating that the big four make a profit in both turnaround advice, and again in liquidation services when that advice fails.

Carillion's auditor, KPMG, was also subject to scrutiny, with the FRC identifying a decline in audit quality, as well as a failure to challenge management or demonstrate professional scepticism, across the work of the big four, with KPMG's performance deemed the worst.

Subsequent to Carillion's collapse Sir John Kingman, Chair of Legal & General plc and UK Research and Innovation, was tasked with undertaking an independent review of the FRC's role and effectiveness in the UK regulatory environment. This review is referred to as the Kingman Review.

Further, the Competition and Markets Authority (CMA) have released a report on an audit market study they have undertaken, with a focus on improving the independence and quality of the audit profession.

In response to these reports, the BEIS committee has produced a report on the future of audit in the UK.

This summary examines the two reports by Sir John Kingman and the CMA, as well as the BEIS Future of Audit report.

Kingman Review

The Kingman Review released its final report in December 2018, listing several recommendations.

This report may be access here.

The report recommends the wholesale replacement of the current FRC, in both its function and structure, with a new Audit, Reporting and Governance Authority (ARGA). This new body should:

- have an overarching duty to promote the interests of consumers;
- promote competition and innovation; and
- apply proportionality.

The report recommends that the ARGA should be composed of a new, smaller Board, which should consist of publicly appointed members and should not seek to be representative of stakeholders. In relation to audit quality, audit quality review reports be published in full, initially on an anonymised basis.

The report also recommends that the new body have the scope to cover a company's entire annual report, as well as direct power to require restatements (currently, the FRC must apply for a court order). This would include strengthening regulation to cover a wider range of investor information with the aim to improve the quality of disclosures made by companies.

Another key recommendation is that a new enforcement regime be enacted which captures all directors, not just those belonging to a professional body. This would promote consistency when taking enforcement action against auditors, accountants, and directors.

Sir John makes a number of criticisms of the current FRC within his report, including the self-perpetuating nature of the Board; the use of delegation to industry bodies, which results in a lack of direct regulatory powers over audit firms; and its reliance on industry for part of its funding, deterring the FRC from "biting the hand that feeds".

In March 2019, the UK government announced they would adopt the recommendations of Sir John's report, including replacing the FRC.

Appointment and compensation of company auditors

Further to his review, Sir John was asked by the Secretary of State for BEIS, Greg Clark, whether there is a case for a fundamental change in who appoints company auditors, and how their fees are set. The specific scenario discussed by Sir John in his letter to Mr Clark is whether the new ARGA should be placed in charge of appointing auditors to audit clients, and approving audit fees between auditor and client.

Sir John considered several arguments both for and against such a regime, as follows:

The case for change

- There is a fundamental lack of scepticism and independent challenge from auditors across the board;
- There is a conflict of interest between auditors and external users, as auditors are paid by the company they are reviewing, not by users of financial reports;
- Whilst audit committees may mitigate this conflict, a lack of scepticism and independence is still present;
- Companies with a weaker audit committee are those most in need of a challenging auditor;
- A regulator would have clear incentives to ensure fees consistent with quality are set; and
- Appointing a Big 4 auditor is "much of a muchness", with limited practical choice anyway

The case against

- There is a belief that a company's Board of Directors retains a fundamental right to appoint an auditor, in line with their duty to be directly accountable for governance of the company;
- It is unlikely a public authority could undertake as complex a job as appointing an auditor as efficiently as the company itself;
- Sector experience, strength of character, independence of mind, and track record are all best assessed by a strong audit committee;
- Limited appetite from the Big 4 for audit work due to the profitability of non-audit work;
- The relationship with an auditor is a continual process which needs to be managed – it is not set and forget; and
- There is, therefore, still need for a company audit committee.

Sir John ultimately recommended against the new ARGA being placed in charge of auditor appointment and fee approval, however, did give two focussed recommendations to promote the importance of the investor-auditor relationship above that of the auditor-company relationship, as follows:

1. Giving the new regulator the right to appoint an auditor where:
    - Quality issues have been identified;
    - The auditor has been removed outside the regular rotation cycle; and
    - Where there has been a meaningful shareholder vote against appointment of the auditor (even below 50%).
2. Giving the new regulator the right to approve audit fees where this is in the best interests of audit quality

CMA Audit Market Study

The Competition and Markets Authority (CMA) undertook a market study over 2018-2019, speaking to over 100 parties including auditors, investors, companies, public authorities and academics. Attention was focussed on audits of larger companies.

The CMA's final report may be accessed here.

There were three major findings of this study – that the ability for companies to choose their own auditor reduced scrutiny; that choice for the biggest companies is essentially limited to the big four; and that there is an appearance of a dilution of audit quality, driven by a reliance by the big four on non-assurance services as a majority revenue stream (at least 75% of revenue).

As a result of this study, the CMA have proposed that the UK parliament enact legislation with the following five recommendations:

1. **A five-year review of the new regulator**
   Reviewing the progress and effectiveness of ARGA five years after full implementation.

2. **Audit Committee scrutiny**
   Increasing scrutiny of company audit committees by the new regulator, in order to increase accountability and oversight of auditors, and reducing bias against mid-tier firms. This would involve ARGA mandating minimum standards for appointment and oversight of auditors, monitoring compliance, and taking remedial action such as public reprimands or making direct statements to auditors. CMA also suggest increasing engagement between audit committees and shareholders could improve committee performance.

3. **Mandatory joint audit and peer review**
   This recommendation would require FTSE 350 companies to be jointly audited by two firms, one of whom would not be a Big 4 firm. The aim of this recommendation is to improve choice and resilience within the audit sector. Certain exemptions would apply and would be decided by ARGA, and implementation would be gradual. This would be a flexible undertaking, with ARGA able to adapt these requirements over time, and would involve cooperation of audit committees in order to facilitate such an audit.

   For some companies which are not part of the joint audit regime, it is recommended by the CMA that ARGA be given the power to appoint a peer reviewer, who is not a big four firm, to review in real time the audits of specific firms. The peer reviewer would report to ARGA and would not be liable for the accuracy of the accounts being audited.

4. **Measures to mitigate distress or failure of a Big 4 firm**
   The CMA recommend ARGA be given the power to obtain information on the health of the large audit firms in order to monitor the going concern of the firms, and to intervene to transfer audit clients to challenger firms in the case of financial distress of a big four auditor.

5. **Operational split between audit and non-audit practices**
   This recommendation would see the large firms initially undertake an operational split, including separate audit and non-audit financial statements, CEOs and Boards of Directors. Where an operational split fails to improve audit quality, ARGA should consider a full functional split of the audit and non-audit functions of the big firms.

   n.b. as of January 2019, KPMG, EY and PwC have all voluntarily committed to banning non-assurance services for FTSE 350 audit clients in the UK, regardless of the outcome of legislative changes. Deloitte have not as yet voluntarily banned non-assurance services for audit clients, stating that they wished to wait for the final government decision on audit reforms.

BEIS Future of Audit report

The BEIS Future of Audit report was published on April 2, 2019, and aims to examine how the Kingman Review, the CMA Audit Market Study, and a third report by Sir Donald Brydon, complement each other.

This report may be accessed here.

Please note Sir Donald's report, into the quality and effectiveness of audit, has not been finalised and is therefore outside the scope of this summary. The Terms of Reference for this review may be found here.

The Future of Audit report's recommendations can be summarised under the following four topics:

1. **The effectiveness of audit;**
    - The introduction of graduated findings, rating key management estimates and judgements on a scale between cautious and optimistic
    - Improving engagement with shareholders
    - Prioritising the detection and investigation of fraud within an audit

2. **Conflicts of interest and auditor independence;**
    - Introduction of an operational split of audit and non-audit functions within firms
    - If this operational split is not effective in improving culture and ending cross-subsidies, a full structural break-up of the big four
    - Increased regulatory oversight of audit committees, with the aim to ensure audits are independent and robust. Where this is ineffective, it is recommended that independent appointment of auditors be considered.

3. **Competition and resilience; and**
    - Introduction of a pilot of segmented market caps for audit firms and joint audit capabilities for mid-tier firms

4. **Regulation**
    - Replacement of the FRC with the proposed Audit, Reporting and Governance Authority (refer to section 2 of this summary)
    - Publication of audit quality reviews
    - Greater responsibility for non-financial directors relating to financial reporting
    - Greater internal controls for banks

Further, the BEIS recommends the production of a clear, simple, and prudent definition of realised profits in order to tighten the current dividend regime and prevent collapses similar in nature to Carillion, which was at least in part caused by hasty payment of dividends from unrealised profits.

Potential Impacts

The full impacts of the developments in the UK are unknown. We do know that the FRC UK will be replaced by the new ARGA in the future, but the specific details are still being worked out.

We are aware that the IESBA is undertaking projects in relation to audit fees and non-assurance services. We expect that the developments at the UK will have an impact on these projects.