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BEIS consults on audit reform

Audit Committee Institute
Part of the KPMG Board Leadership Centre

The Department for Business, Energy & Industrial Strategy (BEIS) has released an initial consultation on the recommendations made in the Competition and Market Authority's (CMA's) Final Report on the Statutory Audit Market. The BEIS consultation seeks views on the effectiveness and impact of the CMA's final recommendations as well as how they would interact with the findings from Sir John Kingman's Review of the Financial Reporting Council (FRC Review).

In his foreword, the Rt Hon Greg Clark MP remarks on the critical importance of the audit sector to the UK economy, acting not only as oversight, but also as a "proving ground for financial and corporate leaders in the UK and across the World".

The foreword goes on to stress that the Government is committed to acting on the CMA's findings to create a fit-for-purpose and proportionate regulatory regime that delivers a competitive and resilient audit market

Audit committee scrutiny

The CMA highlighted the importance of the role played by the audit committee in appointing, supporting and challenging auditors, but noted that there was significant variation in the performance of audit committees within the FTSE 350.

They recommend that audit committees are subject to scrutiny by the new regulator (also proposed as part of the Kingman FRC review), arguing that this would help to ensure that auditors are selected based solely on quality.

BEIS welcomes the CMA's recommendations and pose specific questions around the practicalities of audit committee oversight, including whether intervention should be imposed on every audit committee or only where there had been a trigger, such as poor performance.

Mandatory joint audit and peer review

This group of CMA recommendations are "*designed to improve audit quality and increase the number of viable competitors for complex audit tenders*" by removing barriers to challenger firms (non-Big Four), thereby increasing the number of credible firms in the FTSE 350 audit market.

BEIS argues that previous reforms have not significantly enhanced competition and that more needs to be done to create a more competitive market. BEIS is attuned to the finely balanced arguments between joint audits (the CMA's preferred option) and shared audits – which the CMA presents as an alternative, but which in its view may cement preconceptions that challenger firms are less capable and may limit opportunities for them to gain experience on more complex audits.

The questions posed by BEIS concern, *inter alia*:

- the detail around the CMA's proposed exemptions to the joint audit proposals and how the regulator should decide whether company qualifies;
- the capacity of challenger firms to provide joint audit;
- the impact on the liability regime; and
- the predicted additional cost of joint audits (25-50%).

Further, BEIS seeks input on the quantification of the impact these proposals would have on the audit market and ask what else if anything, is needed to optimise the benefits that might arise.

Measures to mitigate the effects of distress or failure of a Big Four

The CMA's third recommendation is that the regulator should be given powers to obtain the information it needs to monitor the health of audit practices and intervene where a firm is likely to fail.

The recommendation does not aim to prevent a failure of an audit practice at all costs – rather it aims to enable the regulator to moderate the impact on the market.

Proposed measures the regulator may wish to employ include *inter alia*:

- requiring audit firms to modify their contingency plans;
- taking measures to discourage audit contracts transferring to Big Four firms;
- taking measures to incentivise audit teams to move to non-Big Four firms along with their existing audit clients;
- using regulatory reliefs for audit practices to help retain or move staff; and
- providing certainty to the markets and transparency to staff to prevent a 'run' on a distressed audit practice.

BEIS seeks views on the factors the regulator should take into account when considering action in the case of a distressed statutory audit practice; and the powers of intervention the regulator should have in those circumstances.

Operational split between audit and non-audit practices

While acknowledging the commitment of three of the Big Four firms to stop providing non-essential non-audit work to the FTSE350 companies they audit, the CMA concludes that underlying tensions remain between audit and non-audit functions which may be detrimental to the conduct of high quality audits.

As a consequence the CMA recommend that the Secretary of State empowers and requires the regulator to establish an operational split of the Big Four firms-, and to smaller firms over time. This would include: a separate CEO and board for the audit practice; remuneration and career progression linked to audit quality; separate regulatory reporting and financial statements for the audit practice; and no profit sharing between the audit practice and non-audit practice.

BEIS references steps already taken to mitigate the risk of actual and perceived conflicts of interest, but pledges to implement a package of measures to increase choice and capacity in the audit market – specifically referencing the restriction on choice arising when audit firms cannot tender because of past consultancy work.

Whilst acknowledging that the CMA has taken significant time and care in balancing the issues, BEIS seeks further input on *inter alia*:

- the impact on audit quality of the tensions identified by the CMA;
- the design of the proposed split and the likely market impact;
- any alternative or additional measures; and
- full structural separation as a backstop measure.

Other possible measures

In addition to the recommendation for a five year effectiveness review of the overall package of remedies, BEIS raises a further six non-core suggestions on which they invite comment, namely:

- deferral and clawback of remuneration of senior audit staff;
- opening up audit firm ownership to non-auditors to encourage capital investment;
- mandating cross-industry technology licensing;
- more information for shareholders on audit metrics such as hours and fee breakdowns;
- restriction on long notice periods and non-compete clauses;
- Increased frequency of mandatory tendering and rotation.

Despite being described as 'other measures' they represent over a third of the total 32 questions raised. They focus mainly on the impact of the measures, how they would work in practice, and suggested additional or alternative actions which could be taken voluntarily by the audit firms.

This call for views closes on 13 September 2019.

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