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Business, Energy and Industrial Strategy Committee

The Future of Audit

Nineteenth Report of Session 2017–19

Report, together with formal minutes relating to the report

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Business, Energy and Industrial Strategy Committee

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Summary

Concerns about the audit industry arose during Committee inquiries into Carillion and BHS and have deepened through a series of further high-profile audit failures. Questions around competition, resilience, conflicts of interest, regulatory weakness and the nature of audit itself have contributed to a crisis of trust in the industry. None of these problems are new; but previous attempts at reform have not delivered necessary improvements. The Government commissioned two independent reviews to look at regulation (Kingman) and the effectiveness of audit (Brydon), while the Competition and Markets Authority (CMA) has looked primarily at competition and resilience. Our recommendations feed into these reviews and indicate how reforms can be implemented in a coherent and timely manner.

The effectiveness of audit

We examined one of the core reporting and audit failures that brought down Carillion—the imprudent payment of dividends out of optimistically booked, and in hindsight unrealised, profits. We recommend that the Government and the Financial Reporting Council urgently produce a clear, simple and prudent definition of what counts as realised profits, and make further recommendations to tighten the UK dividend regime. To make audits more transparent and useful, we recommend the use of graduated findings and several measures to improve engagement with shareholders. We are clear that the detection of fraud should be a priority within an audit and audits must demonstrate how potential fraud has been investigated. We fully support the fundamental rethink of audit that Sir Donald Brydon is undertaking. We encourage him to consider how the scope of audit might be widened to give the auditor more opportunities to express forward-looking opinions and to report on more issues affecting stakeholders such as suppliers, employees and pension holders. This will make audit a more useful, informative product and a more varied, interesting career.

Conflicts of interest and auditor independence

There are still fears that auditors are conflicted by the commercial culture in which they operate. The culture of advisory services does not sit easily with the culture of challenge required by audit. We recommend that the CMA aims for a structural split or at the very least implements its proposed operational split between audit and non-audit. If operational separation does not end cross-subsidies and fails to produce improvements in culture, independence and transparency, we recommend that the CMA implements a full structural break-up of the Big Four into audit and non-audit businesses.

Many audit committees are placing an auditors’ ‘cultural fit’ and ‘chemistry’ above their professional scepticism and some committees are spending too little time on audit. We welcome the CMA’s proposal to increase regulatory oversight of audit committees to ensure that audits are independent, robust and free of bias towards the Big Four. We recommend that if this does not work, independent appointment of auditors by the regulator should be considered.
**Competition and resilience**

The Big Four dominate the FTSE 100 and FTSE 250 audit markets. The obstacles facing challenger firms have led to a lack of competition and choice for some of our most important companies when they change auditors. Choice would all but disappear if one of the Big Four failed. This precarious situation must be addressed before it is too late. To improve resilience and choice, the challengers need to gain a secure foothold in FTSE 350 audits. We therefore recommend a segmented market cap and the use of joint audits, on a pilot basis, for the most complex audits to enable the challengers to step up.

**Regulation**

The Financial Reporting Council’s (FRC) weak response to several audit scandals contributed to the current crisis of trust in audit. We agree with the Kingman Review and the Government that the FRC, with its voluntary base, needs replacing with a new statutory body, the Audit, Reporting and Governance Authority (ARGA). We also agree it needs more powers. We welcome the decision to replace the FRC’s leadership and recommend that the Government introduces the necessary legislation to establish ARGA in the next session of Parliament. We also recommend stronger audit quality reviews to be published in full, greater responsibility for non-financial directors for financial reporting and further consideration to be given regarding greater internal controls and enhanced audit checks for banks.

We believe that the package of measures we recommend will improve the quality and usefulness of audits, promote independence and challenge among auditors and, in time, deliver a more competitive and resilient audit market for FTSE 350 companies.
1 Introduction

What are audits and why do they matter?

1. The origins of modern audit can be traced back to several corporate failures in the nineteenth century, such as the collapse of the City of Glasgow Bank in 1878, which identified the need for independent audits. An annual audit is now a statutory requirement for all listed and large companies. The purpose of the audit is to provide assurance to shareholders that the financial statements produced by the company’s management give a “true and fair view” of the company, including its assets, liabilities, financial position and profit or losses.

2. Audits matter because they underpin confidence in financial reporting by companies. This in turn supports the orderly functioning of financial markets, where shareholders, investors and other stakeholders can form a view about an audited entity built on trustworthy and transparent information. If audits are not carried out properly and fail to detect significant problems in a company’s accounts, the consequences can be far-reaching not only for shareholders, but also for wider stakeholders such as employees, customers, suppliers and pensioners, who have a strong interest in the success and viability of the company.

Parliamentary interest in the UK audit market

3. Concerns about the audit industry arose during our joint inquiries with the Work and Pensions Committee on the collapse of Carillion, and BHS. The Secretary of State told us that the public were right to be concerned about these collapses. These were followed by the collapse of Patisserie Valerie, which went into administration in January.
2019 after an accounting ‘black hole’ was discovered in the company’s books, estimated at £94 million. The pain inflicted by these failures runs deep and wide. In the case of BHS, 11,000 workers lost their jobs, and 19,000 current and future pensioners initially faced seeing their pensions cut. By May 2018, the collapse of Carillion had led to the loss of over 2,000 jobs, with over 27,000 pensioners facing reduced pensions, £2 billion owed to 30,000 suppliers, unfinished projects, and a cost to the tax payer of £148 million. The collapse of Patisserie Valerie into administration led to the closure of 71 stores and the loss of over 900 jobs.

4. One of the key recommendations of our joint report on Carillion was that the Government should refer the statutory audit market to the Competition and Markets Authority (CMA). In October 2018, the Secretary of State wrote to the Chairman of the CMA and said he would welcome the CMA’s consideration of the operation of audit market for UK companies, citing his concerns about Carillion and BHS. Our interest in audit is also part of our continuing wider work on corporate governance.

A crisis of trust in the auditing profession: key issues

5. The audit failures at BHS, Carillion and Patisserie Valerie are indicative of a wider crisis of trust in the audit industry. The Chief Executive of the Institute of Chartered Accountants in England and Wales noted that a “continual cycle of high-profile corporate failures” had produced a “palpable crisis in public trust” in the audit profession, which
“required fundamental change if trust was to be regained”. The media has given prominent coverage to the multiple audit failures and commentators have raised serious questions about the role and quality of audit in the UK.

6. The British origins of audit, and the fact that several of the world’s biggest audit companies were established in this country, means that the UK has a special responsibility to ensure that audit as an industry is robust and trusted. And, as several stakeholders and commentators have noted, the world is watching how the UK addresses the current crisis of trust in audit.

Audit quality

7. Key to this crisis is a clear sense that audit quality has declined and from a low base. Along with Carillion, BHS and Patisserie Valerie, other recent auditing failures and audits currently under investigation include:

- **Conviviality** - the audit regulator the Financial Reporting Council (FRC) is looking into KMPG’s auditing of the company which went into administration in April 2018 after a £30 million tax bill was found to have not been paid;

- **Tech Data Ltd** - EY were fined £2.75 million after failing to obtain sufficient appropriate audit evidence and exercise professional scepticism;

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20 ICAEW, Michael Izza: Facing the Findings, (December 2018). See also: Institute of Chartered Accountants in England & Wales (FOA0015); CityAm, Audit must reclaim its Victorian roots to win back public trust, (15 January 2019); Financial Times, Whole audit profession accepts the need for change, (31 December 2018).

21 Financial Times, ‘The Big Flaw: Auditing in Crisis’, (August 2018); BBC, Why are accountants getting their sums wrong?, (4 February 2019); Accountancy Daily, 2019: trials and tribulations for accountants in the year ahead, (December 2018); The Times, Audit review: two inquiries, the same conclusion, (December 2018) CityAM, Audit sector faces huge shake-up as new reports make radical recommendations, (December 2018); Guardian, Audit sector faces inquiry as minister points to deficiencies, (September 2018); BBC, Carillion: The Audit industry’s existential question, (May 2018); Accountancy Age, FRC shout for independence, viability and higher quality in the UK audit market, (October 2018); The Economist, What is an audit for?, (May 2018). There has also been criticism that despite a series of scandals and audit failures, the profits of the Big Four and partners’ pay has continued to rise. See: Times, KPMG Profits Sing Despite Off-key Audits, (December 2018); Financial Times, Deloitte’s bumper payout raises stakes for Big Four, (August 2018).

22 See for example: Financial Times, UK auditing shake-up looks set to hit company directors, (21 March 2019); ICAS, UK audit debate: the world is watching, (November 2018); Daily Telegraph, We need long-term answers over the future of audit, (28 January 2019); Financial Times, Big four UK accounting firms face radical shake-up, (December 2018); Financial Times, Breaking up the Big Four is not the answer to audit problems, (November 2018); Global Finance, Auditing the Auditors, (July 2018); Reuters, Breakingviews - UK audit reform leaves unfinished business, (May 2018).

23 A full list of enforcement outcomes since 2014 is provided in Letter from FRC to BEIS Committee Chair, (5 March 2019). Recent cases can also be found on the FRC website at: FRC, Recent Enforcement sanctions imposed against audit firms and Audit partners, (accessed 21 March 2019). The Times noted in December that the FRC was investigating PwC over its auditing of the Eurasian Natural Resources Corporation. See: Times, Watchdog to dig deep into PWC audits, (December 2018). The FRC singled KPMG’s audits out as “unacceptable”. See: Times, Carillion’s auditor KPMG is singled out for censure, (July 2018). In June 2018, the FRC announced that it was looking into Deloitte’s audits of SIG. See: Times, Financial Reporting Council orders investigation into Deloitte audits of SIG, (June 2018).

24 See: FRC, Investigation into the financial statements of Conviviliy plc, (July 2018); Financial Times, Watchdog probes KPMG over Conviviliy audit, (July 2018); BBC News, KPMG’s audit of collapsed drinks firm Conviviliy faces probe, (July 2018); Guardian, Decline in quality: auditors face scrutiny over string of scandals; In recent years, major audit firms have failed to spot key problems. We list the most prominent cases, (1 February 2019).

25 FRC, Sanctions against senior auditor and EY in relation to Tech Data Limited, (October 2017).
• **Aero Inventory (UK) Ltd** - Deloitte were fined £4 million for misconduct in relation to its auditing of the company’s financial statements and stock valuations;\(^{26}\)

• **Rolls-Royce** - the FRC is looking at KPMG’s auditing of the company between 2010 and 2013, following penalties awarded against Rolls-Royce by the Serious Fraud Office’s relating to corruption charges;\(^{27}\)

• **Mitie Group** - the FRC is investigating Deloitte’s audit of the Mitie Group who posted a £42.9 million deficit after material errors had been found in its accounts;\(^{28}\)

• **Sports Direct** - the FRC is investigating Grant Thornton’s audit of Sports Direct, after it was alleged that its owner Mike Ashley had made undisclosed payments to his brother’s company;\(^{29}\)

• **RSM Tenon Group** - PwC were fined £6 million due to misconduct on several accounts, including its assessment of goodwill;\(^{30}\)

• **Ted Baker** - KPMG were fined £3 million by the FRC after they admitted misconduct in relation to its audits of Ted Baker;\(^{31}\)

• **Domino’s Pizzas** - it was reported that the company had made £85 million of unlawful distributions (dividend payments) over a period of 16 years from 2000;\(^{32}\)

• **Quindell** - KPMG was fined more than £3 million by the FRC for misconduct in its audit of the company, after a probe by the Serious Fraud Office.\(^{33}\)

In October 2018 the industry regulator—the Financial Reporting Council (FRC)—reported that there had been a decline in auditing standards since the previous year, with 27 per cent of audits not meeting its quality standards, up from 19 per cent the year before. In 2011/12, 44 per cent of audits had not met its quality standards.\(^{34}\)

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\(^{26}\) FRC, **Deloitte LLP and John Clennett fined for Misconduct in relation to Aero Inventory Plc**, (November 2016)

\(^{27}\) See: FRC, **FRC launch investigation into KPMG in relation to the audit of the financial statements of Rolls-Royce Group**, (May 2017); Guardian, **Accounting watchdog to investigate KPMG over Rolls-Royce audit**, (May 2017); ICAEW, **KPMG’s Rolls-Royce audit under investigation**, Economia, (May 2017).

\(^{28}\) See: FRC, **FRC announcements in connection with Mitie Group plc’s 2016 annual report and accounts**, (November 2017); BBC, **Deloitte’s auditing of Mitie faces probe by watchdog**, (July 2017); Telegraph, **Accounting watchdog launches investigation into Deloitte over Mitie accounts**, (July 2017).

\(^{29}\) See: Accountancy Age, **FRC investigating Grant Thornton’s Sports Direct audits**, (September 2018); Financial Times, ‘Sports Direct told to hand documents to UK watchdog’, (September 2018).

\(^{30}\) See: FRC, **Sanctions against senior auditor and PwC in relation to RSM Tenon Group plc**, (August 2017).

\(^{31}\) See: FRC, **Sanctions against KPMG and Senior Statutory Auditor in relation to the audits of Ted Baker Plc**, (August 2018); Independent, **KPMG fined £3m over misconduct in Ted Baker audits**, (August 2018).

\(^{32}\) See: Domino’s Pizza, **Annual Report & Accounts 2016**, p 71; Financial Times, ‘Trust in auditors will be elusive without an overhaul of priorities’, (17 February 2019); IPE, **Accounting roundup: ‘illegal’ dividends, PIRC, FRC, s172, EFRAG**, (6 February 2019).

\(^{33}\) See: FRC, **Sanctions in relation to the audit of Quindell plc**, (June 2018); Financial Times, ‘KPMG fined £3.2m over work with Quindell’, (June 2018); Guardian, **KPMG fined more than £3m over Quindell audit**, (June 2018).

\(^{34}\) FRC, **Developments in Audit 2018**, (July 2018).
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FRC went as far as to say that KPMG’s audits had shown an “unacceptable deterioration”, while PwC, EY and Deloitte needed to reverse a decline. The Government have been clear that they are not satisfied with the current levels of audit quality.

**Competition, choice and resilience**

8. There is also concern about the lack of competition and choice in the audit market for large listed companies. In 2016–17, EY, PwC, KPMG and Deloitte (the ‘Big Four’ audit firms) accounted for 97 per cent of FTSE 350 audits and 99 per cent of FTSE 100 audits. In 2016–17, only one FTSE 100 audit was carried out by a non-Big Four company. This concentration has increased in recent years; for instance, the Big Five became the Big Four when Arthur Andersen failed in 2002. This concentration has meant that many audit committees, especially those of the UK’s biggest firms, who are responsible for tendering and advising on the appointment of auditors, are often faced with a minimal number of audit firms from which to choose. Choice would all but disappear if one of the Big Four was to fail and was not replaced by one of the non-Big Four firms.

**Conflicts of interest and the big four alumni**

9. Critics have also questioned whether auditors are conflicted by their relationships with their clients. Several commentators have argued that audit firms are conflicted by the temptation to sell non-auditing services, which are more lucrative, and because they are auditing the very people they are being paid by and looking to be re-appointed by. Relationships between audit firms and clients can be further complicated by an ‘alumni effect’ with many members of audit committees, who run audit tenders, and chief financial officers formerly working for audit firms, especially the Big Four.

**Regulation and guidance on audit matters**

10. The UK audit industry is currently regulated by the Financial Reporting Council (FRC). The FRC is an independent regulator in the UK and Ireland, responsible for regulating

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Footnotes:

35 The FRC found that 39 per cent of KPMG’s audits had fallen below its standards, which had increased from 35 per cent the year before. See: FRC, *KPMG AUDIT PLC: AUDIT QUALITY INSPECTION*, (June 2018), p 4.
36 See: FRC, *Big Four Audit Quality Review results decline*, (June 2018); BBC, *KPMG’s audit work unacceptable, says watchdog*, (June 2018). All of the FRC’s individual audit quality inspections for the top eight audit firms can be found here.
37 Q698 (Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy).
39 BDO was the only non-Big Four company to carry out an audit of FTSE 100 Company. See: FRC, *Key Facts and Trends in the Accountancy Profession*, (July 2018), p 47.
40 The concentration of the FTSE 350 audit market amongst the Big Four has been a feature of the market for some time. The Competition Commission’s market investigation into the audit market published in 2014, indicated that market concentration in the FTSE 350 audit market amongst the Big Four between 2002 and 2010 in terms of the annual share of audit fees was almost 100 per cent. See: Competition Commission, *Statutory Audit Services Market Investigation: Descriptive Statistics*, (2012), p 4.
41 Market concentration in the audit industry occurred mainly through mergers, especially in the 1980s and 1990s. Before the Big Five, there was a Big Eight, which included: Arthur Andersen; Coopers and Lybrand; Deloitte Haskins and Sells; Ernst and Whinney; Peat Marwick Mitchell; Price Waterhouse; Touche Ross; Arthur Young. See: House of Lords Economic Affairs Select Committee, *Auditors: Market concentration and their role*, (HL Paper 119; March 2011), pp 9–11.
42 See: Prem Sikka et al., *REFORMING THE AUDITING INDUSTRY*, (December 2018), p 3; Vinita Mithani, ‘More audit competition: who loses out?’, *Economia*, (November 2018);
43 See: Financial Times, ‘An illusion of choice: the conflicts that mire the audit world’, (August 2018); Accountancy Daily, *Two thirds of FTSE 100 CFOs ex Big Four audit firms*, (December 2018);
10 The Future of Audit

Auditors, accountants and actuaries, and setting the UK’s Corporate Governance and Stewardship Codes. It seeks to promote transparency and integrity in business by aiming its work at investors and others who rely on company reports, audits and high-quality risk management. More detail on the FRC can be found in Chapter 8.

11. The FRC has received heavy criticism in recent years. This has centred on its perceived weakness in dealing with audit failures. For instance, it was heavily criticised for not investigating KPMG’s auditing of HBOS bank, which collapsed in 2008. The Treasury Select Committee called the decision not to investigate a “serious mistake”. Its subsequent decision, after finally investigating KPMG’s audit of HBOS, not to take any action was also questioned. It was similarly criticised for deciding not to pursue action against PwC for its auditing of Tesco, which had significantly overstated its profits. This led some critics to question the set-up of the FRC, especially its non-statutory basis and the fact that many former Big Four accountants sit on FRC panels and committees. The FRC’s ability to provide oversight of the audit profession was further thrown into doubt when it emerged that it had reviewed Grant Thornton’s audit of Patisserie Valerie, which failed to spot a £94 million discrepancy in the company’s accounts. It has been proposed that the FRC should be replaced by a more powerful regulator, the Audit, Reporting and Governance Authority (ARGA). This is covered in detail in Chapter 8.

Previous attempts to reform the audit industry

12. Previous attempts at reforming the audit industry have not been successful. Calls for reform of audit have invariably followed previous failures in the 1930s, 1970s and 1980s and more recent scandals such as Enron in 2002. In 1992, an Auditing Practices Board paper—the Future Development of Audit, began by stating that “the auditing profession needs to accept change” before pointing to issues such as independence, competition, governance and regulation and scope. These issues remain today.

13. The most recent major attempt to reform the UK audit industry was the Competition Commission’s statutory audit services market investigation. The Commission’s final report, published in October 2013, concluded that: “competition is restricted in the audit market due to factors which inhibit companies from switching auditors and by the

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45 See: Financial Times, ‘Watchdog admits it was slow to investigate HBOS audit’, (November 2017).
49 See: Accountancy Daily, Big Four alumni: who’s working at the audit regulator?, (December 2018); Financial Times, ‘UK accountancy watchdog’s competence faces government probe’, (March 2018); Financial Times, ‘Britain’s accountancy watchdog has neither bark nor bite’, (October 2017); Sarasin & Partners et al., Investors require a robustly independent audit regulator, (October 2017); IPE, ‘Accounting roundup: PIRC attack on FRC, watchdog funding changes, review work’, (December 2016).
54 Competition Commission, Statutory audit services for large companies market investigation, (October 2013).
incentives that auditors have to focus on satisfying management rather than shareholder needs.\textsuperscript{55} Its implemented remedies included a requirement for FTSE 350 companies to put their statutory audit engagement out to tender at least every 10 years and measures to strengthen the accountability of the external auditor to the audit committee and reduce the influence of management.\textsuperscript{56} Subsequent EU audit reform, which came into force in 2016, required mandatory rotation of auditors (at least every 20 years), the prohibition of certain non-audit services to audit clients and the limiting of other non-audit services.\textsuperscript{57} However, the scandals of 2018 indicate that these reforms have not fixed audit yet.

The three reviews of audit

14. In response to the growing crisis in the UK statutory audit market, the Secretary of State and the CMA announced three separate reviews to look at different aspects of the market:

- The independent \textbf{Kingman Review of the FRC} was set up to enhance the regulator’s “transparency, independence and reputation and ensure that its structures, culture and processes, oversight, accountability, and powers, and its impact, resources, and capacity were fit for the future”.\textsuperscript{58} The Review reported in December 2018,\textsuperscript{59} and the Government is currently consulting on its recommendations.\textsuperscript{60}

- \textbf{The Competition and Markets Authority (CMA)} launched a market study into the supply of statutory audit services in the United Kingdom in October 2018.\textsuperscript{61} It published an update paper in December 2018,\textsuperscript{62} giving preliminary views and is expected to make a final report in the spring of 2019.

- The independent \textbf{Brydon Review} of the quality and effectiveness of audit was announced in December 2018.\textsuperscript{63} It is expected to report later this year.

The Secretary of State told us said that he had decided to start the review of the FRC as quickly as possible, with relevant input from the Brydon Review as its recommendations were implemented.\textsuperscript{64} We comment on the output and remit of these reviews in the ensuing chapters.

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{55} \textit{Competition Commission, CMA finalises audit changes}, (September 2014).
  \item \textsuperscript{56} As above.
  \item \textsuperscript{57} \textit{Europa, Audit reform in the EU}, (accessed 10 March 2019).
  \item \textsuperscript{58} \textit{BEIS, Independent Review of the Financial Reporting Council, Terms of Reference}, (May 2018).
  \item \textsuperscript{60} \textit{BEIS, INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL: Initial consultation on the recommendations}, (11 March 2019).
  \item \textsuperscript{61} \textit{CMA, Market Study Notice Supply of Statutory Audit Services in the United Kingdom}, (May 2018).
  \item \textsuperscript{62} \textit{CMA, Statutory Audit Services Market Study: Update Paper}, December 2018).
  \item \textsuperscript{63} \textit{BEIS, Government takes next step in improving standards of UK audit market with new independent review into audit standards}, (18 December 2018). The Terms of Reference for Sir Donald’s Review and details of his Advisory Board and Auditors’ Advisory Group can be accessed \underline{here}.
  \item \textsuperscript{64} Q647 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).
\end{itemize}
\end{footnotesize}
Our inquiry

15. We launched our inquiry on the future of audit on 12 November 2018. The object of our inquiry was to examine how the three reviews announced would complement each other, given the links between the quality of the product, its regulation and the health of competition. We wanted to ensure that what emerges from these reviews is a coherent framework for auditing that could regain the confidence of investors and the public. We make a contribution on behalf of the public to the ongoing work of the CMA and Sir Donald Brydon, and call on the Government to implement the recommendations of the Kingman Review as a matter of priority.

16. We received 34 pieces of written evidence. In addition to a number of informal meetings with audit firms and investors, we held six oral evidence sessions between 15 January 2019 and 13 March 2019. We heard from academics, investors, audit committee Chairs, the Big Four and challenger audit firms, Sir John Kingman, Sir Donald Brydon, the FRC, professional audit bodies and the Secretary of State and officials. We would like to thank all those who appeared before the Committee and who submitted written evidence. We would particularly like to thank Federico Mor, from the House of Commons Library, for his work on the inquiry and Vinita Mithani from Middlesex University and Professors Stuart Turley and Brendan O’Dwyer from the Alliance Manchester Business School for sharing their views with us.

65 BEIS Select Committee, BEIS Committee examine the future of audit, (12 November 2018).
2 The audit product

17. Directors are responsible for the accounts of their company. The accounts are usually signed by the Finance Director (or CFO), but they are normally prepared by specialised financial reporting teams with input from managers across the company. Accounts must give a true and fair view, and companies must also follow suitable accounting standards.

18. It is the job of the auditor to verify that the accounts are true and fair, and that the standards have been applied properly. To do so, auditors work closely with the company’s managers (hereafter “management”), who supply them with evidence and explanations. The closeness of this relationship is both a strength (enabling an efficient and effective audit) and a weakness (diminishing the auditor’s ability and willingness to challenge management).

19. The main principles and objectives of audit are laid out in International Standard on Auditing (ISA) 200:

   The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.

20. Two key words in this definition are “material” and “opinion”. The concept of materiality means that accounts do not have to be 100 per cent true and accurate. In fact, most sets of accounts are likely to contain small errors considered to be immaterial. An error is material if it is likely to matter to the users of the accounts (e.g. shareholders and lenders):

   In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

21. Auditors set materiality thresholds for the companies they audit. These thresholds are used both in planning the scope of the audit work (the aim is to have a good chance of finding errors above the threshold) and in evaluating results (errors below the threshold will normally not affect the auditor’s opinion). To give an example, Tesco’s auditor, Deloitte, set materiality at £50 million for Tesco’s 2017/18 group accounts, which equated to 4.4 per cent of profit before tax before exceptional items.

22. The second keyword is “opinion”. The auditor provides an opinion, not a guarantee or a fact. It is an informed, evidence-based opinion, but it is not expected to be infallible.

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67 See: FRC, Description of the auditor’s responsibilities for the audit of the financial statements, (accessed 21 March 2019)
68 FRC, ISA 200, (June 2016), p 2.
69 FRC, ISA 200, (June 2016), p 3.
71 FRC, ISA 200, (June 2016), p 3.
The ‘expectation gap’

23. The existence of an ‘expectation gap’ was felt to be a central issue by a wide range of witnesses in our inquiry and in the other Government-initiated reviews of audit.\(^{72}\) In short, the expectation gap is “the difference between what the public and other stakeholders expect an audit to do and what an audit is required to do.”\(^{73}\)

24. In their written and oral evidence, most audit firms told us that the public misunderstands audit. As we outline below, they said that audit does not look at the future, does not look for fraud and does not look at compliance with the law, besides accounting standards.\(^{74}\) They all welcomed Sir Donald Brydon’s review as the vehicle to tackle this expectation gap. The Brydon Review’s terms of reference include understanding “the origins and perceptions of the expectation gap”.\(^{75}\)

Audit delivery gaps

25. We do not accept the attempts of auditors—particularly the Big Four and Grant Thornton—to underplay the role or scope of audit, nor to implicitly blame the public for failing to understand the purpose of audit. Rather, the firms should focus on the poor quality of their audits, and on how they are falling short of what audits are for within the current framework. Audit is already tasked with:

- detecting material fraud (as per the International Standards on Auditing)
- making a forward-looking assessment of the company’s prospect (via the going concern assumption and the viability statement)
- stopping grossly imprudent distributions (via the capital maintenance regime)
- achieving a certain level of quality (via quality targets set by the regulator, currently the Financial Reporting Council or FRC)

26. In the next sections (and in Chapter 3 for capital maintenance), we set out how audit and auditors have failed to deliver consistently on each of these four fronts.

Quality

27. In our introduction, we exposed how short the firms have fallen from delivering the quality that the regulator (and other stakeholders) rightly expect, with 27 per cent of all audits not meeting their quality standards. In evidence, the heads of three of the Big Four admitted that the quality of their audits was not good enough.\(^{76}\) For example, Bill Michael, in respect of KPMG’s audits told us that he was “not happy with the results” and that KPMG recognised the challenges and was “working hard to resolve them”.\(^{77}\)

\(^{72}\) See for example: Q229, Q307, Q321, Q483; and: CMA, Appendix C to audit market study update paper: the ‘expectation gap’; the purpose and scope of audit, (18 December 2018), p 1.

\(^{73}\) See for example: CMA, Appendix C to audit market study update paper: the ‘expectation gap’; the purpose and scope of audit, (18 December 2018), p 1.

\(^{74}\) See oral evidence of 30 January 2019, for example: Q229, Q307, Q321, Q483.

\(^{75}\) Independent review into the quality and effectiveness of audit: terms of reference, (14 February 2019), p 2.

\(^{76}\) For example, see: Q389 (David Sproul, Senior Partner and Chief Executive Officer, Deloitte UK); Qq470–471 (Steve Varley, Chairman, EY UK);

\(^{77}\) See: Qq453–456, Q467 and Q479 (Bill Michael, UK Chairman and Senior Partner, KPMG).
Ellis, however, told us that the quality of PwC’s audits was strong,\textsuperscript{78} despite significant failings in the audit of BHS and the FRC finding that 18 per cent of PwC’s audits had not met the expected quality standards.\textsuperscript{79} Not many companies can afford an 18 per cent rate of faulty products, and we are not aware of other industries in which 27 per cent of products sold are defective.

\textbf{Fraud}

28. The current framework requires the auditor to have reasonable assurance that the financial statements are free from material misstatements, “whether due to fraud or error”.\textsuperscript{80} We therefore note that the level of assurance is the same as for any other type of material misstatement. Put another way, whilst the auditor cannot detect every error in the accounts, the auditor must be just as likely to detect fraud as they are likely to detect other errors.

29. In some way, the bar is actually higher for fraud. Size is not the only factor in determining whether a misstatement is material; the nature of the misstatement matters too.\textsuperscript{81} Much smaller misstatements can and should be considered material when the misstatement is due to fraud. The auditing standard on the auditor’s responsibilities in relation to fraud (ISA 240) explains how fraud has implications for the rest of the audit, even if the size of fraud is not material in relation to the financial statements. In particular, fraudulent reporting by management is almost always material, as explained in the guidance of the Institute of Chartered Accountants in England and Wales (ICAEW):

\begin{quote}
Fraudulent financial reporting that results in misstatements caused by management is, by definition, almost always material (regardless of the size of the misstatements) because of management’s intent to influence some action or decision. For example, if management has deliberately pushed sales near the year end into the next financial year, it may have done so in order to reduce the entity’s tax liability.\textsuperscript{82}
\end{quote}

30. We were both surprised and disappointed to hear the view from audit firms that because fraud is difficult to detect, the public should not expect auditors to find it. The most blatant example came from Grant Thornton’s CEO, David Dunckley:

\begin{quote}
We are not looking for fraud. We are not looking at the future. We are not giving a statement that the accounts are correct. We are saying they are reasonable. We are looking in the past and we are not set up to look for fraud.\textsuperscript{83}
\end{quote}

Seldom can a product have been so undersold in public. We were pleased to hear the FRC’s CEO, Stephen Haddrill, subsequently rejecting this notion, telling the Committee that

\textsuperscript{78} Qq473–477 (Kevin Ellis, Chairman and Senior Partner, PwC UK).
\textsuperscript{80} See: FRC, ISA (UK) 200, (June 2016).
\textsuperscript{81} FRC, \textit{ISA (UK) 320 – Revised June 2016}, p 2.
\textsuperscript{83} Q238.
a “mythology” had developed that auditors cannot detect fraud: “The auditor is clearly responsible for pursuing fraud in the company, but there is this mythology that has grown up of, ‘We’re not going to find it’.” 84

31. **Fraudulent reporting by directors is almost always material, by nature if not by size.** The detection of material fraud is, and must continue to be, a priority within an audit. Audits must state how they have investigated potential fraud, including by directors.

**A forward-looking product**

32. The firms argued that an important part of the expectation gap is that the public thinks that auditors should also look ahead, when in fact audits are only an inspection of past, historical transactions. 85 The public is right. Audits are and should be forward-looking, under the “going concern” assumption. Accounts are almost always 86 prepared under the assumption that the business is a going concern, i.e. that the company will in all likelihood continue to trade for at least a year from the date of approval of the financial statements. 87 The auditor must form an opinion on the appropriateness of the going concern assumption, and report on it if there are material risks to the business.

33. The FRC announced a consultation to strengthen the going concern standard for auditors on 4 March 2019. The consultation follows instances “where the auditor’s report failed to highlight concerns about the prospects of entities which collapsed shortly after as well as findings from recent FRC Enforcement cases”. 88 The launch of this consultation is long overdue.

34. Among other things, the FRC says that auditors should make greater use of the viability statement, 89 which is a requirement of the Corporate Governance Code. 90 Directors are asked to assess the future prospects of the company in the Annual Report. The auditor is required to state whether they have anything to add or draw attention to in respect of the assessment made by directors. In oral evidence, FRC CEO Stephen Haddrill told us that “we need more information about the auditor’s view of the future prospects of the company, not just its current position”. 91

35. **Auditors are required to look ahead.** We support work to strengthen the audit of and reporting on the going concern assumption and the viability statement. But we encourage Sir Donald Brydon to go further and explore how to make audits more forward-looking. In particular, **Sir Donald should consider how widening the role and scope of audit might give the auditor more opportunities to express forward-looking opinions.**

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84 Q590.
86 “The financial reporting frameworks applicable in the UK generally require the adoption of the going concern basis of accounting in financial statements, except in circumstances where management intends to: liquidate the entity; to cease trading; or has no realistic alternative to liquidation or cessation of operations. In effect, an entity that does not meet the threshold for that exception is described as a going concern.” In: FRC, *Proposed International Standard on Auditing (UK) 570 (Revised) Going Concern: Exposure Draft*, (March 2019), p 1.
87 FRC, *ISA (UK and Ireland) 570*, (September 2014), p 8.
90 The requirement is in Provision 31 of the [2018 Code](#), and C.2.2 of the [2016 Code](#).
91 Q645.
Graduated findings

36. If the performance of auditors against the current regime needs to improve, the audit product itself also needs to evolve in fundamental ways. One such reform is ‘graduated findings’, which refers to the auditor expressing an opinion on key management estimates and judgements in the accounts, describing them on a range from cautious to optimistic.

37. A number of witnesses said that the role and work of auditors are not sufficiently transparent and understood. Some of the firms argued that shareholders and the public do not get to see the good work auditors do behind the scenes. It follows that more transparency will make audits more useful and better understood. The introduction of the “extended auditor’s report” in 2012 was a good step in this direction. The extended report turned indistinguishable “boiler-plate” statements into much more detailed and specific accounts of the auditor’s work and findings.

38. The extended report, however, does not require auditors to give more details about their opinion on the accounts. When the accounts are unqualified (i.e. the auditor is overall happy with the accounts), the auditor’s report provides no further insight into the opinion. The accounts are either true and fair, or they are not. This is a blunt and potentially destructive tool, applied to matters that “are very rarely black or white”. The audit opinion provides a seal of approval, but no further useful information for investors and the public. The complex judgements that pervade the accounts of any large company require a more nuanced approach than the current binary pass or fail. Graduated findings fill that gap.

39. With graduated findings, the auditor can give an unqualified opinion, and at the same time express reservations about the lack of caution in the accounting of certain items (e.g. aggressive revenue recognition, imprudent treatment of goodwill). Graduated findings were pioneered by KPMG when it included subjective findings, such as describing profit recognition as “mildly cautious”, in the Rolls-Royce 2013 audit report. This innovation generated great interest and some surprise among the profession. The addition of qualitative observations on particular areas of the financial statements, alongside the overall true and fair opinion, was considered a bold move.

40. In their submission the CMA, KPMG argued that graduated findings would be an “effective and proportionate way” to help close the part of the expectation gap relating to auditors communicating their findings to shareholders. In evidence, investors, professional bodies and the firms were all in favour of graduated findings. However, we were told that companies (management) are reluctant to volunteer. Liz Murrall, Stewardship and Reporting Director at The Investment Association explained:

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92 E.g.: Q2, Q646.
93 Deloitte (FOA0017); PwC, Response to the CMA’s Update Paper, (February 2019), p 6.
95 Michael Izza, ICAEW CEO, Q642.
96 It is often said about accounts that cash is fact, and everything else is a matter of opinion. See for example: Tim Steer, The Signs Were There, Profile Books, (2018), p 141.
98 Private conversations with auditors.
99 KPMG, Response to the Competition and Markets Authority Invitation to Comment, (30 October 2018), p 34.
100 Private conversations.
It was very interesting that one audit firm, KPMG, went one step further [than the extended audit report], and in relation to the risk of material misstatement they reported graduated findings, […] Investors really welcomed that. KPMG then wrote to all its audit clients and said “Investors want this. Can we do this for all our audits?” It was disappointing that they did not take it further, and only nine clients agreed. That did not send a very good message to the investor community, who are the real clients of the audit process and wanted these graduated findings.101

41. The Kingman Review said that the regulator should consider requiring graduated findings for all audits.102 We recommend that the FRC make graduated findings mandatory.

Widening the scope of audit

42. Extended reports and graduated findings are welcome developments, but not the only way to improve the usefulness of audits. Another way is to widen the scope of audit, which investors expressed support for during our inquiry.103 Euan Sterling of Aberdeen Standard Investments told us that his firm had been trying to encourage companies “to expand the scope of their audits” to think more expansively about the company’s future, but had had little success so far. He hoped Sir Donald Brydon would look into this.104

43. Examples of what audits could cover include compliance with the Corporate Governance Code,105 reporting on executive pay,106 pay gaps and pay ratios,107 environmental sustainability,108 and payment practices such as the treatment of suppliers and late payment terms.109 In this context, we welcome the announcement by the Chancellor in his 2019 Spring Statement that companies are to be required to include in their annual report details of their performance in paying invoices.110 We believe that this information should be scrutinised as part of the audit. ICAEW CEO Michael Izza also suggested auditing risk-weighted assets, “arguably the most crucial number for a bank’s security” and currently unaudited.111

101 Q61.
103 Q85, Q86.
104 Q85.
105 See: BEIS Select Committee, Corporate governance, (HC 702; April 2017).
107 See: BEIS Select Committee, Gender pay gap reporting, (HC 928; July 2018).
108 See: EAC Select Committee, Greening Finance: embedding sustainability in financial decision making, (HC 1063; June 2018); Climate Disclosure Standards Board and CDP, First Steps: Corporate climate and environmental disclosure under the EU Non-Financial Reporting Directive, (November 2018); European Commission, Non-financial reporting, (accessed 27 March 2019); ICAEW, Environmental issues and UK annual reporting, (2015).
109 In March 2019, it was reported that the regulator had been asked by the Government to consider how audit committees of listed companies could police payment performance to address late payments for suppliers. See: Times, Late payers may answer to their audit committees, (18 March 2019). In our report on small businesses and productivity we recommended that auditors should look at payment practices, as late payments are an indicator of the culture and health of a company. See: BEIS Select Committee, Small businesses and productivity, (HC 807; 5 December 2018), p 45.
110 HC Deb, 13 March 2019
111 Q646.
44. The broadening of the audit remit would improve the usefulness of the product and the value of the job. Auditors would acquire new skills, employ more of their professional judgement and communicate their views clearly and openly.

45. As part of his review, Sir Donald Brydon should consider extending the scope of audit to cover the entire annual report, albeit with different levels of assurance and reporting. Critical areas such as corporate governance and payment practices ought to be subject to a robust assurance process and meaningful reporting by the auditor. Auditors should be encouraged and empowered by the new regulator to speak their mind openly and clearly in audit reports, without fear or favour. They should call out poor management when they see it. If there are barriers to auditors taking on more responsibilities and reporting on them candidly (such as unlimited liability and skills issues), the Brydon Review should include proposals for removing these barriers.

Shareholder engagement

46. The formal process for the appointment of auditors in listed companies is as follows. First, the audit committee (composed of independent non-executive directors) makes a recommendation to the board of directors. Following this recommendation, the directors make a decision, and the decision is voted on by shareholders at the company’s Annual General Meeting (AGM).\(^{112}\) In practice, however, the role of shareholders is minimal, while the opposite is true of executive directors, and in particular the CFO. The Competition Commission concluded in 2013 that “shareholders almost always follow the recommendations of the board”, and that they are “poorly placed to judge the performance of their auditors”.\(^ {113}\)

47. Several witnesses told us that shareholders either do not actively engage with the audit process,\(^ {114}\) or audit committees do not do enough to engage with shareholders.\(^ {115}\) Sir John Kingman told us that “while shareholders have the power of approval of the appointment of an auditor, and it is right that they should have that power, they hardly ever exercise the power to do anything”.\(^ {116}\) The CMA too found that there was a lack of engagement by shareholders and that audit committees did not do enough to encourage such engagement.\(^ {117}\)

48. In evidence to this inquiry and to our previous inquiry into the collapse of Carillion, investors expressed dissatisfaction with the quality and usefulness of audits.\(^ {118}\) Yet, routine engagement with audit matters remains, by and large, very low.\(^ {119}\) We think that there is a negative feedback loop at work here. Audits do not communicate much of value to

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\(^ {112}\) The law is found in Part 16, Chapter 2 of the Companies Act 2006


\(^ {114}\) For instance, see: Q44 (Leon Kamhi, Head of Responsible Investment, Hermes Investment Management); Q132 (Steve Barber, Audit Committee Chair, AA plc); Q134 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); ICAS (FOA0019); Mazars LLP (FOA0025).

\(^ {115}\) For instance, see: Q55 (Natasha Landell-Mills, Head of Stewardship, Sarasin & Partners).


\(^ {118}\) See: Carillion, HC 769, (7 March 2018), Q1043, QQ1128–9; and: Future of Audit, HC 1718, (15 January 2019), Q35, Qq85–90.

\(^ {119}\) As explained in previous paragraphs.
shareholders, and so shareholders do not engage. Since shareholders do not engage, there is little incentive for companies and auditors to innovate and provide more information (such as graduated findings, which most companies do not want to volunteer for).\(^{120}\)

49. We believe that there is a chance to reverse this dynamic by making audits more useful and transparent. A first step in starting a positive loop was the extended audit report discussed in the previous section. Two years on, the FRC found that investors greatly valued the new information:

> Investors have welcomed extended auditor reporting, and greatly value the enhanced information it provides. The value added can be particularly important for those audited entities where there are fewer sources of other information, including smaller companies.\(^{121}\)

50. We received evidence that more could and should be done to encourage investors to attend meetings to understand how their interests are being protected,\(^{122}\) and that the audit process needs to be more transparent.\(^{123}\) Euan Sterling from Aberdeen Standard Investments recommended that shareholders be shown how auditors have exercised professional scepticism in their audits.\(^{124}\) ICAEW CEO Michael Izza suggested that auditors make presentations to shareholders at the AGM, in order to get “auditors and investors closer together”.\(^{125}\)

51. We believe that requiring auditors to present at the AGM is a good way to generate engagement. This direct dialogue with shareholders would also remind auditors who they are accountable to. It would require them to demonstrate their independence and evidence their willingness to challenge management to a wider audience than the Audit Committee.

52. Our proposals to make audit more useful and transparent should also increase investor interest in audit matters. Interested investors will be more likely to engage and use their voice to push for continued improvements and greater transparency. But there is a long way to go. We have three recommendations to increase investor engagement. Combined with our proposals to make audits more transparent and useful, we believe that this package will lead to significant and positive engagement from investors.

53. **There should be a requirement in the new Stewardship Code for investors and asset owners to consider audit matters.**

54. **Auditors should make a presentation at the AGM to show how they have challenged management and exercised professional scepticism to underpin their audit opinion, and to raise any major issues.**

55. **In order to be useful, information must be timely. The FRC and its successor should consider requiring companies to publish the audit report at the same time as results**

\(^{120}\) See subsection on graduated findings.

\(^{121}\) FRC, Extended auditor’s reports: A further review of experience, (January 2016), p 4.

\(^{122}\) UKSA & ShareSoc (FOA0005); Association of Practising Accountants (FOA0012).

\(^{123}\) Investment Association (FOA0014).

\(^{124}\) Q85 (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments).

\(^{125}\) Q578 (Michael Izza, Chief Executive, Institute of Chartered Accountants in England and Wales).
are announced (instead of waiting for the full annual report to be published, which often happens a month later, even though the audit report is ready and signed off before results are announced).

Conclusions on the expectation gap and the audit product

56. We support the work that Sir Donald Brydon is doing to understand “the origins and perceptions of the expectation gap”. Nevertheless, the expectation gap must not be allowed to mask the serious failure of audit to deliver on its own current terms. If auditors delivered on the existing regime reliably and well, the expectation gap would shrink greatly. The delivery gap is far wider than the expectation gap and that is what must be fixed as soon as possible.

57. We also support the fundamental rethink of audit that Sir Donald has been tasked with. As a product, audit should be more useful and forward-looking. A revamped product will make a career in audit more varied, exciting and rewarding. Audit should be as attractive as consulting and be seen that way but should also be much more meaningful in its service to the public interest.
3 Capital maintenance

Compliance

58. 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’.

59. We received evidence that there is little compliance with and enforcement of the capital maintenance regime. For example, Sarasin & Partners LLP said that “key actors, including the audit firms, their regulator and even many investors, have lost sight of capital maintenance as a central purpose of accounts and audits.”126

60. Four examples illustrate the current confusion and poor practice in relation to capital maintenance and the payment of dividends:

- Domino’s Pizza: it emerged in 2017 that Domino’s Pizza had made £85 million of unlawful distributions (dividend payments) over a period of 16 years from 2000.127

- Carillion: a £54.4-million dividend was paid on 9 June 2017.128 A month later, the company announced a £845-million hit to profits (10th July 2017).129 In total, Carillion paid out £333 million more in dividends than it generated in cash from its operations in the five-and-half-year period from January 2012 to June 2017.130

- Capita: the company paid £74 million of dividends on 30 November 2017, and £137 million in July 2017. In January 2018, it sought a £700-million rescue from shareholders.131

- AssetCo: on 31 January 2019, the High Court ordered Grant Thornton to pay a record £21 million in damages for “negligence of the highest order” and “flagrant breaches of duty” in relation to its audits of AssetCo in 2009 and 2010. One of these breaches concerned capital maintenance. The Judge concluded that Grant Thornton should have identified and told the company that they were not allowed to pay a dividend in 2009, because “there were no distributable reserves, and so there was no possibility of a dividend”.132

61. Compliance with the capital maintenance regime is patchy at best and it is not adequately audited. We recommend that the FRC urgently reminds directors and auditors of their duties relating to the accounts and impose severe sanctions for breaches. Most importantly, auditors must be prepared to challenge management on their accounting of realised profits and distributable reserves.

126 Sarasin & Partners LLP (FOA0024).
128 FT, Carillion PLC CLLN:LSE equity data [accessed 20 March 2019].
132 High Court Approved Judgement, [2019] EWHC 150 (Comm), p 27.
The requirements

62. One of the reasons compliance may be poor is the lack of clarity over how the rules governing the payment of dividends are to be interpreted. Part 16 of the Companies Act 2006 sets out requirements for audited accounts, the appointment and removal of auditors, their functions and their liability. Section 495 says that the auditor’s report on the accounts “must state clearly whether, in the auditor’s opinion, the annual accounts give a true and fair view” and “have been prepared in accordance with the requirements of this Act”.

63. An important requirement of the Act is capital maintenance. Companies can only pay dividends out of past, realised profits available for distribution in the company’s ‘distributable’ reserves. Distributions to shareholders must be justified by reference to ‘relevant accounts’—normally the company’s last annual accounts.

64. A company can only rely on its annual accounts to make a distribution if they have been “properly prepared” in accordance with the provisions of the Act. The auditors must have made their report on the accounts (unless the company is exempt from audit). If the auditor expresses a negative opinion on the accounts, a company cannot rely on its annual accounts to justify a distribution without a further opinion from the auditor on the effect of the matters at issue on the ability of the company to make a distribution.

65. Distributions also need to be compatible with the fiduciary and other duties of directors:

Thus, directors should consider both the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due. In reaching their decision they must take into account any change in the financial position of the company after the balance sheet date of the relevant accounts and the future cash needs of the company.

66. We explore below the discrepancies that have been created by accounting standards evolving away from the letter and spirit of the law.

The accounting standards and the law

67. The FRC is responsible for issuing accounting standards in the UK, but the international financial reporting standards ("IAS" and "IFRS") that most large companies use are set by the International Accounting Standards Board (IASB) of the IFRS Foundation. As of April 2018, 144 jurisdictions require IFRS Standards for all or most listed companies, including EU countries. The major exception is the United States, which uses

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133 Part 23 Distributions.
134 Section 830 and 831.
135 Sections 836–839.
136 Section 837(2).
137 Section 837(3).
138 837(4)(a).
139 ICAEW, Guidance on realised and distributable profits under the Companies Act 2006, (April 2017), para. 2.3A.
140 FRC, Roles and Responsibilities, (June 2017), p 4.
141 All listed companies in the EU must use IAS/IFRS for group accounts. Member states can permit or require the use of IAS/IFRS for individual company accounts and unlisted groups. Regulation (EC) No 1606/2002 of 19 July 2002 on the application of international accounting standards, Articles 4 and 5.
its own national standards.\textsuperscript{142} 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.

68. In submissions to the audit market study, the CMA received views that the current audit framework and accounting standards are failing to deliver a key purpose of audit: assessing whether the company’s capital is properly protected, as required by the capital maintenance regime. The CMA summarised these views as follows:

Because accounts are prepared in accordance with accounting standards, and auditors review the accounts against these standards, the Companies Act 2006 requirements are not necessarily met—a case of company law following the standards, rather than the other way around. As a result, a key purpose of the audit report is lost. [ … ]

This particular submission on the purpose of audit has been subject to significant legal analysis in recent years. It seems unsatisfactory that what appears to be quite a fundamental question about the purpose of an audit as required by the Companies Act 2006 can be subject to such debate and difference in legal opinion. We are supportive of a review which examines this debate in detail and resolves in certain terms what the purpose of audit is.\textsuperscript{143}

69. We agree with the CMA that this is an utterly unsatisfactory situation. In their evidence to us, Sarasin & Partners LLP argued that profits should be broken down in the accounts between realised and unrealised, and reserves between distributable and undistributable. They also called on the Government to own the guidance for calculating what counts as realised profits, arguing that accrued income should not be treated as realised. Instead, realised profits should be those that are realised in cash or near cash.\textsuperscript{144} A number of auditors supported this simple and prudent definition of realised profits in private conversations.

70. Sarasin explained how the law was gradually conflated with the new accounting standards, the IFRS (International Financial Reporting Standards):

With the introduction of IFRS, the industry lobbied the authorities to reduce the ‘complexity’ in the calculation of distributable reserves (an aspect of Company Law, which they described as “outdated” and “flawed”) by expanding the definition of what could be treated as “realised” profits to include the profits recognised by IFRS.

The result is that the Guidance explicitly states that accrued income can be treated as realised for the purposes of distribution. This not only flies in the face of common sense (accrued income is by definition not realised as cash), but runs contrary to the purpose of capital protection. If directors are permitted to distribute income that they expect to receive,\textsuperscript{144}

\textsuperscript{142} \textit{IFRS, Analysis of the IFRS jurisdiction profiles, (updated 25 April 2018).}
\textsuperscript{143} \textit{CMA, Appendix C to audit market study update paper: the ‘expectation gap’: the purpose and scope of audit, (December 2018), pp 5–6.}
\textsuperscript{144} Sarasin & Partners LLP (FOA0024). Near cash refers to assets that can readily be converted into cash.
then there are significant risks that in the event that the expected income never materialises, dividends could be paid out of capital, thereby directly contravening company law.\textsuperscript{145}

71. A 2005 paper by the Institute of Chartered Accountants in England and Wales (ICAEW, the body responsible for producing the Guidance referred to by Sarasin above) outlined how IFRS is not aligned with the law. It explained that the transition to IFRS was creating “serious concerns” and “many issues” about the lawful payment of dividends under the capital maintenance regime. And yet, ICAEW did not side with the law, arguing instead that the rules were flawed and needed to be adapted to IFRS:

The [capital maintenance] regime imposes a rigid link between company balance sheets and the amount of company distributions and, especially with the introduction of IFRS, is becoming increasingly flawed. […]

It is necessary to break this traditional link between accounting profit and dividends.\textsuperscript{146}

72. In oral evidence, Scott Knight from BDO agreed that “the financial reporting standards that include fair values create profits that are not realised”, and so not distributable under the law.\textsuperscript{147} Being more explicit, Jac Berry from Mazars was very clear that the standards do not deliver the law. She said that part of the auditor’s role is to make sure that companies adhere to relevant laws and regulations.\textsuperscript{148}

73. In oral evidence there was some confusion among the Big Four on this issue. The heads of KPMG and EY explicitly said they thought the standards delivered the law, and the head of Deloitte agreed with them.\textsuperscript{149} The head of PwC said he was not an auditor, but generally trusted that his firm complied with whatever the law was.\textsuperscript{150}

74. It is clear that the law needs both clarifying and tightening. One crucial gap concerns the definition of realised profits. The \textit{Companies Act 2006} states that “realised profits” and “realised losses” are such profits or losses “to be treated as realised in accordance with principles generally accepted […] with respect to the determination for accounting purposes of realised profits or losses”.\textsuperscript{151} The problem here is that the concept of realisation does not inform the recognition of profits in IFRS—a clear indication that the accounting standards have not been designed to be in line with the purpose of the law. In the words of ICAEW, “accounts, especially under IFRS, are becoming less and less driven by realisation.”\textsuperscript{152} The mismatch between the international standards and the law is not surprising. The IFRS, whose purpose is to provide international comparability, “cannot reflect in detail specific requirements of the multitude of different capital maintenance regimes among the more than 140 jurisdictions that now require the use of our Standards”.\textsuperscript{153}

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\bibitem{footnote9} Nick Anderson (IFRS), \textit{Feature: Returns, reinvestment opportunities and dividend distribution}, 8 February 2019.
\end{thebibliography}
75. This discrepancy is one reason why the ICAEW’s Guidance on realised and distributable profits under the Companies Act 2006 runs to 173 pages. This guidance was written by the industry to bridge the gap but was not vetted by government lawyers. Instead of resolving the issue, the FRC spent the best part of a decade fighting the concerns of a range of major institutional stakeholders about the flaws in IFRS and ICAEW’s interpretation of the law. A battle of legal Opinions ensued between eminent QCs. It is surprising that four conflicting Opinions did not trigger a deeper investigation by the Government and the FRC. The industry needs clarity.

76. The House of Lords became involved in 2016. Lord Hollick (Chairman of the Economic Affairs Committee) wrote to the Chief Executive of the FRC, Stephen Haddrill, to ask him what the FRC was doing to address these legal questions, but ultimately no further action was taken. In response to parliamentary questions in that House, the Government explained that it was content that the FRC accepted the legal advice it had received.

77. In oral evidence, BEIS permanent secretary Alex Chisholm said that the 170-page ICAEW guidance was part of the problem and needed to be simplified. Secretary of State Greg Clark welcomed our and Brydon’s interest in these issues, and reassured us that it was not in any way his intention to weaken the regime.

78. We are alarmed and disappointed that the FRC has not provided clarity on these fundamental issues, given the potential and actual problems that have arisen. The Government and the FRC should work together to resolve these issues as soon as possible, and produce simple and prudent guidance for companies and auditors to follow.

79. We recommend that the Government and the FRC urgently produce a clear, simple and prudent definition of what counts as realised profits for the purpose of distributions. We support defining realised profits as realised in cash or near cash.

80. We reject any legislative change the aim of which is to adapt the law to the accounting standards. Instead, auditors and directors need to be reminded that compliance with the accounting standards does not fulfil all legal obligations, and that the law comes

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154 Sarasin & Partners LLP (FOA0024).
155 The Universities Superannuation Scheme Investment Management (USSIM), the Local Authority Pension Fund Forum (LAPFF), Colombia Threadneedle and the UK Shareholders’ Association (UKSA) sought legal opinions from George Bompas QC on this question.
156 George Bompas QC argued that IFRS cannot be relied upon to meet the statutory true and fair view requirement for accounts and that the FRC guidance and legal advice it relied on are defective. [In: George Bompas QC, International Financial Reporting Standards (Issues arising in relation to the Companies Act 2006): Opinion, (March 2013); and: Further Opinion, (August 2015). In response, the FRC asked Martin Moore QC, who had provided the initial Opinion that Bompas considered to be flawed, and who also advised the ICAEW on their guidance, to provide a second Opinion. [See: Martin Moore’s page in Erskine Chambers website for ICAEW work [accessed 13 March 2019]; and for the Opinions: FRC, True and Fair, June 2014, p 1.]
157 We note that the Independent Non-Executives of KPMG wrote in their report that they “raised these issues with the FRC, asking for further work [to] be done by them to explore whether accounting rules might be used in a way that was against the public interest (e.g. are there areas where current rules might allow early declaration of profits, which in turn could encourage reckless behaviour by investors and lead to the over statement of company solvency). […] We are concerned that there is no programme in place that would aim to give better assurance on this issue.” In: KPMG, UK Transparency Report 2018, (December 2018), p 59.
159 HLS214.
160 Q709.
161 Q689, Q712.
first. We regret that the FRC has failed to clarify this basic point with those it regulates. We recommend that the FRC and its successor vigorously enforce the revised capital maintenance regime.

**Goodwill**

81. The Government has agreed that something needs to be done about capital maintenance. A BEIS consultation on corporate governance and insolvency included proposals to strengthen the UK’s dividend regime. In its response (August 2018) to the consultation, the Government said it would consider tightening one of the key capital maintenance rules known as the ‘net assets test’.162 The **Companies Act 2006** prohibits companies from paying dividends that would bring the company’s net assets (assets minus liabilities) to a level lower than the sum of the company’s paid-in capital and undistributable reserves.163 In short, dividends cannot be paid out of the capital invested by shareholders.

82. The problem with the net assets test is again one of interaction between the law and accounting standards (IFRS in particular). The net assets test is only as prudent as the underlying accounting. If accounting standards become less conservative (as IFRS did by abandoning the principle of prudence in favour of ‘neutrality’),164 so does the test.

83. The treatment of goodwill illustrates the impact that accounting standards can have on the level of prudence in the accounts, and therefore the prudence of distributions. Goodwill is the amount a company pays for an acquisition over and above the fair net value of the assets acquired. For example, if a company bought a very popular restaurant, it would pay a lot more than the value of the restaurant’s assets (e.g. kitchenware, tables, chairs, etc), because the company is buying a popular brand with a large client base and the expectation of future profits.

84. It used to be a requirement for goodwill to be “amortised” every year.165 Companies would gradually reduce the value of the goodwill by charging themselves a notional expense known as amortisation. The expense may be notional, but it has the real effect of reducing accounted profits, and so reducing the funds available for distributions.

85. When accounting standards were changed in 2005, the requirement to amortise goodwill every year was dropped.166 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 not, 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 strong evidence that it should have been impaired).167 The auditor did not successfully challenge management’s assessment of the value of goodwill. It is welcome that the Government proposed requiring companies and auditors to take a more critical look at the valuation of goodwill for the purpose of distributions.168

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163 Section 831
164 FRC, True and Fair, (June 2014), pp 1–2.
165 IAS Plus, IAS 22—Business Combinations (Superseded), [visited 21 August 2018].
166 See: IAS Plus, Goodwill and impairment project - Agenda paper 18, (16 February 2016).
167 FT, Carillion’s troubles were shrouded in a fog of goodwill, (18 June 2018).
86. We strongly support the Government’s proposal to require companies and auditors to take a more critical look at the valuation of goodwill for the purpose of distributions. We recommend that the Government urgently take steps to tighten the net assets test.

Prudence

87. At its heart, the divergence between IFRS and the law is that the overriding principle behind IFRS is neutrality, whereas the overriding principle behind the law is prudence. The two can be wildly different at times, as exemplified by Carillion. We cannot unilaterally reform the international standards, but we can ensure that prudence remains at the heart of the law. Prudence leaves companies better capitalised, and so more resilient to shocks.

88. Prudence is fundamental to good accounting and underpins a key purpose financial statements, showing the amount of profit that is available for distribution. In short, prudent accounting means recognising losses and liabilities earlier than gains and assets. It is synonymous with being cautious or conservative. The European Financial Reporting Advisory Group explains that central role of prudence in good financial reporting “reflects the use of financial statements in showing the amount of profit that is available for distribution”. They define the essence of prudence as ensuring that “assets and income are not overstated and that liabilities and expenses are not understated”, and so gains are reported only if they are highly probable or reasonably certain (often not until realised) whereas (expected) losses are recognised as soon as they are identified. Therefore, prudence treats assets and liabilities asymmetrically, requiring “a higher degree of certainty before recognition of assets than of liabilities”.

89. For auditors, challenging management when the letter of the standard permits optimistic accounting is difficult. Without a clear breach of the rules, the auditor in practice will probably give management the benefit of the doubt. By contrast, it is much easier to challenge imprudent accounting when prudence is embedded in the standards or the law.

90. The Government cannot unilaterally change the international accounting standards, but it can seek to tighten the law. Stopping imprudent distributions makes companies more resilient and encourages management to think longer term and tackle problems earlier. The principle of prudence should be made explicit in the law and its interpretation.

91. The Government and the FRC should lead international efforts to improve accounting standards. If the Government wants to achieve its ambitions of a Global Britain advancing UK influence and interests, then it should be prepared to spell out how it wants to lead international standards on key sectors such as accounting and audit.

169 FRC, True and Fair, (June 2014), pp 1–2.
Disclosure

92. Every witness we asked agreed that companies should be required to disclose the balance of distributable reserves in the annual accounts, and break down profits between realised and unrealised.\(^\text{171}\) This proposal was also made by the Government in its response to the consultation on Insolvency and Corporate Governance.\(^\text{172}\)

93. There are two good reasons to require disclosure. First, reporting on the application of capital maintenance rules makes it more likely that they will be complied with in the first place and, if necessary, enforced. Second, the information will be very useful to investors, who “need to understand better what the quality of profits are”.\(^\text{173}\) We recommend that companies be required to disclose the balance of distributable reserves in the annual accounts and break down profits between realised and unrealised.

Solvency-based system

94. The consultation on Insolvency and Corporate Governance also “explore the case for a comprehensive review of the UK’s dividend regime and more significant change such as considering the merits of a solvency-based system”.\(^\text{174}\) A solvency-based system is one where dividends can be paid only when the board is satisfied (and makes a statement to that effect) that the company will, after the payment of the dividend, still be able to pay its debts as they become due in the normal course of business. Key advantages of this system are said to be its greater simplicity and stronger protection for creditors. A number of non-EU countries took this approach, such as the US, Canada, Australia and New Zealand.\(^\text{175}\) Some respondents to the BEIS Insolvency consultation argued in favour of adopting a similar system in the UK.

95. There is no incompatibility between capital maintenance rules and a solvency-based system—the two systems can be combined. Indeed, solvency-based systems are usually allied with net assets tests such as that in the capital maintenance regime discussed earlier. We also note that similar solvency requirements already exist in the UK regime under the fiduciary duties of directors,\(^\text{176}\) but there is little enforcing of these duties and no reporting. Moving to a formalised solvency system would bring these duties to the forefront of directors’ minds. ICAEW described moving to a solvency-based system as a “radical” reform,\(^\text{177}\) but they are not against it in principle and they agree that the current capital maintenance regime is “not fit for purpose”.\(^\text{178}\)

96. A solvency system should complement the revised capital maintenance regime that we recommend, not replace it. We recommend that the Government adopts a complementary solvency-based system in which directors must state that dividend payments will not make the company insolvent or create cashflow problems.
4 Separating audit from non-audit

The case for separation

97. The CMA’s update paper on its market study, published in December 2018, set out a number of preferred remedies, including a split between the audit and advisory business. In this chapter, we explain how separation would improve quality by:

- creating a strong audit culture in the firm and eliminating tensions with the very different culture of advisory services;
- enhancing transparency; and
- making audit truly independent by ending the subsidies from the rest of the firm.

98. Separation could also improve choice by removing barriers to competition and reducing conflicts, depending on the model of separation adopted. We discuss the forms that separation can take later in this chapter.

99. To a greater or lesser degree, the Big Four acknowledge the benefits of separation. KPMG’s response to the CMA’s update paper recognises that audit is too opaque and needs more transparency. In oral evidence, the head of KPMG, Bill Michael, expressed support for separation:

> [O]ur business model [ … ] needs to become more transparent because it is impairing confidence in audit quality. We have heard before that there is scepticism as to whether large multidisciplinary firms are focused enough on audit, so some form of separation is the right direction of travel and we have started doing that.

100. Deloitte agreed that separation can address “cultural and incentive concerns” and “serve to increase audit quality.” Their response to the CMA explains that separate governance and management can achieve “significant and far-reaching enhancements” to the audit business, such as:

> an overriding responsibility to act in the public interest, an overarching performance management structure aligned solely with the delivery of audit quality and management process and systems to reinforce that.

Separation would demonstrate “a culture of quality, independence and objectivity”, and eliminate “undue influence from the wider (non-audit) business.”

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179 CMA, CMA proposes reforms to improve competition in audit sector, (18 December 2018).
180 CMA, CMA proposes reforms to improve competition in audit sector, (18 December 2018).
182 Q353
185 Deloitte, Response to statutory audit market study, (21 January 2019), para 7.7.
101. BDO’s Scott Knight argued that the audit practice needs to be governed by auditors, that separate financial statements must be available to the regulator and that the issue of cross-subsidies between audit and non-audit should be dealt with.\textsuperscript{186}

\textbf{Audit culture}

102. PwC emphasised the importance of creating the right culture in an audit firm:

We agree with the CMA that promoting the right culture within an audit practice is critical; we are open to remedies designed to enhance audit firm governance in order to better embed the right culture and increase the focus on audit quality.

103. We believe that a strong audit culture of independence and challenge is one of the most important, if hard to quantify, determinants of audit quality. Culture is crucial because “auditing, by its very nature, is judgemental and based on human decisions and actions”, as argued by the FRC.\textsuperscript{187} We are therefore concerned about audit representing a small and shrinking part of the multidisciplinary firms. The smaller the audit practice becomes as a part of the firm, the less we would expect it to shape the culture, priorities and investments of the firm. Firms argue that audit is at the core of their identity (their “raison d’être”).\textsuperscript{188} We are sceptical that this can be true, when non-audit is already four times larger (and growing) than audit across the Big Four.\textsuperscript{189} As the relative size of audit declines, there is inevitably a point at which audit can no longer be regarded as core to the firm. It is perhaps a sign of the status of audit in these firms that none of the Big Four in the UK is headed by an auditor. Indeed, in their evidence to us, the non-audit heads of these multidisciplinary firms revealed an at times shocking lack of knowledge about the purpose and nature of audit.\textsuperscript{190}

104. Secondly, since the culture of advisory (helping management) is by nature antithetical to that of audit (challenging management), a multidisciplinary firm needs to have a strong and distinct subculture in its audit practice. However, evidence suggests that this is hard to achieve. The CMA reported a recent study on the Big Four in the US that found a negative relation between the importance of non-audit services at the firm level and audit quality.\textsuperscript{191} The study concludes that the observed impact on quality can only be explained as the result of internal competition for resources, non-audit fee pressure on audit partners, reduced management attention to audit, or a change in the firms’ culture. The CMA also cites other studies that indicate how the culture of “client service” within accounting firms may conflict with audit notions of independence and public service.\textsuperscript{192}

105. The FRC’s Audit Culture Thematic Review (May 2018) offers convincing evidence that predominantly non-audit firms have a culture problem. The FRC found:

\begin{footnotesize}
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\item \textsuperscript{186} Q222.
\item \textsuperscript{187} FRC, \textit{Audit Culture Thematic Review}, (May 2018), p5.
\item \textsuperscript{188} EY, \textit{Response to Update paper: Statutory audit market}, (25 January 2019), Appendix A p 2.
\item \textsuperscript{189} CMA, \textit{Audit update paper}, (18 December 2018), p 28.
\item \textsuperscript{190} Oral evidence of 30 January 2019.
\item \textsuperscript{191} Meckfessel, M. D., and D. Sellers (2017). The impact of Big 4 consulting on audit reporting lag and restatements. \textit{Managerial Auditing Journal}, 32(1), 19–49.
\item \textsuperscript{192} See Anderson-Gough, F., C. Grey, and K. Robson 2000. In the name of the client: The service ethic in two professional services firms, \textit{Human Relations}, 53(9), 1151–1174.
\end{itemize}
\end{footnotesize}
• Culture (being purpose, values and encouraged behaviours) is designed for the whole multidisciplinary firm.

• In some firms, audit specific values such as objectivity and independence are not sufficiently prominent.

• All firms could do more to promote to partners and staff the purpose of an audit and the societal value that it brings.

• Only in one firm was there a clear sense of audit being there to provide confidence in the capital markets.

• Only four of the eight firms prominently included improving audit quality within their whole-firm strategies.

• Most firms recognised that their multidisciplinary nature contributes to cultural challenges, but few firms have clearly articulated those challenges or taken specific, explicit actions to address them. Examples include:
  - The tensions that can be created by audit sometimes being less profitable than other lines of service.
  - The extent to which the multidisciplinary firm model contributes to a mindset of partners and staff that is focussed on providing the best possible client service, with the client defined as the company to which the service (including audit) is being provided. Such a mindset may make it more difficult for auditors to apply an appropriate degree of professional scepticism and challenge in their work.\(^\text{193}\)

106. As to increasing choice, the CMA’s update paper explains that separation “might allow relaxation of the conflicts rules and therefore a return to greater choice among the Big Four.”\(^\text{194}\) This depends on the degree of separation. Relaxing conflict rules might not be possible or desirable without full legal separation of audit from non-audit, but full separation is costly.

**Degrees of separation**

107. Three alternative models of separation are discussed in this debate:

• governance separation,

• operational separation (to separate economic interests), and

• structural separation (to create two fully independent entities).

108. Governance separation is the shallowest and easiest to implement. Structural separation is the fullest and most disruptive. Operational separation is a compromise. A fuller separation delivers more benefits and with greater certainty, but also entails higher costs and risks. We discuss below the balance of risks and rewards of the different degrees of separation.

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\(^{193}\) FRC, Audit Culture Thematic Review, (May 2018), pp 7–9, 16, 29.

\(^{194}\) CMA, Audit update paper, (18 December 2018), para 4.114.
Governance separation

109. A governance separation would be an internal arrangement to separate the running of the audit practice from the rest of the firm. Everything else would still be shared—including profits. Precise models might differ, but Deloitte’s proposed version includes the following features:

- An audit business with its own CEO, overseen by a new separate governance board and a completely independent Chairman;
- The Audit Governance Board […] would have clear terms of reference including maintaining a culture of audit quality within the audit practice;
- Oversight and enforcement of clear, transparent policies that link partner and staff remuneration to audit quality, overseen by the governance board;
- A firm-wide strategy and budget set at a firm level, with the level of investment in audit agreed by the Audit Governance Board, to ensure investment levels are consistent with its aims of safeguarding audit quality;
- Disclosures akin to a listed company together with an annual report and an AGM.195

110. A governance separation would deliver some improvements in transparency and focus on audit quality, but it does not go nearly far enough in tackling the conflicted commercial culture of the firms. We share the CMA’s concerns in the Audit update paper that auditors are being damagingly exposed to the commercial pressures and culture of non-audit services in multidisciplinary firms. This culture undermines the audit mindset of challenge and professional scepticism.196 A clear and tangible way in which wider business interests seep into the audit practice and compromise its culture is that the vast majority of profits distributed to audit partners come from the non-audit business (see next paragraph). A fatal shortcoming of the governance split is that it does not in any way separate the economic interests of the audit and non-audit arms of the firms. We agree with the CMA that “changes at the firm level are […] necessary to ensure a single-minded focus on audit quality.”197

111. Across the Big Four as a whole, non-audit services accounted for 79 per cent of total revenues in 2018.198 In other words, non-audit fees are four times larger than audit fees. As non-audit has been consistently more profitable than audit,199 the percentage of the firms’ profits accounted for by non-audit is even greater. Non-audit profits feed directly into the remuneration of audit partners, who receive a share of the overall profits of the firm. In the words of the CMA, “[t]his means that audit partners are incentivised to care about the overall performance of the firm (the majority of which relates to non-audit services).”200

199 CMA, Audit update paper, (18 December 2018), p 76.
200 CMA, Audit update paper, (18 December 2018), p 83.
Cross-subsidy

112. The Big Four reported overall profits from their audit practices.\textsuperscript{201} The fact that audit appears profitable, however, does not mean that it is not subsidised. On the contrary, hidden subsidies make audit more profitable than it would otherwise be. Without subsidies, audit would look a lot less profitable or may not be profitable at all based on current prices. Below we look at three forms of subsidy currently taking place, none of which would be ended by a governance split.

113. The remuneration of audit partners is effectively subsidised by non-audit profits. KPMG’s response to the CMA’s update paper explains that without non-audit profits, “audit partner remuneration could not be maintained at a sufficiently competitive level to continue to attract the requisite talent based on the current audit prices.”\textsuperscript{202} We do not think that this is a healthy state of affairs. Audit partners must not be or feel indebted to non-audit partners. That frame of mind can only lead to audit partners being mindful of the interests of the non-audit practice, when we expect them to serve the interests of the firm, its shareholders and the wider public.

114. A second form of subsidy from non-audit to audit stems from the specialist skills of non-audit staff being made available to audit at cost, rather than at an arm’s-length market rate.\textsuperscript{203} A third implicit subsidy is that audit does not bear its fair share of certain costs such as pensions and professional indemnity insurance.\textsuperscript{204} In light of this list of subsidies, we conclude that the true cost of audit is not currently reflected in the audit fee. By implication, audit is also less profitable than might appear from reported figures.

115. We question why non-audit partners are apparently content to provide this subsidy. EY argued that the audit practice deserves compensation for making “an important contribution to brand and reputation, and to the firm’s risk management and compliance frameworks”.\textsuperscript{205} From that perspective, audit is a branding investment which helps the non-audit practice win business. Audit also gives firms special access to corporations and executives (for example via contacts and networking), and that access may be worth paying for because it helps secure non-audit contracts. This underlines our argument over conflicting interests.

116. Far from being an objection, as the firms argue, ending cross-subsidies and letting prices rise if need be is a desirable development. In oral evidence, Sir John Kingman stated that this was a key reason for the sort of separation proposed by the CMA: “An important attraction of what the CMA is proposing is that there would be a clean ring-fencing within the firms, such that cross-subsidy could not occur.”\textsuperscript{206}

117. Finally, the scale of subsidy currently enjoyed by audit in multidisciplinary firms makes it all but impossible for an audit-only model to be viable. It only serves to reinforce the dominance of multidisciplinary firms.\textsuperscript{207} That runs contrary to the goal of improved choice.

\textsuperscript{201} CMA, Audit update paper, (18 December 2018), p 83.
\textsuperscript{202} KPMG, Response to CMA’s Audit update paper, (25 January 2019), para 21.15.
\textsuperscript{203} EY, Response to CMA’s Audit update paper, (25 January 2019), p 4.
\textsuperscript{204} EY, Response to CMA’s Audit update paper, (25 January 2019), pp 2–3.
\textsuperscript{205} EY, Response to CMA’s Audit update paper, (25 January 2019), Appendix A, Part 5.
\textsuperscript{206} Q186
\textsuperscript{207} The point that cross-subsidies make it difficult for a stand-alone audit firm to compete with the large multidisciplinary firms is also made by the CMA in the Audit update paper, (18 December 2018), p 79.
118. The opaque economics of audit undermine independence, erode trust and stifle competition. Audit can only be transparent and independent when it is fully priced. It will only be fully priced when it is no longer subsidised. Therefore, subsidies must end and audit must stand on its own two feet. We conclude that governance separation does not go far enough on the grounds that it fails to deliver independence and does not end cross-subsidies.

Operational separation

119. Operational separation goes one step further than governance separation by also separating economic interests. The CMA proposed the following key features for the operational split:

   a) separation of the audit and non-audit businesses, with the audit business having a separate board, chief executive, staff and assets;

   b) separate profit and pension pools for the audit and non-audit entities;

   c) restrictions on audit partners (but not staff) moving between audit and non-audit businesses of the same firm;

   d) transfer pricing arrangements between the two entities, for example to support use of non-audit staff on audits; and

   e) both the audit and non-audit businesses could share some central operations, systems, branding and know-how, and both would remain part of the same multidisciplinary network.\(^{208}\)

120. It is (b) and (d) that deliver the separation of economic interests, over and above governance separation: the operational split is governance separation plus separate profit pools and proper transfer pricing between audit and non-audit to end cross-subsidies. These extra measures have the potential to deliver independence and transparency needed, if effectively implemented and carefully monitored.

121. The main objection from the firms to separating profit pools is that this might lead to higher audit prices.\(^{209}\) However, as we argued above, letting audit be fully priced is precisely the goal that we are pursuing for competition and transparency reasons. Independence is worth paying for.

122. An economic separation of audit and non-audit is highly desirable. We recommend that the CMA at the very least implements the proposed operational split to achieve the separation of economic interests.

Structural separation

123. The CMA’s “structural split” is the most radical proposal. It involves splitting audit and non-audit into two separate and independent legal entities. The proposed structural split includes the following features:

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\(^{209}\) This is a logical consequence if audit currently enjoys subsidies from non-audit, as explained in the previous section.
any audit firm over a certain size threshold would be prohibited from providing non-audit services in the UK;

- the UK audit firm would then become a stand-alone firm, but could remain part of a multidisciplinary international network;

- audit-only firms would need to replicate in-house the non-audit expertise required to support an audit (for example, by recruiting non-audit specialists to work on audit engagements), or contract externally from an independent non-audit practice. [210]

124. **We believe that there is a strong case for independent audit firms.** A full, clean legal separation would comprehensively address the real and perceived problems we have identified above: cultural tensions, conflicts and concerns over the financial independence of audit services. It would be far more likely to achieve the benefits of separation than an operational split: it would be fully transparent, more likely to foster trust and simpler to monitor. It could also obviate the need for some of the other independence remedies such as cooling off periods, and corporate hospitality could simply be banned for the audit-only firms.

125. Full legal separation could also increase choice, because it would reduce the conflicts between audit and non-audit that can disqualify firms from auditing companies they supply other services to. Currently, there is a 70 per cent cap on non-audit services to audit clients that applies to the firm, but not to the other members of the network. However, the ‘blacklist’ of services that cannot be provided to the audit client applies to all the members of the network, and so would continue to limit choice even after a structural split. [211]

126. The benefits of legal separation are compelling. However, we recognise that a structural split involves significantly greater costs and risks than an operational split.

127. The Big Four argue that a structural break-up would lower audit quality for the following reasons:

- Smaller audit firms would be more dependent on their large clients, and so less able to challenge them;

- Audit-only firms would find it harder to recruit and retain talent;

- Audit-only firms would not benefit from the vast range of specialist skills and technologies available to multidisciplinary firms. [212]

We tackle these objections in turn.

**Greater dependence on large clients**

128. We acknowledge that smaller firms would be more dependent on large clients. Nonetheless, whether this greater dependence affects auditor behaviour depends on the

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210 CMA, Audit update paper, (18 December 2018), p 117.
211 EUR-Lex, Audit Regulation, Article 4(2).
leverage that company management can exercise against the auditor. In this context, the main threat that management can exercise is firing or not reappointing the auditor. While this is no small threat, we are confident that our package of recommendations, together with Sir John Kingman’s new regulator (ARGA) and the CMA’s proposals, can minimise this risk, for the following reasons:

- We are recommending fixed-term, non-renewable contracts of seven years, so that auditors need not worry about being reappointed or fired for doing their job (see Increasing the Frequency of Audit Rotations);
- The CMA’s recommendation for regulatory scrutiny of audit committees would ensure that auditors are selected based on quality and willingness to challenge management;
- ARGAr’s right to appoint the auditor where there are serious concerns with the audit. Where the auditor resigns or is fired before the end of their term, ARGAr would automatically investigate.

Recruitment and retention

129. We do not find the recruitment and retention objection convincing. The CMA looked at this issue in the Audit update paper and found:

[ ... ] evidence [ ... ] submitted to us, ranging from 2011 to 2018, suggests that the number of audit staff that permanently moved into or seconded into a non-audit team within their firms is relatively low compared to the total number of either audit staff or graduates.  

130. Moreover, we reject the notion that a structural split would stop audit staff from moving to non-audit at some point in their career. Part of the attraction of working for firms that are part of a global network is that they already can and do offer opportunities to move to a member firm in another country. If the non-audit business is allowed to remain part of the network (a decision for the CMA), a structural split would make it no more difficult to move from audit to non-audit than it is to move from the UK firm to the US or Australian firm.

Specialist skills and technologies

131. The third objection is stronger and comprises two parts: specialist skills and specialist technologies. The resourcing of specialists would no doubt be costlier and less seamless after legal separation, but we explained why this is desirable when discussing the merits of economic separation. Moreover, developing some of these skills ‘in house’ would ensure that these specialists share the culture, values and goals of audit. For those skills that the audit practice is unable to deliver in house, the CMA expects the practice to be able to contract for those externally. Currently, audit firms rely on expert input of non-audit specialists for between 10 per cent and 20 per cent of a FTSE 350 audit: not insignificant
but by no means prohibitive. In time, the potential additional cost of contracting for these services should create a positive incentive to develop as many of those skills as possible in house.

132. On technology, we are unconvinced that legal separation would prevent the audit practice from accessing and/or investing in the technology it needs. The Big Four already share a large number of key technologies across their networks. As a member of the network, we see no reason why the audit-only firm would be stopped from accessing these technologies, or from investing in new technology together with the UK non-audit firm or with the US practice. There is nothing in a structural split to stop firms from investing together. Indeed, that is one of the key advantages of being a member of a large network.

133. In both the cases (skills and technology), deep and extensive collaboration is already taking place between legally separate and independent members of the network. Every time a multinational is audited, the Big Four provide an integrated international service which relies on foreign auditors auditing the subsidiaries based in their countries. Legal separation is no barrier to providing a seamless international audit and different examples of varying types and degree already exist.

134. Some countries’ ownership rules, designed to safeguard the independence of auditors, in effect separate audit from non-audit. One example is France, where 75 per cent of the capital and shareholding of an audit firm must be held by statutory auditors. 75 per cent of the management, administrative and supervisory bodies must also be statutory auditors. The effect of these rules is described in the Transparency Report of PwC France, which explains that audit, advisory and tax services are delivered by separate legal entities. Audit services are “grouped in the holding company called PwC Audit, owned by natural persons who for the most part are professional auditors and/or chartered accountants, and who finance the company.”

135. We note that similar independent ownership requirements applied in the UK with respect to law firms until 2012. Well before then, the Big Four still considered it worthwhile to set up independent, separately owned law firms. To give one example, PwC’s legal arm operated as a separate and independently owned legal entity up until 2016.

136. It is clear that there are well-functioning models of legal separation and audit-only firms.

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214 CMA, Audit update paper, (18 December 2018), para 4.128.
215 See the letters from the Big Four to BEIS Committee Chair in answer to the questions posed in the Chair’s letter dated 13th February 2019.
217 On the contrary, “one of the primary objectives of the network’s legal structure is to coordinate business development, skills and capabilities development, and the management of liability risk”: In: Oxera, Ownership rules of audit firms and their consequences for audit market concentration, (October 2007), p 104.
218 The above Oxera report explains how US accountancy firm McGladrey & Pullen LLP was separated between audit and non-audit after being acquired by H&R Block. Post separation, the audit business was owned and managed by audit partners, independently of the rest.
219 Oxera, Ownership rules of audit firms and their consequences for audit market concentration, October 2007, p 36.
221 ICAEW, Will accountants embrace multi-disciplinary practices?, (5 November 2014).
222 Lawyer Monthly, PwC Legal – An Overview, (December 2018).
Conclusions on separation

137. We are persuaded that there are models of legal separation that are both preferable to the status quo and perfectly feasible. The precise model should be for the CMA to decide, including whether the fully separated non-audit business should or should not be allowed to remain part of the global network.

138. We have also set out reasons to be highly sceptical of the objections advanced by the Big Four. We do recognise the validity of one remaining objection: legal separation would be complex, disruptive and costly to implement. The CMA will have to weigh these costs against the benefits. That cost-benefit analysis should take into account the fact that implementation costs are one-off, whereas the benefits of separation will recur every year for the long term; and the fact that three of the Big Four sold their consultancy practices between 2000 and 2002,\(^\text{223}\) without apparent damage to the business.

139. We agree with the CMA that “objections to full separation are overstated”. We found the objections against full legal separation to be very weak, as membership of the global network provides an effective avenue to pool resources, access staff and share technologies. We also found well-functioning examples of legal separation and audit-only firms.

140. On the other side of the equation, legal separation offers benefits on multiple fronts: quality, independence, culture, transparency, trust and to some extent, choice. These benefits of separation are large, and in our judgement, worth incurring significant costs.

141. We encourage the CMA to aim for full legal separation of audit and non-audit services. The CMA should look to the long term, and not let one-off, short-term implementation costs weigh too much in its calculations. If the operational split is chosen instead, the CMA and ARGA should conduct a review of the arrangements after three years to determine whether the split has ended cross-subsidies and improved culture, independence and transparency. If not, we recommend that the CMA then move to implement a full structural break-up of the Big Four into audit and non-audit businesses in the UK.

\(^{223}\) Accountancy Age, *How the Big Four have returned to consulting with a bang*, (September 2015).
5 Fees

142. Fees matter for two reasons. First, high-quality audits can only be achieved if they are properly resourced. In turn, audits can only be properly resourced if the audit fees cover these costs. A few audits every now and again might be allowed to be loss-making, but a firm that does not charge sufficient fees to deliver high-quality audits would very quickly have to either sacrifice quality or go out of business. In Sir John Kingman’s words, a properly priced and resourced audit “is the only way of getting quality.”

143. Second, underbidding (charging lower than cost) can undermine competition. To the extent that dominant participants in a market are more able to undercharge than other players, they can all but eliminate competition from those other players. In the world of FTSE 350 audit, the Big Four auditors enjoy subsidies from their non-audit arms on a much greater scale than the challengers. If that was the case, the Big Four would be able to bid at prices lower than the challengers could sustain.

144. In oral evidence, Sir John Kingman stated that the new regulator “needs to understand the economics of audit, and needs to be on top of whether audit fees are sufficient and consistent to deliver quality.” He also referred to the longstanding question of whether audits are under-priced in his letter to the Secretary of State, which accompanied the publication of his Review. In light of this debate, Sir John recommended giving the new regulator the right to approve audit fees in the interests of quality. The letter also notes that “the audit fee [...] need[s] to be set in the light of actual work done”. We are concerned that is often not the case.

145. Fees are largely negotiated and agreed upon before the audit. To an extent, therefore, audit firms have to choose between sacrificing quality or profits when the audit discovers problems that require extra work. In evidence, firms have all said that they prioritise quality over profit whenever extra work is needed. We were also told that auditors negotiate additional fees to cover the extra work.

146. In private, though, we were told that companies can refuse to pay; and audit partners can also be reluctant to ask for more fees in order to preserve a good relationship. We were surprised to find out that half of audits in the last five years at Deloitte and PwC ended up costing over 10 per cent more than originally budgeted. Of these audits incurring significant cost overruns, the Big Four negotiated an increased fee in between 60 per cent and 83 per cent of cases. Deloitte also clarified that in only 24 per cent of cases did the increase fully cover the overrun.

224 Q186.
225 We discuss these subsidies in the Chapter on separating audit from non-audit.
226 Q186.
229 Q309, Q407–410.
230 Qq310–314, Q411–412.
231 The other three firms did not provide this detail.
### The Future of Audit

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<td>Of those, negotiated increased fee</td>
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Source: letters from the Big Four to BEIS Committee Chair in answer to the questions posed in the Chair’s letter dated 13th February 2019

Note: where yearly breakdown was provided, the average percentage was calculated

147. These figures do not fill us with confidence, and we are not alone in this view. The Chartered Financial Analyst (CFA) Institute expressed concern about audit committees advertising their ability to reduce audit fees:

> We worry when audit committee members laud their ability to reduce audit fees as if to engender [sic] themselves to management or flex their muscle on auditors who seek to retain their “clients”. Investors—those who pay the bill—are less price sensitive to audit fees than one might expect. While the cost of an audit is important, pressuring auditors to reduce fees to the point where they are not allowed to make reasonable profits on the audit alone is not a model investors support, as it reduces audit quality.

148. The FRC’s Audit Culture Thematic Review (May 2018) found that auditing is under financial pressures, “with the demands on auditors growing but firms not being successful at increasing or in some cases, maintaining their fees”. The FRC reported views from investors “that the way auditors are remunerated may not promote scepticism, as good auditing may incur additional costs that management are unhappy to pay.” The FRC thought that audit committees should be informed about “the cost of any audit work performed over and above the original audit plan, so the audit committee can decide how this additional cost should be reflected in the final audit fee.”

149. The CFA Institute recommended publishing much more information about fees, skills mix and hours spent in audits in order to move from competition based on price to competition based on quality:

> [Audit fees] are generally large lump sums with very high-level qualitative explanations. This fee reporting, and the tendering process create perverse incentives. [...] Investors need greater reporting on audit hours, staff mix of hours, and rate per hour to be able to be well informed participants in the market place.

150. We recommend that the FRC and its successor require greater reporting on audit fees, potentially including the disclosure of audit hours, staff mix, and rate per hour. Auditors should also report instances where they have performed additional procedures but have been unsuccessful at increasing their fee.

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151. That said, transparency alone does not fully assuage our concerns in this area. We remain concerned about incentives that work against quality. In the FRC’s words, “[c]ost and budget pressures may act as a disincentive to auditors doing the right thing.”\textsuperscript{237} We are not confident in relying solely on the integrity of auditors to do the right thing in the face of conflicting interests. We agree with Sir John Kingman that “economics shapes behaviour”,\textsuperscript{238} and auditors are no exception. The regulator should aim to align as much as possible the incentives that govern auditors’ behaviour with the delivery of quality.

152. Audit must be properly resourced to deliver quality. We have argued that the audit product must improve too. We recognise that many of our recommendations in this report are likely to lead to higher audit prices. This is an acceptable consequence of securing better, more trusted audits.

153. \textit{We recommend that the FRC and its successor be given more powers over audit fees.} We support Sir John Kingman’s proposal that the regulator be given powers to intervene in the interests of quality. To do that well, the regulator needs to better understand the economics of audit. The regulator should also investigate whether the structure of fees is fit for purpose, with the aim of reducing or eliminating economic incentives that work against quality.

\textsuperscript{237} FRC, \textit{Audit Culture Thematic Review}, (May 2018), p 4.
\textsuperscript{238} Q187.
6 Ensuring independence, challenge and professional scepticism

154. The ability to demonstrate professional scepticism and challenge should be a key attribute of any auditor and the foundation of any reliable audit. It is highly concerning that the CMA found that a frequent issue raised by the Financial Reporting Council (FRC) in its reviews of audits was a lack of professional scepticism shown by auditors, \(^{239}\) and that factors such as “cultural fit” and “personal relationships” were often driving auditor appointments by some audit committees. \(^{240}\) While it is important for auditors to display a professional and business-like approach to their work, going beyond this runs the risk of them becoming too close to management. This suggests that “there may be a systemic problem of insufficient challenge across a substantial portion of large company audits”. \(^{241}\) The CMA proposed several measures to tackle this problem, which are explored in this chapter, along with additional remedies.

The role of audit committees

155. Audit committees should play a key independent role in representing shareholders’ interests and ensuring oversight of a company’s internal controls and financial statements. \(^{242}\) The chair of the audit committee is appointed by the Board. Other members, who should be independent non-executive directors, recommended by the nomination committee, in consultation with the audit committee chairman. The chair of the audit committee is also a member of the main board. \(^{243}\) The FRC notes that audit committee members should “bring an independent mind-set to their role” in assessing the work of management and the assurance provided by internal and external audit functions”. \(^{244}\) The audit committee is responsible for relations with the external auditor, in terms of tendering for, recruiting and recommending their appointment. \(^{245}\) It is also responsible for communication with shareholders on audit matters. \(^{246}\)

Are audit committees independent and do they represent shareholders?

156. We heard conflicting views on whether audit committees were independent. Two audit committee chairs told us that committee members were independent and were both challenging and supportive in helping to improve the performance of the company

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240 As above, p 6.
241 As above, p 36.
243 Q100 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV).
245 The Audit Committee negotiates the fee and scope of the audit, initiates a tender process and makes formal recommendations to the board on the appointment, reappointment and removal of external auditors. The Audit Committee should also consider all relationships between the company and the audit firm, including throughout the group and with the audit firm’s network firms, and any safeguards established by the external auditor. The AC is also responsible for approving non-audit services, ensuring that such services do not impair the external auditor’s independence or objectivity. (FRC, *Guidance on Audit Committees*, (2016), p 10–12)
246 As above, pp 14 to 15.
and its management. However, Vinita Mithani told us that despite rules to ensure the independence and competence of audit committees, they “remained under management power”:

A lot of the time the non-execs who sit on the audit committees have been recommended to the board by management, so there are social ties. There is also this view that they are independent although they are directors in the company and have a significant say in the commercial path of the company.

157. There is also disagreement about the relationship between audit committees and shareholders. Several investors also told us that although the appointment of auditors should be agreed by shareholders, it was usually rubber-stamped with minimal scrutiny. There was generally little engagement between the audit committee and shareholders, including on ongoing audit work. In turn, the CMA and audit chairs suggest that there was little appetite amongst shareholders to engage with audit committees and the audit process.

158. We do not doubt that many audit chairs and their committees strive to provide independent oversight of company management, financial controls and reporting. However, the fact that audit committee chairs sit on the main board and other members are appointed by the company will continue to raise questions about whether audit committees can be truly independent and whether some external validation is required. It is also clear, whether the fault lies with audit committees, shareholders or both, that shareholders too often are not involved in the audit process and are not engaging with their proxy, the audit committee. The fact that this is not happening, and shareholders are not holding audit committee to account, makes the case for external validation more persuasive.

**Audit committees and audit**

159. We are particularly concerned about the role of audit committees in appointing and overseeing audits. Audit chairs told us that their main criteria for appointing auditors was audit quality and their ability to challenge management. The CMA identified several problems with this view. They found that although the Competition Commission had previously sought to strengthen audit committees, the fact that they did not directly observe the quality of the audit work undertaken made the whole system “fragile”, because the committees could not ensure that auditors were exercising professional scepticism and challenge.

The CMA also questioned the recruitment process of auditors, which they concluded could lead to “the selection of auditors with the interests of the company and...
its management rather than those of the shareholders”. It sampled several FTSE 350 companies audit tender processes to see what criteria were used to select auditors and found that factors such as ‘cultural fit’ and ‘chemistry’ were often overriding others such as providing independent challenge.

Criteria Used to Select Auditors (Sample of FTSE 350 Companies)

![Bar chart showing criteria used to select auditors](chart.png)


160. Finally, the CMA found wide variations in the amount of time audit committees were spending on their duties; while some committees were spending more than 400-person hours on the external audit (excluding time spent on a tender), others were spending less than 20 hours, with some FTSE 100 companies recording less than 40 hours in a year.

161. It is deeply concerning that many audit committees do not appear to be factoring professional scepticism and challenge into their criteria for selecting auditors and are instead using ‘cultural fit’ as a desirable attribute. Equally worrying is the finding that many audit committees are spending so little time on auditing matters. This questions whether many audit committees are committed to challenging management and to putting in the necessary time to ensure that auditors are as well.

**Increasing regulatory oversight of audit committees**

162. To address these concerns, the CMA proposed greater regulatory oversight of audit committees. Their remedy included:

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254 As above, p 45.
255 As above, p 49.
256 As above, pp 50–51.
257 As above, p 88.
• requiring FTSE 350 audit committees to report directly to the regulator before,
during and after a tender selection process or a representative from the regulator
to sit as an observer on the committee if there had been previous quality issues;258

• requiring audit committees to report directly to the regulator throughout the
audit engagement to demonstrate how they are monitoring quality, and which
could include direct observation by the regulator and the regulator having a
right of inspection at any time;259

• permitting the regulator to issue public reprimands, or direct statements to
shareholders in circumstances where it was not satisfied that audit committees
had followed proper procedures.

163. The CMA proposed that this remedy should only apply to FTSE 350 audits in the first
instance.260 It thought that this remedy would make audit committees more independent,
increase transparency, ensure a level playing field for challenger firms and that audit
committees focused on delivering quality audits.261

164. The majority of evidence to us supported strengthening the oversight of audit
committees.262 However, some argued that they did a good job,263 and disagreed with the
CMA’s analysis regarding cultural fit and lack of challenge and professional scepticism.264
Others who disagreed with the remedy thought that the regulator would not be able to
develop the knowledge and experience to have meaningful oversight of audit committees,265
or that it would be too burdensome for companies and the regulator.266

165. There was disagreement amongst those who supported greater regulatory oversight
about what form this should take. Some questioned whether the level of intervention

258 The CMA noted that it would require a Audit Committee to demonstrate that it had: prioritised independence
and challenge in its tender assessment; made its decisions independently of company management;
competently managed conflicts of interest so as to maximise choice at the time of the audit tender; and (iv)
given fair consideration to challenger firms – having an objective justification for excluding any challenger firm.

259 The CMA said that Audit Committees would need to demonstrate that they had made meaningful interventions
to assess quality beyond simply seeking management feedback; and provide the regulator with an account of
material disagreements between the audit firm and management, including the role of the Audit Committee in
these discussions.

260 As above, pp 88–89.
261 As above, p 91.
262 See: Crowe U.K. LLP (FOA0010); Investment Association (FOA0014); Aberdeen Standard Investments (FOA0023);
Sarasini & Partners LLP (FOA0024); Mazars LLP (FOA0025); Rathbone Brothers PLC (FOA0026); CFA Institute,
Update Paper: Statutory Audit Market, (January 2019); Association of Financial Mutuals, Update Paper:
Statutory Audit Market, (January 2019); Chartered Accountants Ireland, Update Paper: Statutory Audit Market,
(January 2019); Association of British Insurers, Update Paper: Statutory Audit Market, (January 2019); Association of
Chartered Certified Accountants, Update Paper: Statutory Audit Market, (January 2019); Institute of Chartered
Secretaries and Administrators, Update Paper: Statutory Audit Market, (January 2019);
264 See: Institute of Chartered Accountants of Scotland, Update Paper: Statutory Audit Market, (January 2019);
Association of British Insurers, Update Paper: Statutory Audit Market, (January 2019); Association of Chartered
Certified Accountants, Update Paper: Statutory Audit Market, (January 2019); Institute of Chartered Secretaries
and Administrators, Update Paper: Statutory Audit Market, (January 2019);
265 See; Morrisons, Update Paper: Statutory Audit Market, (January 2019); Johnson-Matthey Plc, Update Paper:
Statutory Audit Market, (January 2019);
266 See: 3i, Update Paper: Statutory Audit Market, (January 2019); Aviva, Update Paper: Statutory Audit Market,
(January 2019); GC100, Update Paper: Statutory Audit Market, (January 2019); Rio Tinto, Update Paper:
Statutory Audit Market, (January 2019); Serco, Update Paper: Statutory Audit Market, (January 2019);
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proposed by the CMA was too much, and could put pressure on the resources of companies and the regulator. Some suggested a risk-based proportionate approach to intervention. BDO and KPMG argued that regulatory oversight should particularly focus on auditor appointment rather than ongoing monitoring. Investors told us that they supported the regulator holding audit committees to account but did not want the regulator taking over the role of the audit committee who represented the interests of shareholders.

166. Because of our concerns about the independence of audit committees, their lack of attention to audit and the lack of emphasis they are placing on challenge, we fully support the CMA’s proposed remedy on greater scrutiny. We agree with the CMA and others that sharper oversight of audit committees would help ensure that audits are more independent, able to challenge management and address any bias in favour of the Big Four. It is for the regulator to decide how much intervention and oversight is required to deliver these objectives, both in general and in specific cases.

Other measures to ensure audit independence and challenge

167. We took evidence on several other measures that would seek to increase professional scepticism. These are explored below.

Independent appointment of auditors by the regulator

168. The idea of the independent appointment of auditors is not entirely new. For example, before its abolition in 2015, the Audit Commission appointed and reviewed the work of auditors to all the local authorities in England and Wales. However, applying it to the appointment of auditors for the FTSE 350 would be a novel step, though several commentators have proposed the independent appointment of auditors, or a statutory state-backed body to audit financial bodies. It was considered by Sir John Kingman and the CMA. Sir John, in a letter that accompanied his Review of the FRC, proposed that auditors could be appointed by the regulator in three specific certain circumstances:

267 See: UKSA & ShareSoc (FAO0005); Institute of Chartered Accountants in England & Wales (FAO0015);
268 PwC LLP (FAO0029); HSBC, Update Paper: Statutory Audit Market, (January 2019);
269 See: Q137 (Steve Barber, Audit Committee Chair, AA plc) Q137 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); Nationwide Building Society, Update Paper: Statutory Audit Market, (January 2019); Rothesay Life, Update Paper: Statutory Audit Market, (January 2019); Royal Dutch Shell, Update Paper: Statutory Audit Market, (January 2019); Santander, Update Paper: Statutory Audit Market, (January 2019); Schroders, Update Paper: Statutory Audit Market, (January 2019);
270 BDO, Update Paper: Statutory Audit Market, (January 2019); KPMG, Update Paper: Statutory Audit Market, (January 2019); 100 Group, Update Paper: Statutory Audit Market, (January 2019);
271 See: Q81 (Liz Murrall, Director, Stewardship and Reporting, The Investment Association); Q54 (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments); Q54 (Leon Kamhi, Head of Responsible Investment, Hermes Investment Management).
272 Financial Times, UK to press for shake-up of Big Four auditors, (September 2018).
274 See: Prem Sikka et al., REFORMING THE AUDITING INDUSTRY, (December 2018), pp 4–5. They also called for the independent appointment of auditors for all non-financial sector large companies, as defined by the Companies Act 2006.
if there were quality issues in a company’s audit; if a company parted company with an
auditor outside of mandatory rotation; and, if there was a meaningful shareholder vote,
even one well short of 50 per cent, against an auditor appointment.  

169. Sir John thought that independent appointment of auditors could fall foul of the
EU Audit Directive, which stipulates that the appointment of auditors must be agreed
by shareholders. He suggested that this could be addressed by allowing shareholders the
final say on appointment. However, it should be noted that Article 16(1) of the EU audit
regulations states that member states can set up alternative systems to audit committees,
and Article 37(2) of audit directive states:

Member States may allow alternative systems or modalities for the
appointment of the statutory auditor or audit firm, provided that those
systems or modalities are designed to ensure the independence of the
statutory auditor or audit firm from the executive members of the
administrative body or from the managerial body of the audited entity.  

170. The Government agreed with Sir John that these changes would not change the
fundamental role of shareholders in appointing a company’s auditor, and that “the
proposal is to develop an ability for the regulator to intervene, rather than a requirement
to do so.”  

171. The CMA also considered independent appointment of auditors more generally,
as opposed to specific circumstances as Sir John proposed. They did not think that the
independent appointment of auditors would disenfranchise shareholders, if as Sir John
argued, shareholders retained the final vote. They also did not think that a well-resourced
independent body would be incapable of replicating the functions of audit committees,
not least because they found evidence, as noted above, that audit committee members
on average spent less than 35 hours on matters relating to the statutory audit in the last
financial year.  

However, the CMA backed away from this potential remedy because they
were concerned at widespread opposition, especially amongst shareholders, and because
they were concerned that it might not be in keeping with EU legislation, though Sir John
argued otherwise. Despite this, the CMA did note that if its package of remedies did not
work it would revisit “more drastic but harder to implement remedies, like independent
appointment”.  

172. Several witnesses told us that one of the key reasons causing a lack of audit
independence and professional scepticism by auditors was the fact that they were auditing
the very people they were paid by. Vinita Mithani told us:

In my opinion, the expectation gap is actually that we expect auditors
to carry out their work independently when they could not possibly be
fully independent, considering that they give an opinion on assertions
by the very people who have the greatest influence in appointing them,
remunerating them and dismissing them. The core conflict they have is balancing their commercial interests against any professional regulations as well as legislation.\textsuperscript{281}

173. Vinita Mithani argued that this is built into the career path of auditors, because an auditor’s appointment, remuneration and dismissal is controlled by the audited company and that partner career progression within an audit company is predicated on delivering corporate and not necessarily audit goals.\textsuperscript{282} She told us that the independence of audit committees was also compromised because they were chosen by the company boards of which they were also members.\textsuperscript{283} Therefore she maintained that the best way of addressing this was to break the link between auditors and audited companies altogether by passing the appointment of auditors to the regulator.\textsuperscript{284} The independent appointment of auditors by the regulator was also supported by Grant Thornton, because along with ensuring independent auditors it could help break the bias of audit committees towards the Big Four.

174. Investors told us that they would be concerned if the appointment of auditors was taken away from audit committees or shareholder. Euan Sterling, of Aberdeen Standard Investment, thought that this would break the “relationship of stewardship” and might have further adverse unintended consequences.\textsuperscript{285} Two audit committee chairs told us that they were against independent appointment because they did not think that the regulator could replicate the understanding of a company to evaluate taking on an auditor, and were concerned about who would take responsibility if there were major problems with an audit.\textsuperscript{286} Jac Berry (Mazars) and Scott Knight (BDO) similarly did not think that it would deliver audit quality or replicate the role of audit committees.\textsuperscript{287}

175. The independent appointment of auditors would be a radical reform: an admission that a broken sector is beyond being fixed by the market. We accept that many stakeholders are concerned if adopted this might disempower shareholders and audit committees. However, we note that shareholders rarely engage with audits and both Sir John Kingman and the CMA have argued that if shareholders have the final say after an auditor has been appointed it would probably not diverge drastically from current practices and, importantly, would not fall foul of EU law. We also acknowledge that if the regulator appointed auditors it could not replicate the knowledge and expertise of audit committees. However, the CMA has evidence that members of some audit committees are spending sometimes as little as 20 hours a year considering external audit matters.

176. If audit quality, choice, resilience and the professional scepticism and independence of auditors remain a problem despite the remedies proposed by the CMA, Sir John Kingman and Sir Donald Brydon, we believe that independent appointment becomes

\textsuperscript{281} Q1 (Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University). See also: Vinita Mithani, Lecturer at Middlesex University (FOA0016).

\textsuperscript{282} See: Vinita Mithani, Lecturer at Middlesex University (FOA0016).

\textsuperscript{283} Q6 (Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University).

\textsuperscript{284} Vinita Mithani, Lecturer at Middlesex University (FOA0016). See also: 38 Degrees, Update Paper: Statutory Audit Market, (January 2019).

\textsuperscript{285} Q52 (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments). See also Q55 (Leon Kamhi, Head of Responsible Investment, Hermes Investment Management).

\textsuperscript{286} See: Q136 (Steve Barber, Audit Committee Chair, AA plc); Q136 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV).

\textsuperscript{287} Q277 (Jac Berry, UK Head of Quality and Risk, Mazars); Q278 (Scott Knight, Head of Audit, BDO).
a viable option for reform. We recommend that the regulator and the CMA consider the potential independent appointment of auditors with a view to developing it as a viable remedy if other remedies and reforms fail.

**Increasing the frequency of audit rotations**

177. Currently, auditors must be changed every 20 years and audits must be re-tendered every 10 years.288 The CMA decided that it would not increase the frequency of rotation as one of its remedies.289 It accepted that this “could interrupt the close relationship that may develop among management, audit committees and the audit firms, over a long audit tenure”, and increase the independence of auditors, while it could also promote greater competition.290 However, the CMA was concerned that more frequent audit tenders and auditor rotation would increase the costs for the audit firms and companies, and might increase the audit, whilst reducing audit quality if recently appointed audit firms did not fully understand the businesses of their audit clients.291 This view was supported by the Big Four,292 and some of the others who gave evidence to the CMA, who were not sure it would deliver benefits.293 However, some stakeholders did tell the CMA that they thought that 20 year audit engagements were too long, which could damage audit quality.294 We were also told that 20 years were too long. Scott Knight thought that ten years was about the right time period.295 Clive Stephens and Jac Berry both agreed that 20-year audit appointments were too long.296 David Dunckley thought that audit terms should be limited to between five and seven years.297 It was also suggested that prohibiting clients from firing auditors during an audit engagement, except in exceptional circumstances, could also encourage auditors to challenge management and exercise professional scepticism.298

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288 This was introduced in 2016 in Schedule 3 of The Statutory Auditors and Third Country Auditors Regulations 2016. Before this was introduced companies could use the same auditor in perpetuity. For example, in 2015 Barclays Bank changed its auditor to KPMG. Before that PwC had been its auditor for 119 years. See: Financial Times, An illusion of choice: the conflicts that mire the audit world, (August 2018).


290 CMA, Statutory Audit Services Market Study: Invitation to Comment, (October 2018), p 291

291 As above.

292 See: KPMG, Statutory Audit Market: Invitation to Comment, (November 2018); PwC, Statutory Audit Market: Invitation to Comment, (November 2018); Deloitte, though generally not in favour, did think that more frequent rotation could be considered if it was used alongside a market cap to increase competition. Deloitte, Statutory Audit Market: Invitation to Comment, (November 2018);


294 See: HSBC, Statutory Audit Market: Invitation to Comment, (November 2018); Grant Thornton, Statutory Audit Market: Invitation to Comment, (November 2018); Legal and General, Statutory Audit Market: Invitation to Comment, (November 2018); Professor Atul Shah et al, Statutory Audit Market: Invitation to Comment, (November 2018); Croda, Statutory Audit Market: Invitation to Comment, (November 2018); Investment Association, Statutory Audit Market: Invitation to Comment, (November 2018).

295 Q281 (Scott Knight, Head of Audit, BDO)

296 Q282 (Clive Stevens, Chairman, Association of Practising Accountants); Q279 (Jac Berry, UK Head of Quality and Risk, Mazars).

297 Q281 (David Dunckley, Chief Executive Officer, Grant Thornton). While Grant Thornton thought that this would increase auditor scepticism, it also believed it would stop current rotation rules merely increasing rotation amongst the Big Four for FTSE 350 audits. (Grant Thornton, Statutory Audit Market: Invitation to Comment, November 2018). The Investment Association also thought that an audit appointment of 7–8 years more appropriate than 20 years (Investment Association, Statutory Audit Market: Invitation to Comment, November 2018).

298 Association of Chartered Certified Accountants (FOA0021).
178. We accept that a number of stakeholders oppose reducing the frequency of auditor rotations from twenty years and that the CMA decided not to proceed with this as a remedy. We also accept that there might be some additional costs because of more frequent tendering. However, 20 years is far too long because it runs the risk of allowing audit firms to become too familiar with management, so reducing auditor independence and professional scepticism, which the CMA have identified as a key problem and which we have seen in several recent audit failures. For example, KPMG was paid £29 million for auditing Carillion for 19 years and complacently signed off the directors’ increasingly fantastical figures without question. Seven-year non-renewable terms are more appropriate and more likely to disrupt familiarity, while ensuring that engagements can only be terminated in exceptional circumstances will further engender and protect audit independence.

179. We believe that increasing the frequency of audit rotations will, especially if used alongside a market cap, also encourage challenger firms to enter the FTSE 350 audit market, which will increase choice, competition and resilience. We believe these benefits outweigh any possible increases in costs. We also maintain that seven years will allow an audit firm to gain a good understanding of the companies they audit and would contend that even with a twenty-year rotation, a new audit firm will be required to develop knowledge of the firms they audit and the sectors within which they operate. We recommend that the CMA should revisit increasing the frequency of audit rotations, which should be reduced to seven-year non-renewable terms that can only be terminated in exceptional circumstances.

**A cooling-off period for non-audit services after an audit engagement**

180. In terms of non-audit services, EU regulations currently prohibit audit firms selling certain non-audit services during an audit or in the financial year preceding the audit, and limit other non-audit services to no more than 70 per cent of the average fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity. KPMG announced in November 2018 that it would cease selling non-essential non-audit services for its current FTSE 350 clients because of perceptions over conflicts of interest. Bill Michael told us that this would be fully implemented within 12 months. David Sproul confirmed that Deloitte was planning to do the same and agreed with KPMG that it was because of the perceived conflict of interest between audit and non-audit services as did Kevin Ellis of PwC.
181. While current prohibitions and limits on the selling of non-audit services are in place during an audit, and certain controls are in place before an audit engagement is taken up, audit firms are allowed to offer non-audit services afterwards. We received evidence which suggested that this should be addressed so that audit firms would not be conflicted whilst auditing a client if it later wanted to sell non-audit services. The Association of Chartered Certified Accountants (ACCA) suggested that a “cooling-off” period of two years might allay fears that the “judgement in the final years of the audit relationship could be affected by the firm’s desire to sell consulting services to that entity in the following year”.\(^\text{305}\) Maggie McGhee of ACCA told us that two years represented a good balance between independence and competition, while it might also “increase the number of non-audit services for challenger firms, offer a different route to market and allow them to grow their experience.”\(^\text{306}\) Sarasin and Partners agreed with this approach, though they thought that at least three years was more appropriate,\(^\text{307}\) though Natasha Landell-Mills told us that this would not be required if there was a full structural split between audit and non-audit services.\(^\text{308}\)

182. We are persuaded that a “cooling off” period during which non-audit services could not be sold after an audit engagement had ended would remove a major potential conflict of interest for auditors. It would help focus auditors’ minds on audit quality and remove any concern that challenging management or exercising professional scepticism would have adverse financial implications after an audit term ended. This would also be a good option if a full structural split of audit and non-audit services was not adopted. It would also most likely increase challenger firms’ non-audit work, which would allow them to build up experience, expertise and a fee base to develop and invest in audit work. On balance we think a cooling-off period of three years would be optimal in delivering audit independence. We recommend that the CMA seriously considers the benefits of a cooling-off period of three years across which non-audit services could not be offered after an audit engagement had ended. The CMA should see this is a viable option if it does not decide to proceed with a full structural split of audit and non-audit services.

Corporate hospitality for audit clients

183. Though we accept that there is a role for corporate hospitality in the business world, we question its role for audit, whose guiding principles should be independence, professional scepticism and challenge. The public would rightly be concerned if statutory inspectors in the public sector were offering or receiving hospitality from those they were about to inspect. Public servants are required not to accept gifts or hospitality “from anyone which might reasonably be seen to compromise their personal judgement or integrity”.\(^\text{309}\) In relation to statutory audit, the test should be the same. Where hospitality is accepted—

\(^{305}\) Association of Chartered Certified Accountants (FOA0021).
\(^{306}\) Q585 (Maggie McGhee, Executive Director, Governance, Association of Chartered Certified Accountants).
\(^{307}\) Sarasin & Partners LLP (FOA0024).
\(^{308}\) Q75 (Natasha Landell-Mills, Head of Stewardship, Sarasin & Partners). See also: Sarasin and Partners, Statutory Audit Market: Invitation to Comment, (November 2018);
where it was felt personal judgement or integrity was not compromised—we would expect total transparency. We have concerns that this is currently not the case for statutory audit.

184. The FRC re-issued its ethical rules in July 2016 to address conflicts of interest which might impact on the “practitioner’s judgment or actions”. In terms of hospitality or gifts, whether given or taken from current clients the rules state:

The firm, its partners and staff and any other covered person, and persons closely associated with covered persons, shall not provide or accept gifts and hospitality in relation to an engagement unless it is probable that an objective, reasonable and informed third party would consider the value thereof to be trivial or inconsequential.

185. Figures supplied to us by the Big Four audit firms note that they have set maximum entertainment budgets per head: PwC (£20 per head); KPMG (£200 per head); Deloitte (£150 per head); EY (£175 per head). Since the introduction of the rules in 2016, two of the Big Four have reported 35 breaches to the FRC. The FRC have also told us that EY needed to amend its policy and guidance on hospitality in relation to allowable thresholds.

186. The rules on gifts and hospitality do not apply to prospective clients. Figures supplied by the Big Four suggest that over the last five years they have spent considerably more on such clients: KPMG on average each year spent £1,463 per client, PwC £1,709 and Deloitte £2,561. Deloitte spent on average a total of £60,184 per year on all such clients in 2017 and 2018. The equivalent figures for the other three Big Four firms were: KPMG £27,177 (2014–2018); PwC £43,300 (2014–2018) and EY £60,990 (2014 to 2018).

310 HMRC publishes its hospitality register for senior HMRC managers on a quarterly basis and discloses in full what hospitality was offered, by whom and whether it was accepted. See: HMRC, HMRC’s Hospitality register, (accessed 21 March 2019).
311 FRC, Revised Ethical Standard 2016, (June 2016), p 7.
312 FRC, Revised Ethical Standard 2016, (June 2016), p 15.
313 PwC advised us that PwC UK’s general policy is that hospitality may not be offered to companies that PwC UK audits—or to the directors, officers and employees of that company. However, they have a de minimis limit where the cost per person is less than £20 per person, to allow for the purchase of coffees or light meals, during the normal course of business. They also allow directors and employees of audited companies to be invited to “mass-participation” events hosted by PwC. The latter would include, for example, their Building Public Trust annual awards for excellence in corporate reporting.
314 Financial Times, MPs call for five years of hospitality data from Big Four, (17 February 2019). The Financial Times stated: “There are no rules on how much accounting firms are allowed to spend on hospitality for prospective audit clients”.
315 Letter from KPMG to BEIS Committee Chair (6 March 2019). KPMG confirmed that the limit was £200 excluding VAT for FTSE 350 clients. KPMG also advised us that they have a further limit for listed and certain other companies. This sets a limit for lunches or dinners at £60 per head for food and £25 per head for wine.
316 Letter from Deloitte to BEIS Committee Chair (6 March 2019). This is for FTSE 350 clients.
317 Letter from EY to BEIS Committee Chair (6 March 2019). This is for FTSE 350 clients.
318 FRC, ERNST & YOUNG LLP AUDIT QUALITY INSPECTION, (June 2018), p 5.
319 Financial Times, MPs call for five years of hospitality data from Big Four, (17 February 2019). The Financial Times stated: “There are no rules on how much accounting firms are allowed to spend on hospitality for prospective audit clients”.
320 Letter from KPMG to BEIS Committee Chair (6 March 2019). KPMG supplied figures for each year for 2014 to 2018.
322 As above.
323 Letter from KMPG to BEIS Committee Chair (6 March 2019).
324 Letter from PwC to BEIS Committee Chair (6 March 2019).
325 Letter from EY to BEIS Committee Chair (6 March 2019).
187. Importantly, audit firms do not currently publish registers showing which companies, current or prospective, attend their hospitality events. However, the FRC, for example, publishes a gifts and hospitality register, including details of companies and organisations and whether it accepts or declines, which applies to members of the board, its committees and councils and to the FRC executive.326

188. The amounts being spent by audit firms for prospective clients seem high and lack transparency, raising significant concerns about whether this undermines auditor independence. Auditors themselves said that part of the current crisis of trust in the audit profession is the perception of conflicts of interest. We are therefore concerned that since the FRC’s policy on hospitality was introduced in 2016 there have already been 35 breaches. We recommend that the regulator tightens the current rules and applies them also to prospective audit clients and requires audit companies to publish details of all hospitality in full.

326 See: FRC, Gift and Hospitality Register, (accessed 1 March 2019). This includes details of hospitality that the FRC has accepted from audit firms, including the Big Four. See: Times, Audit watchdog enjoyed scores of Big Four hospitality events, (December 2018).
7 Competition, choice and resilience

189. This chapter considers the related issues of competition, choice and resilience in the UK’s statutory audit market of the FTSE 350 companies. The combination of a lack of choice through market concentration and a lack of challengers to compete with established audit companies together undermine the resilience of the FTSE 350 audit market.

Levels of competition and choice in the UK audit market

190. The domination by the Big Four of the FTSE 350 statutory audit market is well established and has increased in recent years.\textsuperscript{327}

**Concentration of the FTSE 100 and FTSE 250 Audit Market 2013 to 2017**

<table>
<thead>
<tr>
<th></th>
<th>Big Four Firms (%)</th>
<th>Next Five Firms (%)</th>
<th>Other Firms (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 500</td>
<td>99.0</td>
<td>99.0</td>
<td>99.0</td>
</tr>
<tr>
<td>FTSE 250</td>
<td>96.0</td>
<td>96.8</td>
<td>96.8</td>
</tr>
</tbody>
</table>


Currently, only one FTSE 100 audit is carried out be a non-Big Four company (BDO), while only seven FTSE 250 audits are carried out by challenger firms (Grant Thornton and BDO).\textsuperscript{328}

The dominance of the Big Four audit firms is also reflected in their share of fees:

\textsuperscript{327} The concentration of the FTSE 350 audit market amongst the Big Four has been a feature of the market for some time. The Competition Commission’s market investigation into the audit market published in 2014, indicated that market concentration in the FTSE 350 audit market amongst the Big Four between 2002 and 2010 in terms of the annual share of audit fees was almost 100 per cent. See: Competition Commission, *Statutory Audit Services Market Investigation: Descriptive Statistics*, (2012), p 4.

\textsuperscript{328} FRC, *Key Facts and Trends in the Accountancy Profession*, (July 2018), p 47.
Audit Firm Shares of FTSE 350 Audit Fee


And their total income compared to their nearest rivals:

UK Fee Income of the Largest Accountancy Firms, Year Ended 2017

<table>
<thead>
<tr>
<th>Firm</th>
<th>No of PIE Audit Clients</th>
<th>Non-Audit Work to Audit Clients (£m)</th>
<th>Non-Audit Clients (£m)</th>
<th>Total Fee Income (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwC</td>
<td>533</td>
<td>676</td>
<td>351</td>
<td>1,975</td>
</tr>
<tr>
<td>KPMG</td>
<td>464</td>
<td>548</td>
<td>221</td>
<td>1,403</td>
</tr>
<tr>
<td>EY</td>
<td>287</td>
<td>442</td>
<td>229</td>
<td>1,677</td>
</tr>
<tr>
<td>Deloitte</td>
<td>337</td>
<td>418</td>
<td>214</td>
<td>2,309</td>
</tr>
<tr>
<td>BDO</td>
<td>100</td>
<td>151</td>
<td>68</td>
<td>237</td>
</tr>
<tr>
<td>Grant Thornton UK</td>
<td>69</td>
<td>133</td>
<td>55</td>
<td>312</td>
</tr>
</tbody>
</table>


191. The size of the gap between the Big Four and their nearest rivals was underlined by the announcement in November 2018 that BDO is to merge with Moore Stephens to become the UK’s fifth biggest audit firm. Despite the merger between the sixth and tenth
The Future of Audit

biggest audit firms in terms of total fee income, the new firm would still only be about 30 per cent of the size of KMPG, the smallest of the Big Four firms in terms of its total fee income.

192. Choice appears to be the preserve of the Big Four for all but one of FTSE 100 audits and almost all FTSE 250 audits. But that choice is restricted further because audit firms are prohibited from carrying out audits if they carry out certain non-audit services or pass a threshold of providing other non-audit services. That means that when companies retender their audits (every ten years), the choice may be three firms and when they have to rotate auditors (every 20 years), the choice may be only two firms. The Secretary of State agreed that only having four companies to carry out the majority of audits in the FTSE 350 did not represent “a high degree of competition”.

Why are challenger firms not taking on more FTSE 350 clients?

193. Previous attempts to open up the UK’s FTSE 350 audit market do not appear to have broken down the barriers facing challenger firms. The inability or reluctance of non-Big Four challenger firms to take on more FTSE 350 clients was underlined by the decision of Grant Thornton in March 2018 to stop bidding for such clients altogether.

194. On the demand side, challenger firms have a much lower bid success rate (20 per cent) compared to the Big Four (35 per cent) when bidding for FTSE 350 audits. This is due partly to a perceived concern that challenger firms lack the capability to audit the largest, most complex companies, especially those at the top end of the FTSE 350. Challenger firms told us that they thought they did have the ability to carry out more FTSE 350 audits. This can lead to a ‘chicken and egg’ problem for challenger firms in that they are frequently ruled out of tenders on the basis that they lack experience that can only be gained through carrying out such audits.

On the supply side, challenger firms are often reluctant to tender for FTSE 350 audits because of high tender costs and their limited success, plus the greater regulatory, financial and reputational risk involved in

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329 At year-end 2017, BDO had a total fee income of £456mn and Moore Stephens a total fee income of £120mn. See: FRC, Key Facts and Trends in the Accountancy Profession, (July 2018), p 39; Times, Mid-size rivals put on bulk to fight Big Four accountants, (November 2018).


331 Financial Times, An illusion of choice: the conflicts that mire the audit world, (August 2018).

332 SKY News suggested that for Lloyds Bank, the choice was one, because “conflicts involving the other so-called ‘big four’ accountancy firms have left [Deloitte] as the only viable option.” See: Sky News, Big Four conflicts leave Lloyds banking on Deloitte as next auditor, (August 2018). See also: Financial Times, Lloyds’ pick of new auditor after 153 years is no choice at all, (November 2018); Times, Lloyds Bank in dilemma over auditing conflict, (August 2018). This has been a long-running concern. See: House of Lords Economic Affairs Select Committee, Auditors: Market concentration and their role, (HL Paper 119; March 2011), pp 12. They concluded: “All witnesses fear the real possibility that one of the Big Four might withdraw leaving a Big Three (or even a Big Two, in the bank audit market). We agree. Loss of one of the Big Four would restrict competition and choice to an unacceptable extent.”

333 Q668 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).

334 Financial Times, Grant Thornton exits audit market for big UK companies, (March 2018).

335 See Q111 (Steve Barber, Audit Committee Chair, AA plc); Q156 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV). See also: CMA, Statutory audit services market study: Update paper, (18 December 2018), p 65.

336 See: Q194 (David Dunckley, Chief Executive Officer, Grant Thornton); Q195 (Scott Knight, Head of Audit, BDO); (Mazars LLP (FQA0025));


338 See: Times, Big Four audit rivals priced out of market, (June 2018).
There are also difficulties involved in scaling up an audit business to take on more complex clients, such as attracting audit partners from the Big Four or investing in appropriate IT systems. The CMA therefore concluded that a general reluctance to bid for such work was “a rational response to their perception of the return on investment they can expect.”

The CMA’s market study into the statutory audit market

In its market case study, the CMA included a major focus on choice, competition and resilience, and, in particular the barriers facing the challenger firms entering the FTSE 350 audit market. The CMA settled on several preferred remedies to address these issues:

- mandatory joint audits;
- the introduction of a market cap to reduce the number of FTSE 350 audits carried out by the Big Four;
- resilience measures in the event of an audit firm, especially one of the Big Four, failing.

We consider each of these in turn.

Mandatory joint audits

The CMA examined joint and shared audits and peer reviews, which are explained in the box below.

<table>
<thead>
<tr>
<th>Mandatory Joint Audits</th>
<th>Shared Audits</th>
<th>Peer Review</th>
</tr>
</thead>
<tbody>
<tr>
<td>A mandatory joint audit requires two audit firms to sign off on the accounts of their audit client. Responsibility for the audit opinion, and audit liability, would rest with both auditors.</td>
<td>One audit firm (the statutory auditor) takes overall control, responsibility and liability for the audit. Another audit firm supports the statutory auditor on certain aspects of the audit.</td>
<td>An independent audit firm (not the company’s statutory auditor) reviews the audit file and assesses the accuracy of the audit opinion before it is signed off by the statutory auditor.</td>
</tr>
</tbody>
</table>

The CMA supported mandatory joint audits, involving a Big Four and a challenger firm, because it believed that they were more likely to reduce the barriers faced by the challenger firms to audit large, complex companies. It would do this by allowing them to develop the required expertise and experience and would lead, in the medium term, to improvements in the quality and capability of the challenger firms. This would lead to stronger competition and deliver improved market resilience, because larger challenger firms would be able to take on more complex audits and those of a current Big Four audit firm if it failed. The CMA noted that the implementation of mandatory joint audits

See: Q191 (David Dunckley, Chief Executive Officer, Grant Thornton); Q200 (Clive Stevens, Chairman, Association of Practising Accountants); Mazars LLP (FOA0025); Crowe U.K. LLP (FOA0010). See also: CMA, Statutory Audit Services Market Study: Update Paper, (December 2018), pp 69–70.

CMA, Statutory Audit Services Market Study: Update Paper, (December 2018), p 70.

CMA, Statutory Audit Market: Invitation to Comment, (October 2018), p 4


CMA, Statutory Audit Services Market Study Update paper, (December 2018), p 99.
would require the regulator to set out how the regime would operate and then oversee the Audit Committees’ implementation of it. It proposed that joint audits should at least apply to FTSE 350 companies.\footnote{344}

198. The CMA decided not to support shared audits,\footnote{345} although we found some support for them.\footnote{346} It feared that they would lead to Challenger firms being subordinate to Big Four statutory auditors–with the Big Four firm dictating how the audit is carried out.\footnote{347} As one witness told us: “You could divide up the work, but then you would always have the issue that you would still always have a junior player, so it would not necessarily open up the market”.\footnote{348} While we generally accept this argument, we acknowledge that one key advantage of shared audits is the sharing of unlimited liability, which can act as a deterrent for some smaller challenger firms.\footnote{349} We suggest that if unlimited liability continues to be seen as a bar to challenger firms, the CMA should consider how to remove this barrier. The CMA thought further consideration could be given to the use of peer reviews to improve quality by introducing an additional, independent quality check. However, it did not see them as a mechanism to give challenger firms enough experience to become more competitive in tendering for the audits of large companies.\footnote{350} We agree.

199. The evidence we received and submissions to the CMA indicated that a wide range of stakeholders, including the Big Four and FTSE 350 companies, were either against joint audits,\footnote{351} or had significant concerns about implementing them.\footnote{352} However, there were

\begin{footnotes}
\item[344] As above, p 101.
\item[345] CMA, \textit{Statutory Audit Services Market Study Update paper}, (December 2018), p 97.
\item[346] Q335 (David Sproul, Senior Partner and Chief Executive Officer, Deloitte UK). He supported them in combination with a market cap. See also: Q345 (Kevin Ellis, Chairman and Senior Partner, PwC UK); Association of Chartered Certified Accountants (FOA0021); PwC UK (FOA0008); Association of Practising Accountants (FOA0012); Association of Chartered Certified Accountants (FOA0021); PwC LLP (FAO0029).
\item[347] CMA, \textit{Statutory Audit Services Market Study Update paper}, (December 2018), p 97. See also:
\item[348] Q66 (Liz Murrall, Director, Stewardship and Reporting, The Investment Association). See also: Grant Thornton (FOA0029); Investment Association (FOA0014).
\item[349] Q200 and Q321 (Clive Stevens, Chairman, Association of Practising Accountants). See also: Association of Practising Accountants (FOA0012).
\item[352] See: KPMG (FOA0009); Institute of Chartered Accountants in England & Wales (FOA0015); Investment Association (FOA0014); Deloitte, \textit{Update Paper: Statutory Audit Market}, (January 2019);
a number of other stakeholders, including Challenger firms, who supported their use,\textsuperscript{353} some of whom thought they could be used in conjunction with a market cap,\textsuperscript{354} or who thought that they should be at least considered.\textsuperscript{355}

200. The question of whether joint audits would deliver higher or lower quality was key to much of the debate around their utility. The CMA concluded that the evidence was mixed.\textsuperscript{356} This reflects the evidence we heard. For instance, David Sproul of Deloitte, told us that there was no evidence that joint audits improved quality,\textsuperscript{357} while others warned that quality might suffer because responsibility could be diluted,\textsuperscript{358} with audit issues “falling through the gaps”.\textsuperscript{359} Others argued that they would be less efficient, slower and would duplicate work.\textsuperscript{360} However, Mazars, who deliver joint audits in France, thought that they could improve quality because two auditors could review each other’s work,\textsuperscript{361} and cited evidence that joint audits had delivered quality in France.\textsuperscript{362} In terms of the independence


\textsuperscript{354} See: Mazars LLP Mazars LLP (FOA0025); Aberdeen Standard Investments (FOA0023); Chartered Accountants Ireland, \textit{Update Paper: Statutory Audit Market}, (January 2019).


\textsuperscript{357} Q334 (David Sproul, Senior Partner and Chief Executive Officer, Deloitte UK). See also: Q7 (Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School); Q7 (Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University); Q72 (Liz Murrall, Director, Stewardship and Reporting, The Investment Association). See also: TheCityUK, \textit{Statutory audit services market study: update paper}, (February 2019); Schroders, \textit{Statutory audit services market study: update paper}, (February 2019).

\textsuperscript{358} See: 100 Group, \textit{Statutory audit services market study: update paper}, (February 2019). See also: Mingcheng Deng et al., Do Joint Audits Improve or Impair Audit Quality?, Journal of Accounting Research, (2014). They noted that joint audits by one big firm and one small firm might impair audit quality, because it could induce a free-riding problem between audit firms and reduce audit evidence precision.

\textsuperscript{359} Q7 (Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School); Q71 (Liz Murrall, Director, Stewardship and Reporting, The Investment Association). See also: Deloitte, \textit{Statutory Audit Market – Invitation to Comment}, (November 2018); PwC, \textit{Statutory Audit Market – Invitation to Comment}, (November 2018); 100 Group, \textit{Statutory audit services market study: update paper}, (February 2019); Schroders, \textit{Statutory audit services market study: update paper}, (February 2019).

\textsuperscript{360} See: Steve Barber, \textit{Statutory audit market: Invitation to comment}, (November 2018); RBS, \textit{Statutory audit market: Invitation to comment}, (November 2018); HSBC, \textit{Statutory audit market: Invitation to comment}, (November 2018); Kevin Parry, \textit{Statutory Audit Services Market Study Update paper}, (February 2019); Santander, \textit{Statutory Audit Services Market Study Update paper}, (February 2019).

\textsuperscript{361} Mazars LLP (FOA0025).

\textsuperscript{362} Q292 (Jac Berry, UK Head of Quality and Risk, Mazars).
of auditors, the CMA thought that joint auditors would increase professional scepticism by reviewing each other’s work, while Vinita Mithani thought the opposite would be true because joint auditors might vie for the favour of the company’s management.

201. On balance we believe that joint audits may lead to marginal improvements in audit quality and that if proper checks are put in place, such as effective communication between the joint auditors and regulatory monitoring, they will not lead to a decline in audit quality. Either way, the quality debate, important though it is, misses the key point. The main reason for introducing joint audits in the UK is not to improve quality. It is to provide more choice and resilience in the FSTE 350 market by allowing challenger firms to work alongside the Big Four and to gain the necessary experience to carry out more complex audits. In addition, building up the capacity of challengers would enable them to pick up the work of a failed Big Four firm.

202. There was a consensus amongst witnesses that the introduction of joint audits would lead to an increase in fees, though there was disagreement as to how much this would be. ICAEW, for instance, thought that joint audits would inevitably be more expensive. Mazars, however, suggested that for the bigger audits there might be little cost difference and for others the cost differential with a single audit was between 10 and 28 percent. The CMA thought that this could be as much as 50 per cent, but probably more likely to be up to 20 per cent. We accept that joint audits might cost significantly more. However, we believe that the extra cost can be justified if the use of joint audits, especially for FTSE 100 companies, allows more choice and competition, improves standards and helps deliver greater resilience.

203. Several stakeholders also argued that joint audits might lead to an unequal relationship between Big Four auditors and challenger firms, with the former doing more “heavy lifting” than their smaller counterparts, on the more complex aspects of the audit. Other witnesses similarly argued that challenger firms could not build up the expertise to take part in joint audits of complex global companies, such as BP. ICAEW argued that one way of allowing challenger firms to build up the technology and expertise to carry out

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363 CMA, Statutory Audit Services Market Study Update paper, (December 2018), p 99.
364 Q7 (Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University). See also CFA Institute, Statutory Audit Service Market Study: Updated Paper, (February 2019).
365 CityAm, Joint audit could inject some competition and help avoid more failures like Carillion, (22 January 2019).
366 Mazars LLP (FOA0025).
367 See, for example: Q141 (Steve Barber, Audit Committee Chair, AA plc). See also: Q141 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); Q342 (Kevin Ellis, Chairman and Senior Partner, PwC UK); Q16 (Professor Christopher Humphrey, Professor of Accounting, Alliance Manchester Business School). See also: Deloitte, Statutory Audit Market – Invitation to Comment, (November 2018); KPMG, Statutory Audit Market – Invitation to Comment, (November 2018). See also: Financial Director, Joint audits: Do they add up?, (February 2017).
368 ICAEW, Statutory Audit Market – Invitation to Comment, (November 2018). See also: Schroders, Statutory audit services market study: update paper, (February 2019); HSBC, Statutory audit services market study: update paper, (February 2019). HSBC suggested that fees could increase between 30% and 100%.
369 Mazars, Statutory audit services market study, Update paper, 18 December 2018
370 CMA, Statutory Audit Services Market Study Update paper, (December 2018), p 99. It noted that some evidence suggested that audit fees could increase by 25–50 per cent, but thought on balance it would be less than 20 per cent.
371 Q329 (Bill Michael, UK Chairman and Senior Partner, KPMG). See also: See also: Mingcheng Deng et al., Do Joint Audits Improve or Impair Audit Quality?, Journal of Accounting Research, (2014).
372 See: Q142 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); Q141 (Steve Barber, Audit Committee Chair, AA plc). See also: Royal Shell, Statutory audit services market study: update paper, (February 2019); BP, Statutory audit services market study: update paper, (February 2019); BT, Statutory audit services market study: update paper, (February 2019).
more complex audits was the use of its preferred option a market cap which would allow challengers to build up a fee base to invest in such capacity.\textsuperscript{373} The mid-tier challengers told us that they were ready to take up audits in the FTSE 250 and the FTSE 100, apart from the top 30 or so companies,\textsuperscript{374} and that entry into this market would allow them to invest in technology and people to expand their capabilities to take on more complex audits.\textsuperscript{375}

204. We acknowledge that the regulator would need to carefully design and implement the rules on joint audits to ensure that challenger firms are afforded the opportunity to gain experience from working on the complex aspects of a big audit. The FRC told us that it could produce a feasibility report for the CMA to explore these sorts of issues.\textsuperscript{376} We agree, as we argue below, that a market cap would allow challengers to develop a fee base from the less challenging FTSE 100 and 250 audits. However, if challengers were unable to carry out the bigger audits, they would be excluded from higher audit revenues, and so the dominance of the Big Four would remain. The argument that challenger firms cannot deliver complex audits because they have not carried them out in the past is circular, and in fact makes the argument for joint audits to break that circle.\textsuperscript{377} Otherwise, without developing more capacity in the upper reaches of the FTSE 100 we will continue to have minimal choice, an absence of competitive pressures to drive quality and continuing concerns about the impact that a Big Four failure might have.

205. We share the reservations of many about the utility and impact of joint audits but believe that they have a role to play in increasing the resilience of the market in the medium term. \textit{We recommend that joint audits should be piloted in the upper reaches of the FTSE 100 in conjunction with our preferred option of a market cap for the rest of the FTSE 350, which is discussed below. Such audits should include a Big Four and a challenger firm; it should not include two Big Four firms. The new regulator should recommend joint audits where it believes challengers have not yet developed the resources and skills to take on the most complex audits alone but where, working alongside a Big Four firm, they would not affect audit quality. The regulator should monitor the quality of these pilots carefully and draw lessons from them to inform debates on which mechanisms are the most likely to increase competition and choice without damaging quality. Finally, we recommend that if unlimited liability is a significant deterrent to the challenger firms auditing the largest and most complex companies, the CMA should consider how to remove this barrier.}

\section*{Auditing of banks}

206. The CMA argued that in the case of banks, joint audits might be carried out by two Big Four auditors, owing to their complexity and size. We did not specifically consider the auditing of banks but recognise the case for treating them as a special category in view of

\begin{itemize}
\item \textsuperscript{373} Q586 (Michael Izza, Chief Executive, Institute of Chartered Accountants in England and Wales).
\item \textsuperscript{374} See: Q284 (David Dunckley, Chief Executive Officer, Grant Thornton); Q284 (Scott Knight, Head of Audit, BDO; Clive Stevens).
\item \textsuperscript{375} O194 (David Dunckley, Chief Executive Officer, Grant Thornton)
\item \textsuperscript{376} O584 (Stephen Haddrill, Chief Executive, Financial Reporting Council).
\item \textsuperscript{377} Mazars LLP (FOA0025).
\end{itemize}
the dire consequences of their failure. On this basis, further consideration is warranted and might include several options. For example, bank audits could be peer reviewed by the new regulator, the Audit, Reporting and Governance Authority (ARGA). Alternatively, ARGA could carry out enhanced audit quality reviews (AQRs), or real-time inspections of bank audits. Others have suggested that there should be a statutory auditor for the financial whole financial sector. We believe that the Government, perhaps with ARGA and the Prudential Regulation Authority, should explore this further. We recommend that because of their strategic importance the Government should examine the auditing of banks to explore whether additional safeguards are required in this sector.

A market cap

207. The CMA’s Update paper proposed a market cap as a potential alternative to its preferred mandatory joint audit remedy. The aim of a market cap would be similar to those for joint audits, namely to help challenger firms compete with the Big Four, thereby increasing choice, competition and resilience. The underlying principle of the cap would be to temporarily shield challenger firms from competition with the Big Four, so that they could achieve greater scale and experience and in the longer term become more effective competitors for the audit of large companies. ‘Though the CMA argued that a market cap could be imposed on audits of all Public Interest Entities (PIEs), it thought that they should be applied to FTSE 350 companies in the first instance. They noted that it would also be possible to impose multiple caps on various segments of the market, based on company size or on the industry in which they operated. The CMA thought that a market cap was more likely than joint audits to lead to short-term risks to quality and competition.

208. We found that there was more support for a market cap than for joint audits, most notably amongst the Big Four. KPMG, Deloitte and PwC told us that they could envisage a transitional market cap delivering 75 audits in the FTSE 350 in the near term.

378 The House of Lords Economic Affairs Committee, for example, thought that in view of the financial crisis (2007–2008) there needed to be closer regulatory supervision with the auditors of banks. This was because the lack of such supervision, “particularly in a period of looming financial crisis” had been a “dereliction of duty by both auditors and regulators”. House of Lords Economic Affairs Select Committee, Auditors: Market concentration and their role, (HL Paper 119; March 2011), pp 38–46. This importance of this was flagged in July 2018, by the Chief Executive of the Prudential Regulation Authority who said that he was concerned by the FRC’s finding that Big Four audits of banks had declined in quality. See: Financial Times, Top regulator ‘worried’ about Big Four audit quality, (July 2018); FRC, Big Four Audit Quality Review results decline, (June 2018); Treasury Select Committee, Oral evidence: The work of the Prudential Regulation Authority, (HC 704; July 2018), Q84–Q85.


381 CMA, Statutory Audit Services Market Study Update paper, (December 2018), p 102.

382 As above, p 102.


385 See: PwC UK KPMG LLP PwC UK (FOA0008); Deloitte, Update Paper: Statutory Audit Market, (February 2019);

386 Q335 (David Sproul, Senior Partner and Chief Executive Officer); Q322 (Bill Michael, UK Chairman and Senior Partner, KPMG); Q344 (Kevin Ellis, Chairman and Senior Partner, PwC UK). Deloitte thought that a market cap could be used in conjunction with shared audits.
Many of the challenger firms also supported a market cap, and several supported it being used in conjunction with either joint, or shared audits, though Mazars preferred joint audits over a market cap. Several challenger firms told us that if a market cap was introduced they were already in a position to take up some FTSE 350 audits, if not the bigger companies in the FTSE 100. Michael Izza also favoured a segmented market cap, and one which ensured that Challenger firms were given a proportion of audits across the FTSE 350. Several investors also supported the use of a market cap if it was introduced progressively and with safeguards.

However, opponents and proponents raised several concerns about their implementation, including:

- it could lead to adverse audit quality outcomes;
- it could lead to less choice for audit committees if Big Four firms were ruled out of audits after passing their quota;
- the Big Four could ‘cherry pick’ the best and most lucrative clients, leaving difficult clients to challenger firms;
- challenger firms might not have sufficient time to increase their capability to pick up more FTSE 100 and FTSE 250 audits;
- companies might ‘game the system’ by locking themselves into long-term audit contracts soon before the cap enters into force;
- it could lead to a loss of scale of economies;

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387 BDO LLP (FOA0020).
389 Mazars LLP (FOA0025).
390 Q284 (David Dunckley, Chief Executive Officer, Grant Thornton); Q284 (Scott Knight, Head of Audit, BDO). See also: Times, Accounting rivals look forward to a more level playing field, (August 2018).
391 Aberdeen Standard Investments(FOA0023); Investment Association (FOA0014);
392 See: Q399 (David Sproul, Senior Partner and Chief Executive Officer); Q155 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); Q156 (Steve Barber, Audit Committee Chair, AA plc); Q18 (Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School); GC100, Statutory Audit Market: Update Paper, (February 2019), pp 5–6; KPMG, Statutory Audit Market: Invitation to Comment, (November 2018); EY, Statutory Audit Market: Invitation to Comment, (November 2018); CFA Institute, Statutory Audit Service Market Study: Updated Paper, (February 2019); Morrisons, Statutory Audit Service Market Study: Updated Paper, (February 2019); Nationwide Building Society, Statutory Audit Service Market Study: Updated Paper, (February 2019).
393 See: Q155 (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); Q355 (David Sproul, Senior Partner and Chief Executive Officer); ICAS Association of Chartered Certified Accountants (FOA0019); Rathbone Brothers PLC (FOA0026); Association of Chartered Certified Accountants (FOA0021); BP, Statutory Audit Service Market Study: Updated Paper, (February 2019); ICAS, Statutory Audit Service Market Study: Updated Paper, (February 2019); 3i, Statutory Audit Service Market Study: Updated Paper, (February 2019); AstraZeneca, Statutory Audit Service Market Study: Updated Paper, (February 2019); BT, Statutory Audit Service Market Study: Updated Paper, (February 2019); Schroders, Statutory Audit Services Market Study: Update Paper, (February 2019).
395 See: Q18 (Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School);
396 CMA, Statutory audit services market study: Update paper, (18 December 2018), p 103.
397 KPMG, Statutory Audit Market: Invitation to Comment, (November 2018).
• there were challenges in the practical implementation of a market cap\textsuperscript{398}
• there was little evidence that a market cap would work.\textsuperscript{399}

210. The introduction of a market cap would be novel. However, there is a general acceptance that the current level of market concentration is unhealthy and needs to be addressed. As noted in our introduction, previous attempts at addressing this have not succeeded. We therefore believe that a market cap should be introduced.

211. We agree that a market cap must not lead to a deterioration in audit quality and we believe that this can be avoided if the cap is implemented and monitored carefully by the regulator and if, initially at least, joint audits were used only for the most complex audits, as recommended above. Avoiding the ‘cherry picking’ of the most lucrative clients by the Big Four is key. If this is not addressed, it is questionable whether the divide between the Big Four and the challengers will narrow, or if the challengers can build the revenue streams required to develop their capability and capacity to bid for more FTSE 350 audits. We therefore believe that a segmented market cap, offering a percentage of audits across both the FTSE 100 and FTSE 250, alongside piloted joint audits for more complex audits, will ensure that challenger firms can build up both their revenue base and their experience of delivering the full range of audits.

212. We acknowledge that initially a market cap might reduce choice for some audit committees, if Big Four firms are ruled out on reaching their threshold. However, such choice is already heavily constrained and potentially vulnerable to the Big Four becoming the Big Three. We also believe that it is possible for the regulator to design a system around the market cap and joint audits that is flexible enough to avoid significant choice and quality concerns. For instance, if one of the Big Four had reached its threshold for FTSE 100 audits it might be able to bid for such an audit if was done jointly with a challenger firm.

213. While acknowledging that there are short-term risks to introducing a market cap, we believe that on balance that they are outweighed by the long-term benefits of a more competitive and resilient audit market. We are confident that if the regulator designs, implements and monitors the market cap carefully these risks can be minimised. \textit{We recommend that the CMA draws up detailed proposals for the introduction of a segmented market cap offering challenger firms the chance to take up a proportion of audits across the FTSE 350. This should be done on the basis that each firm should have an individual cap to avoid one of the Big Four keeping all of its clients and remaining dominant. We recommend that the CMA develops this proposal together with a pilot of joint audits in the first instance to allow challenger firms to take on some of the more complex FTSE 100 audits.}

\textbf{Resilience measures}

214. The Big Four’s domination of the FTSE 350 audit market has threatened its overall resilience. If one of the Big Four failed it would leave only three remaining large players,


\textsuperscript{399} EY, \textit{Statutory Audit Market: Invitation to Comment}, (November 2018).
and if challenger firms did not have the capacity to take on Big Four audits at short notice, it would curtail choice for some of the more complex FTSE 100 audits.\textsuperscript{400} This could also have the perverse effect of the regulator being reluctant to take action against the Big Four, if that action, such as a large fine, might drive them out of the FTSE 350 market.\textsuperscript{401} Most audit stakeholders, including the Big Four, accepted that the resilience of the FTSE 350 audit market was a key issue.\textsuperscript{402} They accepted that whilst the risk was small, the failure of one of the large audit firms could have a negative impact on audit quality and therefore the resilience of the market needed to be ensured.\textsuperscript{403}

215. To address this, the CMA recommended that further consideration should be given to a remedy that protected against the negative effects of further concentration in the audit market, especially if the Big Four becomes the Big Three. The CMA noted that at its core, such a remedy would ensure that the audit clients and staff of a failing Big Four firm were not transferred to another Big Four.\textsuperscript{404} The CMA accepted that such a remedy would be difficult to design and for the regulator to implement and would have to consider issues such as: incentivising staff of a distressed audit firm not to join another Big Four firm; avoiding moral hazards, such as ‘too big to fail’ (e.g. bail-outs or a lessening of regulatory oversight and use of sanctions); and the powers needed by the regulator to ensure resilience.\textsuperscript{405}

216. The Big Four argued that resilience remedies need to be considered alongside the CMA’s other remedies, and suggested that dismantling multidisciplinary audit firms, through an operational or structural split, would reduce market resilience by making such firms more vulnerable to market failure.\textsuperscript{406} We are unconvinced by this argument. The best way of ensuring resilience is to ensure that there are more audit firms that can carry

\begin{footnotes}
\item[401] CMA, Statutory Audit Services Market Study: Update Paper, (December 2018), p 71..
\item[402] See: Q381 (Bill Michael, UK Chairman and Senior Partner, KPMG); Q388 (Kevin Ellis, Chairman and Senior Partner, PwC UK); Q73 (Leon Kamhi, Head of Responsible Investment, Hermes Investment Management); CIMA (FOA0033); UKSA & ShareSoc (FOA0005); Crowe U.K. LLP (FOA0010); Sarasin & Partners LLP (FOA0024); Mazars LLP (FOA0025); Investment Association, Statutory Audit Services Market Study: Update Paper, (February 2019); Hermes, Statutory Audit Services Market Study: Update Paper, (February 2019); Kreston Reeves, Statutory Audit Services Market Study: Update Paper, (February 2019); Lloyds Banking Group Plc, Statutory Audit Services Market Study: Update Paper, (February 2019); Nationwide Building Society, Statutory Audit Service Market Study: Updated Paper, (February 2019); Nexia, Smith & Williamson, Statutory Audit Service Market Study: Updated Paper, (February 2019); Professor Atul Shah, Brian Little, Paul Moore, Professor Richard Murphy, Statutory Audit Service Market Study: Updated Paper, (February 2019); The 100 Group, Statutory Audit Service Market Study: Updated Paper, (February 2019). The Government also accepted that resilience was a key concern. See: Q687 (Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy).
\item[405] As above, p 114.
\end{footnotes}
out FTSE 100 and FTSE 350 audits, a view shared by challenger firms, investors, and other stakeholders. If the Big Four turned into Six, Eight or Twelve that would allow a proper market to function whereby if an audit firm failed there would competition for its work to be picked up. The argument that audit firms are more viable if they are allowed to offer non-audit services is an admission of defeat: we believe that audit should be able to stand on its own two feet.

217. **We recommend that the CMA works with the regulator to draw up proposals to mitigate the consequences of an audit market failure, especially if it involved one of the Big Four. However, we strongly believe that the CMA should prioritise remedies that enable more challenger firms to enter the FTSE 350 audit market and develop their ability to undertake the full range of audits.** While acknowledging that there are short-term risks to introducing a market cap, we believe that on balance that they are outweighed by the long-term benefits of a more competitive and resilient audit market. We are confident that if the regulator designs, implements and monitors the market cap carefully these risks can be minimised. We recommend that the CMA draws up detailed proposals for the introduction of a segmented market cap offering challenger firms the chance to take up a proportion of audits across the FTSE 350. This should be done on the basis that each firm should have an individual cap to avoid one of the Big Four keeping all of its clients and remaining dominant. We recommend that the CMA develops this proposal together with a pilot of joint audits in the first instance to allow challenger firms to take on some of the more complex FTSE 100 audits.

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8 Regulation of audit

218. The regulation of audit is currently overseen by the Financial Reporting Council (FRC). Sir John Kingman’s independent review of the FRC identified significant weaknesses in the regulator and proposed reforms designed to ensure that the new regulator has sufficient powers and reach and is constituted on a statutory basis. This Chapter considers Sir John’s recommendations relating to audit, in the context of the Government’s response, published in March 2019.

The Financial Reporting Council

219. The non-statutory FRC regulates auditors, accountants and actuaries, and produces the UK’s Corporate Governance and Stewardship Codes. It aims to “promote transparency and integrity in business” and states that its work is “aimed at investors and others who rely on company reports, audit and high-quality risk management.” It publishes guidance on auditing and ethical standards, including on such issues as professional scepticism and audit independence. The FRC’s enforcement regime includes investigations where there appears to be misconduct or a breach of the relevant professional standards. To help enforcement, it possesses a range of possible sanctions, including temporary or permanent bans for auditors and financial penalties for audit firms.

Sir John Kingman’s Independent Review of the FRC

220. The Independent Review, led by Sir John Kingman, was appointed in April 2018 with a remit to conduct a root and branch review of the FRC. Following a consultation, it published its report in December 2018.

221. The Review acknowledged that the FRC had some strengths, such as its effective custodianship of the UK Corporate Governance Code, and that at times it had gone

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411 See: FRC, 2016 Auditing Standards, (accessed 25 February 2019). These standards include: quality control of audits; the objectives of an audit; agreeing terms of audit engagements; consideration of laws and regulations in an audit of financial statements; identifying material misstatements; assessing risks; assessing audit evidence; audit sampling; auditing accounting estimates and fair value accounting estimates and related disclosures; auditor responsibilities relating to fraud in an audit of financial statement; determining whether auditing of financial statements indicate that a company is a “going concern”; forming an opinion and reporting on financial statements; communicating key audit matters in the independent audit report.
412 FRC, Briefing Paper: Professional Scepticism, (March 2012). FRC, Guidance on Audit Committees, (April 2016). This includes guidance on: the establishment and effectiveness of audit committees, relationships with management; oversight of internals controls, internal audit and management systems; tendering for and appointment of external auditors; oversight of external audits; audit and non-audit services; and relationships with shareholders.
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beyond limited statutory powers, for instance, to enhance monitoring of the six biggest audit firms.\textsuperscript{416} However, overall it was very critical, describing the FRC as “a rather ramshackle house, … built on weak foundations”\textsuperscript{417} It identified several key weaknesses:

- **Powers** - the FRC’s powers were described as “clearly deficient” while its leadership had failed to make the case for greater powers and to shape the debate around audit;\textsuperscript{418}

- **Sanctions and Enforcement** - while it had a range of sanctions available to it, the FRC took “an excessively consensual approach to its work”;\textsuperscript{419}

- **Independence** - the FRC lacked independence because it was not on a statutory footing and lacked direct regulatory oversight over the firms who voluntarily funded it, meaning it was more akin to a trade body than a regulator;\textsuperscript{420}

- **Appointments** - there were flaws in its appointment processes, which meant that its Board and Council were “largely self-perpetuating”, and often reliant “on the alumni networks of the largest audit firms” and “inappropriately informal” recruitment methods\textsuperscript{421}

222. The Review’s verdict on FRC resonates with our view and the many views of our witnesses, some of whom thought that it had “gone off the rails”\textsuperscript{422} or had dented public confidence.\textsuperscript{423} The majority agreed that it needed to be replaced by a stronger, independent and more accountable statutory regulator.\textsuperscript{424} The Secretary of State agreed that a “tougher regulator” was required\textsuperscript{425}

223. Our predecessor Committee pressed for the FRC to be given more powers to hold company directors to account and for it to be more interventionist.\textsuperscript{426} We have found it to be far too timid in exercising the powers and influence that it does possess. For instance, it failed to follow up on concerns it identified in Carillion’s accounts in 2015, three years before the company went into liquidation.\textsuperscript{427} It initially did not investigate the auditing of HBOS, and when it did, it decided to take no action even though it concluded that

\textsuperscript{416} As above, p 6. The Financial Reporting Lab was launched in 2011 to provide an environment where investors and companies could come together to develop new reporting formats.


\textsuperscript{418} As above, p 8.

\textsuperscript{419} As above, p 8.


\textsuperscript{421} As above, pp 7–8.

\textsuperscript{422} Q26 (Professor Karthik Ramanna, University of Oxford).

\textsuperscript{423} Association of Practising Accountants (FOA0012).

\textsuperscript{424} See: 649 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).

\textsuperscript{425} See: BEIS, Corporate Governance, (HC 702; April 2017), p 21.

KPMG’s audit “raised questions about the adequacy of the nature and extent of some of the audit procedures”. In recent years the FRC has applied higher fines - £17.96 million in 2017/18 and £14.59 million in 2016/17, with a record fine of £5.1 million for PwC in 2017, although this may in part be a reaction to escalating criticism of its earlier timidity. Even these larger fines are a small fraction of the Big Four’s revenue. The FRC’s leadership half-hearted approach to acquiring greater powers was exemplified by its Chief Executive telling us that he had done so “from time to time” and “not necessarily on a constant basis”, even though he accepted that such powers were needed. Despite asking the FRC for evidence of it asking for more powers, we were not provided with any such examples of formal requests to the Secretary of State.

224. We have also raised questions about the FRC’s transparency and accountability. In January 2018, it emerged that the FRC had reviewed the quality of the audit of Patisserie Valerie’s accounts by Grant Thornton, six months before a £40 million fraud was discovered in these accounts. These reviews are not published. The FRC is currently reviewing its own review of the Grant Thornton audit. Whilst a review is clearly needed, under current arrangements the regulator is, in effect, marking its own homework.

225. The longstanding criticisms of the FRC’s lack of independence and “capture” by the very profession it is supposed to regulate are given credence by the dominance of the Big Four alumni within its ranks. For instance, in October 2017, it was reported that 34 out of 109 members of the FRC Board and Committees were current or former partners of the Big Four. When the FRC decided not to take action over PwC’s audit of Tesco, three out of 15 directors who sat on the main FRC board were former PwC partners, while another seven sat on other FRC committees. This led to one critic to argue that the organisation was “fatally flawed in the way it was set up and has been operating … based on trade association relationships”. Even the FRC’s Financial Reporting Lab, praised as an example of innovation, lost some credibility when one of its reports on the disclosure of dividends highlighted Carillion as an example of “good practice”.

226. We agree with the Kingman Review that the Financial Reporting Council has for too long been a weak and ineffective regulator. Though in recent years it has begun to apply higher penalties for audit failures, we believe that it is too late to repair its reputation and credibility. It seemed unwilling to explore major audit failures, such as at HBOS, and reluctant to use sanctions even when it found substandard audits. It was ineffective in seeking the additional powers, statutory underpinning and funding it
required to make it truly independent of the industry it was regulating. Its leadership also showed a degree of naivety in not acting on perceptions that it was captured by the Big Four, a suspicion fuelled by its self-perpetuating recruitment processes. On balance, the FRC has contributed to the current crisis of trust in audit and now lacks the credibility to address it.

The Independent Review’s key proposals and the Government’s response

227. The Review made 83 recommendations on how to deliver a new regulator, with a new mandate, purpose, leadership and powers. The Government’s response stated that most of the conclusions and recommendations of the Review spoke for themselves and could be implemented straight away; this included 48 recommendations it committed to working on with the FRC. However, it also noted that some recommendations would require legislation, while others would need to take into account the CMA’s final recommendations and the work of Sir Donald Brydon. However, the Secretary was clear that the Government would proceed “at pace with reforming” the FRC.

228. The Secretary of State told us that reform of the FRC was important because it would enhance the UK’s “reputation as a good place to do business.” The Permanent Secretary at BEIS, said that it would make improvements to protect a profession that makes “a very important contribution to economic life as a whole in the UK” as it was “a huge source of gross value added that employs hundreds of thousands of people.”

A new regulator: The Audit, Reporting and Governance Authority

229. The Review’s central recommendation was that the FRC should be replaced by a new independent regulator with statutory powers and objectives, to be named the Audit, Reporting and Governance Authority (ARGA). The Government accepted the recommendations on setting up ARGA, its funding, recruitment and ensuring greater transparency. It also announced that it was recruiting new leadership for the FRC, ahead of ARGA being set up.

230. In common with the vast majority of witnesses, we welcome the proposal that ARGA be accountable to Parliament through its Chair and CEO being subject to pre-appointment hearings with this Committee and the requirement to submit annual reports. The Department has subsequently launched a public appointments competition for a new Chair

438 BEIS, Audit regime in the UK to be transformed with new regulator, (11 March 2019).
440 Q647 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy). He told us that the Government had responded quickly, with a short consultation, so it could legislate as quickly as possible where needed. (Q648). He was confident that until the current leadership was replaced, it could be trusted to implement those recommendations that did not require legislation or further consultation (Q655).
441 Q665 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).
442 Q701 (Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy). See also: Q701 (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).
443 See: Grant Thornton (FOA0029); RSM (FOA0030); Grant Thornton (FOA0029); Rathbone Brothers Plc (FOA0026); Mazars LLP (FOA0025); Sarasin & Partners LLP (FOA0024); Aberdeen Standard Investments (FOA0023); Association of Chartered Certified Accountants (FOA0021); ICAS (FOA0019); Deloitte (FOA0017); Institute of Chartered Accountants in England & Wales (FOA0015); Investment Association (FOA0014); Chartered Institute Of Internal Auditors (FOA0013); Crowe U.K. LLP (FOA0010); KPMG LLP (FOA0009); PIRC (FOA0007); UKSA & ShareSoc (FOA0005); Vinita Mithani (FOA0016); Association of Investment Companies (FOA0034).
of the FRC without consulting the Committee or making reference to a pre-appointment hearing in the job description.\textsuperscript{444} The appointment is expected to be made for a period of four years, well beyond the period by which ARGA should be fully established.\textsuperscript{445}

231. Similarly, we welcome, the recommendation to place ARGA on a statutory footing.\textsuperscript{446} This is essential if the regulator is to become independent and work in the wider public interest and not, as the FRC was perceived, as a “private company with a slightly disparate set of powers pursuing what is a vital national interest”.\textsuperscript{447} We are pleased that the Review did not ask for the taxpayer to fund ARGA and that it has replaced voluntary funding with a mandatory industry levy. This will help protect the regulator from perceptions of it being dependent on special interests within the audit industry. Sir John told us that ARGA would cost more than the FRC.\textsuperscript{448} However, we believe that this is necessary if ARGA is to be effective and address the shortcomings of the current regulator. We are reassured that the Review recommended that ARGA’s budget should be set by BEIS, after consultation with ARGA and stakeholders, which should mean that its funding will be proportionate but sufficient.\textsuperscript{449}

232. We also support the Review’s recommendations on open and transparent recruitment processes and the decision to make board members public appointments. We believe this will help underpin ARGA’s credibility and ensure that staff are recruited on objective criteria. We similarly welcome other recommendations to help ensure that ARGA is more transparent than the FRC, for example, by ensuring full compliance with the Freedom of Information Act,\textsuperscript{450} and better information on the handling of complaints and leaks.\textsuperscript{451}

\textsuperscript{444} We were told that the Government hoped to have the new Chair and Deputy in place by the Summer of 2019. \textit{Q656} (Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy). It hoped to have a CEO in place by the end of 2019. \textit{Q657} (Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy).

\textsuperscript{445} Cabinet Office/HM Government Public Appointments, Financial Reporting Council – Chair (accessed 20 March 2019). The Secretary of State told us that the present leadership of the FRC was necessary to ensure continuity but that the Government wanted the new leadership in place as soon as possible because ARGA would represent a significant change from the current FRC (\textit{Q650}). He also said that the new leadership team should be independent and able to “make often difficult judgements … given the interest of people and organisations that are quite powerful”. (\textit{Q652}).


\textsuperscript{447} \textit{Q500} (Stephen Haddrill, Chief Executive, Financial Reporting Council)

\textsuperscript{448} \textit{Q169} (Sir John Kingman, Chair of the Independent Review of the Financial Reporting Council). Sir John said that he did not want to “put a number” on how much more ARGA would cost (\textit{Q170}). See also: Mr Malcolm Bacchus (FOA0006) he argued that the increased costs had not been subject to a cost/benefit analysis.

\textsuperscript{449} We were told by BEIS that this would address the “peculiar, to say the least” situation were a “regulator should charge a voluntary levy to the bodies it regulates”. \textit{Q664} (Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy).


\textsuperscript{451} As above, pp 55–58. The Review was critical of how the FRC handled complaints. It called for ARGA to be more transparent, with better guidance on how it managed complaints including the publication of trend data on the nature and outcome of complaints and the speed with which they were dealt with. It also said that ARGA should be more proactive in managing complaints against the professional bodies. The Review found the FRC had a problem with leaks and that ARGA should be robust and effective in investigating them and ensuring that sharing of information avoided this.

234. We welcome the Government’s commitment to accept the Kingman Review’s recommendations to establish ARGA and its steps to start implementing those recommendations that do not require legislation. We are particularly pleased that the Government has accepted Sir John’s recommendation that ARGA should be fully funded by a compulsory levy on the industry. We also welcome the Government’s decision to replace the FRC’s current leadership. They have lost our confidence and clearly that of the Government and the majority of audit stakeholders. We \	extit{recommend that current FRC board members should have no meaningful role in the reform process or management of the new organisation. Given concerns about the independence and effectiveness of the FRC, we expect that the Government’s preferred candidate will not be appointed until they have appeared before this Committee and we have reported to the House our opinion.}

\textbf{Whistle-blowers}

235. One of the additional roles of the FRC is investigating the complaints of whistle-blowers, for example, in the case of the HBOS scandal, for which it has been criticised.\footnote{See: Financial Times, FRC accused of ignoring HBOS whistleblower, (7 February 2019) CityAM, Audit watchdog ‘whitewashed’ HBOS evidence, (7 February 2019); Times, City regulator denies failings after leaking whistleblower’s complaints, (28 January 2019).} The FRC told us that since 2009 they have investigated 25 whistle-blowing cases.\footnote{The FRC told us that they referred 44 other cases to other regulators, professional bodies and the police. See supplementary evidence from FRC, letter from Stephen Haddrill, 22 March 2019.} Of these, only three so far have resulted in companies making additional disclosures in their accounts or providing undertakings following FRC intervention. Nine investigations are still ongoing. We are surprised that in ten years only 25 whistle-blowers have seen their concerns investigated and that only three cases led to any sanction by the FRC, none of which could be regarded as punitive. Considering the number of corporate failures and scandals that have occurred since 2009, we would have expected there to have been many more cases. We \textit{recommend that ARGA ensures that it has effective procedures and policies in place to encourage whistle-blowers to come forward when they have serious concerns and investigates them fully.}

\textbf{ARGA’s new powers}

236. Sir John Kingman told us that duties and powers of the FRC were “clearly deficient”,\footnote{Q171 (Sir John Kingman, Chair of the Independent Review of the Financial Reporting Council).} a view shared by the current Chief Executive of the FRC,\footnote{Q494 (Stephen Haddrill, Chief Executive, Financial Reporting Council)} and the Government in its reply to the Review.\footnote{BEIS, \textit{INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL: Initial consultation on the recommendations}, (11 March 2019), p 3.} This includes the inability of the FRC to go into a company to
test the quality of an audit or its financial reporting, or the powers to appoint somebody to review them.\textsuperscript{459} The Review recommended several new powers for the regulator to intervene in companies where serious problems are found. These include:

- directing companies to change accounts if they had been badly prepared or contained misstatements, so corrections could be communicated more quickly to the market;\textsuperscript{460}

- when necessary, requiring companies to produce additional assurance on its financial reporting and viability statements, and an evaluation of particular areas of concern;

- giving the regulator the power, when deemed necessary, to commission, at the company’s expense a “skilled person review” to protect the interests of investors and the wider public;

- enabling the regulator, when in the public interest, to publish the report of the skilled person;\textsuperscript{461}

- requiring the company to respond to the skilled person’s report;

- in the most serious cases, allowing the regulator to:
  - order the removal of an auditor or undertake immediate retendering;
  - issue a report to the company’s shareholders suggesting that the company’s dividend policy should be reviewed or that they consider changing the CEO, CFO, Chair or Audit Committee Chair.\textsuperscript{462}

237. Sir John Kingman told us that these powers would, for the first time, allow the regulator to “to go in and have a look” when it was concerned about the running of a company.\textsuperscript{463} We agree that the regulator should have the powers to intervene in a company if it has serious concerns about the preparation of their financial accounts or the quality of the auditing. This might, if carried out early enough, help avoid a company failure, or at least enable steps to be taken to mitigate some of the worst consequences of such a failure. The powers to commission a skilled person’s report, which might be published, and remove an auditor or retender, should provide powerful incentives to concentrate minds on audit quality. We also consider that the publication of such reports, especially if undertaken shortly after a company failure, will allow key lessons to be learned so that similar failure can be avoided in the future. Similarly, we believe that the ability to recommend to shareholders that they consider removing the CEO, CFO, Chair and Audit Committee Chair, will act as a deterrent to poor financial reporting and financial oversight.

238. We welcome the government’s acceptance of the Kingman Review’s proposals for wider powers to intervene to prevent a significant market failure or lessen its impact if it cannot be averted. \textit{We recommend that the government introduces the necessary}

\textsuperscript{459} Q494 (Stephen Haddrill, Chief Executive, Financial Reporting Council).
\textsuperscript{460} Independent Review of the Financial Reporting Council, \textit{Independent Review of the Financial Reporting Council}, (December 2018), p 35. The Review stated that currently the FRC might have to take companies to court which could delay or defer corrections.
\textsuperscript{461} As above, p 49.
\textsuperscript{462} As above, p 50.
\textsuperscript{463} Q185 (Sir John Kingman, Chair of the Independent Review of the Financial Reporting Council).
legislation in the next session of Parliament. We further recommend that when there has been a major accounting and/or audit failure the new regulator should conduct and publish a swift but comprehensive review of what went wrong to share lessons with the wider audit market.

**ARGA’s proactive remit**

239. The Review concluded that the FRC had not been proactive enough, which had led to its inability to shape the agenda around audit and respond to risks as they emerged. It also thought that auditors and audit firms could do more to highlight key problems before, or as they emerged, so that they could be addressed as quickly as possible. In terms of the regulator shaping the audit agenda and being proactive, the Review recommended that it should:

- be forward looking and proactive in acting on emerging corporate governance or audit risks;
- promote competition in statutory audit services; and, advance innovation and quality improvements;
- to do this, it should develop new teams, including analysts, investment experts, economists, and corporate lawyers.\(^{464}\)

240. In terms of audit firms, it recommended that they should have a “duty of alert” to report viability or other concerns firstly to the company board, then to shareholders and ultimately to ARGA.\(^{465}\) The Government welcomed the Review’s proposed objectives, duties and functions for the new regulator, such as enhanced competition and market review duties.\(^{466}\) It noted that primary legislation would be required and that the FRC had agreed in the interim that it would adopt the new objective, duties and functions as quickly as possible.\(^{467}\)

241. We agree that ARGA should be much more proactive than its predecessor and equipped with the tools to identify early warning signs of companies or sectors under stress,\(^{468}\) including a full market intelligence function, which we understand that the FRC is beginning to develop.\(^{469}\) If the FRC had had the deeper market intelligence suggested by the Review it might have spotted some problems earlier, such as those concerning


\(^{465}\) As above, p 48. The Review listed a number of issues to justify a skilled person review: concerns about the accounting treatment of key areas of audit judgement; evidence of significant investor concern; concerns about the credibility of a company’s viability or going concern statement or the methodologies used to underpin the statements; concerns that corporate governance explanations are seriously misleading or inaccurate; grounds to believe that important aspects of corporate governance are seriously deficient; indications that internal controls or risk management are seriously inadequate; where a dividend has been announced that appears rash or unaffordable and incompatible with the UK’s capital maintenance rules; indications that a company might not be financially viable, and the company is not acting responsibly in dealing with these risks; intelligence that an audit committee is not doing its job effectively or is unduly influenced by executive directors.


\(^{468}\) See Institute of Chartered Accountants in England & Wales (FOA0015); Grant Thornton (FOA0029); Mazars LLP (FOA0025).

\(^{469}\) Q506 (Stephen Haddrill, Chief Executive, Financial Reporting Council).
It is regrettable that auditors do not already have a duty to report concerns to the board, and ultimately to the regulator. We believe that the risks cited by some stakeholders that such reporting could become “self-fulfilling” are outweighed by the benefits to be derived from early warnings. It is essential that the regulator and others can intervene at the earliest opportunity when a company is in trouble to avoid collapse or mitigate its consequences.

242. We welcome the Government’s positive response to the Kingman Review’s recommendations on ARGA’s objectives, functions and its more proactive role. This should enable ARGA to become the strong, credible regulator the audit industry needs.

Enforcement processes

243. The Review examined the FRC’s enforcement processes. It noted that the FRC acknowledged that it had to speed up its investigations and had set a target of concluding investigations within two years. However, the Review still found that “significant delays appear to remain”, though it accepted it was inevitably hard to judge, case-by-case, the extent to which such delays were genuinely avoidable. The Review recommended, that in the first instance, the FRC’s Board and the Government should continue to monitor enforcement performance, while ARGA should report on it in its Annual Report and be held to account by the BEIS Select Committee. The Government said that the FRC would take this forward immediately. Stephen Haddrill accepted that the FRC had been slow in conducting investigations but said that the FRC was now addressing this. However, he told us that the whole process could still take well over two years.

244. We are deeply concerned that investigations into audit failures are still taking two years and longer. We therefore welcome the Government’s commitment to implement immediately the Kingman Review’s recommendation that the FRC and the Government should closely monitor performance in this area and that ARGA should make this a priority. This will be a key area in which we will hold ARGA to account.

Sanctions

245. The FRC already has a wide range of available sanctions. Individual auditors can face temporary or permanent bans and financial penalties and be subject to declarations for poor audit quality. They can also face a ban as a director of a Public Interest Entity (PIE), and exclusion from relevant professional bodies. Audit firms can be prohibited from

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470 Q509 (Stephen Haddrill).
471 PwC LLP (FOA0028)
473 As above, pp 39–40.
475 Q562 (Stephen Haddrill).
476 Q563–570 (Stephen Haddrill).
477 Public interest entity.
478 FRC, Sanctions Policy (Audit Enforcement Procedure), (April 2018). The FRC sanctions can include a combination of sanctions. For examples of recent sanctions imposed on audit partners see: FRC, Recent Enforcement sanctions imposed against Audit firms and Audit partners, (accessed 25 February 2018). For example, in June 2018 the FRC announced that Stephen Denison, an audit engagement partner at PwC, was fined £500,000 (reduced to £325,000 on early payment) and prohibited from carrying out audit work for 15 years because of key failings in the audit of Taveta Group (which included BHS Limited).
carrying out statutory audits and/or signing audit reports. Financial penalties for audit firms for seriously poor audits are unlimited. The Kingman Review found that there was no “shortfall in the severity of sanctions available to the FRC”.

246. However, as the Review noted, the main problem with the sanctions regime has been the FRC’s reluctance to use them. In several high-profile cases, it has been accused of being ‘toothless’, feeding a suspicion that an “occasional rebuke or fine from the regulator is merely seen as the cost of doing business.” For example, it decided not to impose any sanctions at all in relation to the 2007–2008 financial crisis. The Treasury Select Committee described this as a “serious mistake”. It was similarly criticised when it decided to close a subsequent investigation into HBOS because it deemed that the audit “did not fall significantly short of the standards reasonably to be expected”. It also faced questions over its decisions to not take action against PwC for its audits of Tesco and Barclays. In the case of Tesco, it was argued that the FRC had not provided a sufficient explanation of why it had decided not to take action.

247. We acknowledge that there is a balance between effective sanctions and encouraging more entrants into the FTSE 350 audit market. As noted above, the CMA saw the threat of severe financial penalties and reputational damage from high-profile audit failures as a barrier to challenger firms bidding for FTSE 350 audits. Several challenger firms told us

479 FRC, Sanctions Policy (Audit Enforcement Procedure), (April 2018), p 12.
480 As above, p 10. The calculation of financial penalties can also take into account the level of profitability per partner, market share, the number of audit and non-audit clients and the respective size of those clients, and the number of partners and registered individuals. For example, in May 2018, KMPG was fined £4.5m (reduced to £3.1 m after early settlement), because its audit of Quindell Plc did not obtain reasonable assurance that the financial statements as a whole were free from material misstatement, failed to obtain sufficient audit evidence and exercise sufficient professional scepticism. See: FRC, Sanctions in relation to the audit of Quindell Plc, (June 2018). A review of the FRC’s sanctions in 2017, recommended that fines of £10m or more could be appropriate for cases involving seriously poor audit work, carried out by a Big Four firm. The Review’s recommendations which took effect in June 2018, also included the greater use of non-financial sanctions. See: Financial Reporting Council’s Enforcement Procedures Sanctions, Review Panel Report, October 2017.
483 See: Financial Times, Too close for comfort: the incestuous ties that bind auditors and watchdogs, (August 2018). The article noted that FRC fines “pale in comparison” to the penalties issued to banks and other financial services companies by other financial regulators.
485 See: Prem Sikka et al, Regulatory Architecture to enhance democracy and business accountability, (January 2019), p 69. The authors note that in some cases banks collapsed with days or weeks of receiving unqualified audit reports.
487 Financial Times, KPMG cleared over audit of HBOS before collapse, (September 2017).
488 See Financial Times, Britain’s accountancy watchdog has neither bark nor bite, (October 2017); Financial Times, UK audit watchdog drops probe of PwC’s work for Barclays, (October 2017); The Times, PwC cleared of misconduct over Barclays but fears grow, (October 2017); The Independent, Tesco fraud: Questions left unanswered as Financial Reporting Council quietly canc investigation into auditors, (June 2017).
489 See: Prem Sikka et al, Regulatory Architecture to enhance democracy and business accountability, (January 2019), p 61. The report noted that the FRC decided not take action despite the FCA concluding that there was some evidence of concern which resulted in its levying a fine of £129 m.
that this could be avoided by using financial penalties that were proportionate to the size of the audit firm, and where possible, applying non-financial sanctions that encouraged improvement. We agree that the use of sanctions should take into account the facts of the case and the turnover of the business. However, if we are to reduce the number of major audit failings, and concentrate minds on audit quality, there must be serious consequences for delivering poor audit work. We therefore believe that the Review got the balance right by recommending that though ARGA should “use all the available levers it has—including robust enforcement and the powerful deterrent effect this can create—to maximise self-reinforcing incentives to pursue quality and best practice.”

248. We welcome the Kingman Review’s conclusion that ARGA should not be a ‘soft regulator’ and the recommendation that ARGA, unlike the FRC, should make full use of the range of sanctions it has at its disposal. We recommend that while ARGA should be proportionate, in the worst cases it should not be shy of imposing tough sanctions, including large fines.

Monitoring audit quality: Audit Quality Reviews

249. The FRC currently conducts Audit Quality Reviews (AQRs) of audit firms, on a voluntary basis. These reviews examine a sample of audits and related procedures supporting audit quality. AQRs are carried out annually for the larger audit firms. They focus on key audit judgments and the sufficiency and appropriateness of the audit evidence obtained, and also review an audit firm’s procedures and culture. Each year the FRC publishes a selection of individual firm and thematic AQRs, while all AQRs, many of which are confidential, contribute to the FRC’s annual report on audit quality.

250. The Kingman Review recommended that AQRs should be a statutory requirement, and that ARGA should work towards publishing individual AQRs, including gradings, in full, with a first step the publication of AQR reports on an anonymised basis. The Government agreed that AQRs should be put on a statutory basis and that AQRs should be published in full on an anonymous basis immediately, with further consideration to be given to future publication in full.
We were surprised to find that AQRs were conducted on a voluntary basis, a further reflection of the opacity of current audit regulation. We believe that AQRs should be more robust and focus on the key commercial judgements made by auditors. AQRs must also focus on the technology and processes being used by audit firms to conduct audit: we heard that at Carillion, electronic files had been ‘augmented’ after the completion of the audit. It is clearly imperative that audit evidence cannot be retrofitted to camouflage poor audit judgements. Audit firms might not be in favour of publishing de-anonymised AQRs, but transparency will allow audit clients to make more informed decisions about audit quality and provide an added incentive for audit firms to make audit quality a priority.

We welcome the Government’s decision to take forward the Kingman Review’s recommendation that AQRs should be a statutory requirement and be published in full. However, we recommend that AQRs should not be anonymised, even in the first instance. We recommend that AQRs should move beyond process-driven box ticking and offer a robust appraisal of the opinions offered in audits and on the quality of the analysis and evidence used to drive those opinions. This should include reviewing what steps an audit had taken to identify fraud. We also recommend ARGA should as a matter of routine inspect audit firms’ software that records audit files and ensure that it is sound and that the audit trail cannot be tampered with.

A UK Sarbanes-Oxley and the wider reporting eco-system

The Review recommended that serious consideration should be given to introducing a Sarbanes-Oxley (SOX) regime in the UK, and that the Government should consult early on its possible introduction. This would require the CEOs and CFOs of public companies to report on the effectiveness of a company’s financial reporting and internal controls, with the board and management having clear responsibility for the accuracy of reporting and robustness of controls. The Review accepted that such a move might impose significant initial costs, though recurring costs would be lower, and costs might be justified if it led to improvements in both reporting and internal controls. The Government said it would consider a strengthened framework around internal controls on a similar basis to the SOX and bring forward a detailed consultation in due course.

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500 Q116 (Margaret Ewing, Audit Committee Chair, ITV); Q116 (Steve Barber, Audit Chair, AA Plc).
501 Qq459–460 (Bill Michael, UK Chairman and Senior Partner, KPMG). See also: Times, KPMG partner suspended over Carillion audit, (19 January 2019).
502 Crowe U.K. LLP (FOA0010) Grant Thornton thought that AQRs should be in the first instance published anonymously (FOA0029).
503 The Sarbanes-Oxley (SOX) Act was introduced in the US in July 2002, following several high-profile financial scandals such as Enron and Worldcom. The Act inter alia sought to: enhance auditor independence; ensure that senior company executives took individual responsibility for the accuracy and completeness of corporate financial reports; increase financial disclosures and more timely reporting of material changes to a company’s financial position; introduce specific criminal penalties for manipulation, destruction or alteration of financial records or other interference with investigations; provide certain protections for whistle-blowers. For an overview of SOX see: House of Commons Library, Sarbanes-Oxley Act, (2003); ISACA, What is Sarbanes-Oxley (SOX) and what is its impact on audit?, (2019); AccountingToday, Voices Sarbanes-Oxley: 15 years of successes and challenges, (September 2017).
254. We found a lot of support from a range of stakeholders for the introduction of a UK SOX regime,\(^\text{507}\) who argued that it would help improve financial reporting, upon which audits depended and, by placing more responsibility on CEOs and CFOs, improve the overall reliability of the eco-reporting system. We accept that there are key differences between the US and UK regulatory systems that would need to be addressed.\(^\text{508}\) We also note counter arguments that SOX could make management less ready to disclose weaknesses and mistakes for fear of being sued in the future,\(^\text{509}\) and that it might stifle innovation in financial reporting.\(^\text{510}\) However, we believe that if a UK SOX system was introduced carefully and monitored to avoid these unintended consequences, it could contribute to a more robust financial reporting system.

255. \textbf{We welcome the Government’s commitment to consider and consult on the possible introduction of a strengthened framework around internal controls on a similar basis to Sarbanes-Oxley.} If adapted to the UK regulatory system, a UK equivalent could make a significant contribution to improving the reliability of financial reporting.

256. The previous Committee supported the FRC’s desire to be able to hold all directors to account, not just those who happen to be members of the professional bodies which come within the remit of the FRC.\(^\text{511}\) Indeed, we have been told informally that several directors have resigned membership of a professional body precisely to avoid the risk of being subject to FRC sanctions. This is clearly unacceptable. The Kingman Review recommended that the Government, working alongside ARGA, should develop detailed proposals that would hold all directors, including CEOs, CFOs, company chairs and audit committee chairs, to account for true and fair accounts and compliant corporate reports.\(^\text{512}\) The Government welcomed the proposals to review and enhance the sanctions regime for directors, noting that legislation would be required.\(^\text{513}\)

\begin{footnotes}
\footnote{507}{See: \textit{Q84} (Leon Kamhi, Head of Responsible Investment, Hermes Investment Management); \textit{Q84} (Liz Murrall, Director, Stewardship and Reporting, The Investment Association); \textit{Q84} (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments); \textit{Q97} (Margaret Ewing, Nomination, Audit and Risk Chair, ITV); \textit{Q98} (Steve Barber, Audit Committee Chair, AA plc); \textit{Q480} (Steve Varley, Chairman, EY UK); \textit{Q528} (Maggie McGhee, Executive Director, Governance, Association of Chartered Certified Accountants); BDO LLP (FOA0020); KPMG LLP (FOA0009); EY (FOA0022); ICAEW (FOA0002); Deloitte (FOA0017); Grant Thornton (FOA0029).}
\footnote{508}{See: \textit{Q31} (Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School); \textit{Q31} (Professor Christopher Humphrey, Professor of Accounting, Alliance Manchester Business School); Mazars LLP (FOA0025).}
\footnote{509}{\textit{Q31} (Vinata Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University).}
\footnote{510}{\textit{Q533} (Sir Donald Brydon, Chair of the Independent Review of the Quality and Effectiveness of Audit).}
\footnote{511}{Fourth Report of Session 2016–17, \textit{HC 702}, para 42.}
\footnote{512}{Independent Review of the Financial Reporting Council, \textit{Independent Review of the Financial Reporting Council}, (December 2018), pp 43–44. The Review also recommended that the regime for non-member directors should follow the principles of the Audit Enforcement Procedure, with the same threshold for action to be taken, and a graduated range of sanctions. To achieve this, the Review stated that ARGA should set out relevant requirements or statements of responsibilities in relation to auditing and corporate reporting in order that directors are individually accountable for their roles. It thought that though ARGA should be free to impose a range of sanctions, the disqualification of Directors should remain with the Insolvency Service and that ARGA should liaise closely with the latter when investigating Directors.}
\footnote{513}{BEIS, \textit{INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL: Initial consultation on the recommendations}, (11 March 2019), p 21. This Kingman proposals were supported by a number of witnesses. See: CIMA (FOA0033); Crowe U.K. LLP (FOA0010); Chartered Institute Of Internal Auditors (FOA0013); Investment Association (FOA0001); Institute of Chartered Accountants in England & Wales (FOA0015); Deloitte (FOA0017); ICAEW (FOA0019); Sarasin & Partners LLP (FOA0024); Mazars LLP (FOA0025); PwC LLP (FOA0029); Grant Thornton (FOA0029). See also: Financial Times, \textit{Investors to target tarnished directors over audit failures}, (24 March 2019); Financial Times, \textit{UK auditing shake-up looks set to hit company directors}, (21 March 2019).}
\end{footnotes}
acceptance that all company directors, regardless of their professional qualification, should be accountable for their performance and liable to the regulator’s sanctions, including if company reporting falls short of the required standards.

**Registration of auditors by Recognised Supervisory Bodies (RSBs)**

257. In the UK there are four recognised supervisory bodies (RSBs), 514 such as ICAEW, to which the FRC has delegated specific regulatory tasks, including the registration and de-registering of auditors. The Review recommended that this task should be reclaimed by the regulator from the RSBs, and that the Government should work with the regulator to develop and consult on the detail of how this regime would work, including developing a range of sanctions. 515 The Government welcomed the Review’s recommendation and stated that it would consult without delay on what additional sanctions short of deregistering audit firms could be used by the regulator. 516

258. We agree with the Review and others 517 that it is inappropriate for regulatory powers, such as registering statutory audit firms, to be delegated to a professional body. It is further evidence of the unsatisfactory voluntary approach of the current regulatory regime. By removing the registering of auditors from professional accountancy bodies, there is also the possibility that it can allow non-accountants to enter the audit market, who could bring other skills, such as IT technology. 518 Though audit quality is paramount, and opinions cannot be replaced by technology, 519 such as AI, allowing more entrants into a properly regulated audit market could in time help address the competition, choice and resilience issues highlighted in Chapter 7.

259. We welcome the Government’s decision to return the registration of auditors to the industry regulator. **We recommend that the Government and the regulator explore whether non-accountancy entrants, such as technology firms, could also play a role in the statutory audit market, if audit quality can be assured by rigorous registration, monitoring and enforcement policies. We believe that this could help address competition, innovation and resilience issues.**

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514 The four RSBs are: Association of Chartered Certified Accountants (ACCA); Chartered Accountants Ireland (CAI); Institute of Chartered Accountants in England and Wales (ICAEW); Institute of Chartered Accountants of Scotland (ICAS).


517 Q82 (Natasha Landell-Mills, Head of Stewardship, Sarasin & Partners); Q83 (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments).

518 See: Q29 (Professor Karthik Ramanna, University of Oxford); Q83 (Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments).

519 See PwC, The Future of Audit: A framework for Debate, (February 2019), p 15. They note that despite the introduction of transformational audit technology, “much of audit remains a human endeavour”. Though it was reported in March 2019 that a Dublin-based firm was offering an “audit automation” service. See: Times, Audit automation gets go-ahead, (22 March 2019).
9 Conclusion

260. The failures of audit exposed after the banking crisis eventually led to a competition inquiry and some modest reforms. Since then weak audits have contributed to several high-profile company failures and because they failed to identify issues these failures came as a surprise to workers, pension holders, suppliers and to some extent the Government. The high proportion of sub-standard audits and the continued domination of the Big Four together demonstrate that these reforms have proved totally ineffective in increasing competition and delivering acceptable quality of audits.

261. The failings of audit have direct consequences for companies, jobs and investors. It is unacceptable that after so many audit failures, so little action has been taken to improve the quality of audit. People are tired of hearing excuses for failure and are intolerant of blame being shifted from one set of well-paid people to another. As a result, the public and key stakeholders who rely on audits for essential information have become disillusioned with the reliability of audits and distrustful of the performance of directors who look after themselves whilst letting down their business. Radical change is needed. It will also be resisted, by the Big Four and others who fare well out of the current system. They must not be allowed to delay or block necessary change.

262. We welcome the Government’s commitment to implement audit reforms as quickly as possible. We have set out how the current reviews should be taken forward in a coherent way. Our proposals are intended to address problems of:

- 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.

263. Our vision for audit is a positive one. The industry itself should grasp this opportunity to broaden and strengthen its product, under the guidance of the Brydon review, to make it more forward-looking and comprehensive and to rebuild trust that has been shaken badly. This will provide a more useful offering for investors and the public alike. It will also make a career in audit more varied, rewarding and ultimately more meaningful in its service to the public interest.

264. Our proposed reforms are pragmatic and designed to deliver solutions that prove to work the best. If they prove ineffective, the more radical full structural break-up of the Big Four should be pursued. As a package, they will help the UK take a lead internationally on audit quality, reduce risks of corporate failure and ultimately improve the competitiveness and resilience of the UK audit market. The Government should act...
without delay, to take a lead and mitigate the risk of further damaging corporate failures and audit embarrassments. We intend to call key players back to review progress as the reforms are implemented. Reviews are a good start; implementing their recommendations must follow.
Conclusions and recommendations

The audit product

1. Fraudulent reporting by directors is almost always material, by nature if not by size. The detection of material fraud is, and must continue to be, a priority within an audit. Audits must state how they have investigated potential fraud, including by directors. (Paragraph 31)

2. Auditors are required to look ahead. We support work to strengthen the audit of and reporting on the going concern assumption and the viability statement. But we encourage Sir Donald Brydon to go further and explore how to make audits more forward-looking. In particular, Sir Donald should consider how widening the role and scope of audit might give the auditor more opportunities to express forward-looking opinions. (Paragraph 35)

3. We recommend that the FRC make graduated findings mandatory. (Paragraph 41)

4. The broadening of the audit remit would improve the usefulness of the product and the value of the job. Auditors would acquire new skills, employ more of their professional judgement and communicate their views clearly and openly. (Paragraph 44)

5. As part of his review, Sir Donald Brydon should consider extending the scope of audit to cover the entire annual report, albeit with different levels of assurance and reporting. Critical areas such as corporate governance and payment practices ought to be subject to a robust assurance process and meaningful reporting by the auditor. Auditors should be encouraged and empowered by the new regulator to speak their mind openly and clearly in audit reports, without fear or favour. They should call out poor management when they see it. If there are barriers to auditors taking on more responsibilities and reporting on them candidly (such as unlimited liability and skills issues), the Brydon Review should include proposals for removing these barriers. (Paragraph 45)

6. We believe that requiring auditors to present at the AGM is a good way to generate engagement. This direct dialogue with shareholders would also remind auditors who they are accountable to. It would require them to demonstrate their independence and evidence their willingness to challenge management to a wider audience than the Audit Committee. (Paragraph 51)

7. Our proposals to make audit more useful and transparent should also increase investor interest in audit matters. Interested investors will be more likely to engage and use their voice to push for continued improvements and greater transparency. But there is a long way to go. We have three recommendations to increase investor engagement. Combined with our proposals to make audits more transparent and useful, we believe that this package will lead to significant and positive engagement from investors. (Paragraph 52)

8. There should be a requirement in the new Stewardship Code for investors and asset owners to consider audit matters. (Paragraph 53)
9. **Auditors should make a presentation at the AGM to show how they have challenged management and exercised professional scepticism to underpin their audit opinion, and to raise any major issues.** (Paragraph 54)

10. In order to be useful, information must be timely. The FRC and its successor should consider requiring companies to publish the audit report at the same time as results are announced (instead of waiting for the full annual report to be published, which often happens a month later, even though the audit report is ready and signed off before results are announced). (Paragraph 55)

11. We support the work that Sir Donald is doing to understand “the origins and perceptions of the expectation gap”. Nevertheless, the expectation gap must not be allowed to mask the serious failure of audit to deliver on its own current terms. If auditors delivered on the existing regime reliably and well, the expectation gap would shrink greatly. The delivery gap is far wider than the expectation gap and that is what must be fixed as soon as possible. (Paragraph 56)

12. We also support the fundamental rethink of audit that Sir Donald has been tasked with. As a product, audit should be more useful and forward-looking. A revamped product will make a career in audit more varied, exciting and rewarding. Audit should be as attractive as consulting and be seen that way but should also be much more meaningful in its service to the public interest. (Paragraph 57)

### Capital maintenance

13. Compliance with the capital maintenance regime is patchy at best and it is not adequately audited. **We recommend that the FRC urgently reminds directors and auditors of their duties relating to the accounts and impose severe sanctions for breaches. Most importantly, auditors must be prepared to challenge management on their accounting of realised profits and distributable reserves.** (Paragraph 61)

14. We are alarmed and disappointed that the FRC has not provided clarity on these fundamental issues, given the potential and actual problems that have arisen. **The Government and the FRC should work together to resolve these issues as soon as possible, and produce simple and prudent guidance for companies and auditors to follow.** (Paragraph 78)

15. **We recommend that the Government and the FRC urgently produce a clear, simple and prudent definition of what counts as realised profits for the purpose of distributions. We support defining realised profits as realised in cash or near cash.** (Paragraph 79)

16. **We reject any legislative change the aim of which is to adapt the law to the accounting standards. Instead, auditors and directors need to be reminded that compliance with the accounting standards does not fulfil all legal obligations, and that the law comes first. We regret that the FRC has failed to clarify this basic point with those it regulates. We recommend that the FRC and its successor vigorously enforce the revised capital maintenance regime.** (Paragraph 80)
17. We strongly support the Government’s proposal to require companies and auditors to take a more critical look at the valuation of goodwill for the purpose of distributions. We recommend that the Government urgently take steps to tighten the net assets test. (Paragraph 86)

18. The Government cannot unilaterally change the international accounting standards, but it can seek to tighten the law. Stopping imprudent distributions makes companies more resilient and encourages management to think longer term and tackle problems earlier. The principle of prudence should be made explicit in the law and its interpretation. (Paragraph 90)

19. The Government and the FRC should lead international efforts to improve accounting standards. If the Government wants to achieve its ambitions of a Global Britain advancing UK influence and interests, then it should be prepared to spell out how it wants to lead international standards on key sectors such as accounting and audit. (Paragraph 91)

20. We recommend that companies be required to disclose the balance of distributable reserves in the annual accounts and break down profits between realised and unrealised. (Paragraph 93)

21. A solvency system should complement the revised capital maintenance regime that we recommend, not replace it. We recommend that the Government adopts a complementary solvency-based system in which directors must state that dividend payments will not make the company insolvent or create cashflow problems. (Paragraph 96)

Separating audit from non-audit

22. The opaque economics of audit undermine independence, erode trust and stifle competition. Audit can only be transparent and independent when it is fully priced. It will only be fully priced when it is no longer subsidised. Therefore, subsidies must end and audit must stand on its own two feet. We conclude that governance separation does not go far enough on the grounds that it fails to deliver independence and does not end cross-subsidies. (Paragraph 118)

23. An economic separation of audit and non-audit is highly desirable. We recommend that the CMA at the very least implements the proposed operational split to achieve the separation of economic interests. (Paragraph 122)

24. We believe that there is a strong case for independent audit firms. (Paragraph 124)

25. It is clear that there are well-functioning models of legal separation and audit-only firms. (Paragraph 136)

26. We agree with the CMA that “objections to full separation are overstated”. We found the objections against full legal separation to be very weak, as membership of the global network provides an effective avenue to pool resources, access staff and share technologies. We also found well-functioning examples of legal separation and audit-only firms. (Paragraph 139)
27. On the other side of the equation, legal separation offers benefits on multiple fronts: quality, independence, culture, transparency, trust and to some extent, choice. These benefits of separation are large, and in our judgement, worth incurring significant costs. (Paragraph 140)

28. We encourage the CMA to aim for full legal separation of audit and non-audit services. The CMA should look to the long term, and not let one-off, short-term implementation costs weigh too much in its calculations. If the operational split is chosen instead, the CMA and ARGA should conduct a review of the arrangements after three years to determine whether the split has ended cross-subsidies and improved culture, independence and transparency. If not, we recommend that the CMA then move to implement a full structural break-up of the Big Four into audit and non-audit businesses in the UK. (Paragraph 141)

**Fees**

29. We recommend that the FRC and its successor require greater reporting on audit fees, potentially including the disclosure of audit hours, staff mix, and rate per hour. Auditors should also report instances where they have performed additional procedures but have been unsuccessful at increasing their fee. (Paragraph 150)

30. We are not confident in relying solely on the integrity of auditors to do the right thing in the face of conflicting interests. We agree with Sir John Kingman that “economics shapes behaviour”, and auditors are no exception. The regulator should aim to align as much as possible the incentives that govern auditors’ behaviour with the delivery of quality. (Paragraph 151)

31. Audit must be properly resourced to deliver quality. We have argued that the audit product must improve too. We recognise that many of our recommendations in this report are likely to lead to higher audit prices. This is an acceptable consequence of securing better, more trusted audits. (Paragraph 152)

32. We recommend that the FRC and its successor be given more powers over audit fees. We support Sir John Kingman’s proposal that the regulator be given powers to intervene in the interests of quality. To do that well, the regulator needs to better understand the economics of audit. The regulator should also investigate whether the structure of fees is fit for purpose, with the aim of reducing or eliminating economic incentives that work against quality. (Paragraph 153)

**Ensuring independence, challenge and professional scepticism**

33. It is deeply concerning that many audit committees do not appear to be factoring professional scepticism and challenge into their criteria for selecting auditors and are instead using ‘cultural fit’ as a desirable attribute. Equally worrying is the finding that many audit committees are spending so little time on auditing matters. This questions whether many audit committees are committed to challenging management and to putting in the necessary time to ensure that auditors are as well. (Paragraph 161)
34. Because of our concerns about the independence of audit committees, their lack of attention to audit and the lack of emphasis they are placing on challenge, we fully support the CMA's proposed remedy on greater scrutiny. We agree with the CMA and others that sharper oversight of audit committees would help ensure that audits are more independent, able to challenge management and address any bias in favour of the Big Four. It is for the regulator to decide how much intervention and oversight is required to deliver these objectives, both in general and in specific cases. (Paragraph 166)

35. If audit quality, choice, resilience and the professional scepticism and independence of auditors remain a problem despite the remedies proposed by the CMA, Sir John Kingman and Sir Donald Brydon, we believe that independent appointment becomes a viable option for reform. We recommend that the regulator and the CMA consider the potential independent appointment of auditors with a view to developing it as a viable remedy if other remedies and reforms fail. (Paragraph 176)

36. We believe that increasing the frequency of audit rotations will, especially if used alongside a market cap, also encourage challenger firms to enter the FTSE 350 audit market, which will increase choice, competition and resilience. We believe these benefits outweigh any possible increases in costs. We also maintain that ten years will allow an audit firm to gain a good understanding of the companies they audit and would contend that even with a twenty-year rotation, a new audit firm will be required to develop knowledge of the firms they audit and the sectors within which they operate. We recommend that the CMA should revisit increasing the frequency of audit rotations, which should be reduced to seven-year non-renewable terms that can only be terminated in exceptional circumstances. (Paragraph 179)

37. We are persuaded that a “cooling off” period during which non-audit services could not be sold after an audit engagement had ended would remove a major potential conflict of interest for auditors. It would help focus auditors’ minds on audit quality and remove any concern that challenging management or exercising professional scepticism would have adverse financial implications after an audit term ended. This would also be a good option if a full structural split of audit and non-audit services was not adopted. It would also most likely increase challenger firms’ non-audit work, which would allow them to build up experience, expertise and a fee base to develop and invest in audit work. On balance we think a cooling-off period of three years would be optimal in delivering audit independence. We recommend that the CMA seriously considers the benefits of a cooling-off period of three years across which non-audit services could not be offered after an audit engagement had ended. The CMA should see this is a viable option if it does not decide to proceed with a full structural split of audit and non-audit services. (Paragraph 182)

38. The amounts being spent by audit firms for prospective clients seem high and lack transparency, raising significant concerns about whether this undermines auditor independence. Auditors themselves said that part of the current crisis of trust in the audit profession is the perception of conflicts of interest. We are therefore concerned that since the FRC’s policy on hospitality was introduced in 2016 there have already been 35 breaches. We recommend that the regulator tightens the current rules and applies them also to prospective audit clients and requires audit companies to publish details of all hospitality in full. (Paragraph 188)
Competition, choice and resilience

39. The CMA thought further consideration could be given to the use of peer reviews to improve quality by introducing an additional, independent quality check. However, it did not see them as a mechanism to give challenger firms enough experience to become more competitive in tendering for the audits of large companies. We agree. (Paragraph 198)

40. We share the reservations of many about the utility and impact of joint audits but believe that they have a role to play in increasing the resilience of the market in the medium term. We recommend that joint audits should be piloted in the upper reaches of the FTSE 100 in conjunction with our preferred option of a market cap for the rest of the FTSE 350, which is discussed below. Such audits should include a Big Four and a challenger firm; it should not include two Big Four firms. The new regulator should recommend joint audits where it believes challengers have not yet developed the resources and skills to take on the most complex audits alone but where, working alongside a Big Four firm, they would not affect audit quality. The regulator should monitor the quality of these pilots carefully and draw lessons from them to inform debates on which mechanisms are the most likely to increase competition and choice without damaging quality. Finally, we recommend that if unlimited liability is a significant deterrent to the challenger firms auditing the largest and most complex companies, the CMA should consider how to remove this barrier. (Paragraph 205)

41. We recommend that because of their strategic importance the Government should examine the auditing of banks to explore whether additional safeguards are required in this sector. (Paragraph 206)

42. While acknowledging that there are short-term risks to introducing a market cap, we believe that on balance they are outweighed by the long-term benefits of a more competitive and resilient audit market. We are confident that if the regulator designs, implements and monitors the market cap carefully these risks can be minimised. We recommend that the CMA draws up detailed proposals for the introduction of a segmented market cap offering challenger firms the chance to take up a proportion of audits across the FTSE 350. This should be done on the basis that each firm should have an individual cap to avoid one of the Big Four keeping all of its clients and remaining dominant. We recommend that the CMA develops this proposal together with a pilot of joint audits in the first instance to allow challenger firms to take on some of the more complex FTSE 100 audits. (Paragraph 213)

43. We recommend that the CMA works with the regulator to draw up proposals to mitigate the consequences of an audit market failure, especially if it involved one of the Big Four. However, we strongly believe that the CMA should prioritise remedies that enable more challenger firms to enter the FTSE 350 audit market and develop their ability to undertake the full range of audits. (Paragraph 217)

Regulation of audit

44. We agree with the Kingman Review that the Financial Reporting Council has for too long been a weak and ineffective regulator. Though in recent years it has begun to apply higher penalties for audit failures, we believe that it is too late to repair its
reputation and credibility. It seemed unwilling to explore major audit failures, such as at HBOS, and reluctant to use sanctions even when it found substandard audits. It was ineffective in seeking the additional powers, statutory underpinning and funding it required to make it truly independent of the industry it was regulating. Its leadership also showed a degree of naivety in not acting on perceptions that it was captured by the Big Four, a suspicion fuelled by its self-perpetuating recruitment processes. On balance, the FRC has contributed to the current crisis of trust in audit and now lacks the credibility to address it. (Paragraph 226)

45. We welcome the Government’s commitment to accept the Kingman Review’s recommendations to establish ARGA and its steps to start implementing those recommendations that do not require legislation. We are particularly pleased that the Government has accepted Sir John’s recommendation that ARGA should be fully funded by a compulsory levy on the industry. We also welcome the Government’s decision to replace the FRC’s current leadership. They have lost our confidence and clearly that of the Government and the majority of audit stakeholders. We recommend that current FRC board members should have no meaningful role in the reform process or management of the new organisation. Given concerns about the independence and effectiveness of the FRC, we expect that the Government’s preferred candidate will not be appointed until they have appeared before this Committee and we have reported to the House our opinion. (Paragraph 234)

46. We recommend that ARGA ensures that it has effective procedures and policies in place to encourage whistle-blowers to come forward when they have serious concerns and investigates them fully. (Paragraph 235)

47. We welcome the Government’s acceptance of the Kingman Review’s proposals for wider powers to intervene to prevent a significant market failure or lessen its impact if it cannot be averted. We recommend that the Government introduces the necessary legislation in the next session of Parliament. We further recommend that when there has been a major accounting and/or audit failure the new regulator should conduct and publish a swift but comprehensive review of what went wrong to share lessons with the wider audit market. (Paragraph 238)

48. We welcome the Government’s positive response to the Kingman Review’s recommendations on ARGA’s objectives, functions and its more proactive role. This should enable ARGA to become the strong, credible regulator the audit industry needs. (Paragraph 242)

49. We are deeply concerned that investigations into audit failures are still taking two years and longer. We therefore welcome the Government’s commitment to implement immediately the Kingman Review’s recommendation that the FRC and the Government should closely monitor performance in this area and that ARGA should make this a priority. This will be a key area in which we will hold ARGA to account. (Paragraph 244)

50. We welcome the Kingman Review’s conclusion that ARGA should not be a ‘soft regulator’ and the recommendation that ARGA, unlike the FRC, should make full
use of the range of sanctions it has at its disposal. *We recommend that while ARGA should be proportionate, in the worst cases it should not be shy of imposing tough sanctions, including large fines.* (Paragraph 248)

51. We welcome the Government’s decision to take forward the Kingman Review’s recommendation that AQRs should be a statutory requirement and be published in full. *However, we recommend that AQRs should not be anonymised, even in the first instance. We recommend that AQRs should move beyond process-driven box ticking and offer a robust appraisal of the opinions offered in audits and on the quality of the analysis and evidence used to drive those opinions. This should include reviewing what steps an audit had taken to identify fraud. We also recommend ARGA should as a matter of routine inspect audit firms’ software that records audit files and ensure that it is sound and that the audit trail cannot be tampered with.* (Paragraph 252)

52. We welcome the Government’s commitment to consider and consult on the possible introduction of a strengthened framework around internal controls on a similar basis to Sarbanes-Oxley. If adapted to the UK regulatory system, a UK equivalent could make a significant contribution to improving the reliability of financial reporting. (Paragraph 255)

53. We welcome the Government’s acceptance that all company directors, regardless of their professional qualification, should be accountable for their performance and liable to the regulator’s sanctions, including if company reporting falls short of the required standards. (Paragraph 256)

54. We welcome the Government’s decision to return the registration of auditors to the industry regulator. *We recommend that the Government and the regulator explore whether non-accountancy entrants, such as technology firms, could also play a role in the statutory audit market, if audit quality can be assured by rigorous registration, monitoring and enforcement policies. We believe that this could help address competition, innovation and resilience issues.* (Paragraph 259)
Draft Report (The future of audit), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 264 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Nineteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 3 April at 9.45 am]
Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee’s website.

Tuesday 15 January 2019

Prof Christopher Humphrey, Professor of Accounting, Alliance Manchester Business School, Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University, Ilias G. Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School, Prof Karthik Ramanna, University of Oxford

Leon Kamhi, Head of Responsible Investment, Hermes Investment Management, Liz Murrall, Director, Stewardship and Reporting, The Investment Association, Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments, Natasha Landell-Mills, Head of Stewardship, Sarasin & Partners

Wednesday 23 January 2019

Steve Barber, Audit Committee Chair, AA plc, Margaret Ewing, Nomination, Audit & Risk Chair, ITV

Sir John Kingman, Chair of the Independent Review of the Financial Reporting Council

Wednesday 30 January 2019

David Dunckley, Chief Executive Officer, Grant Thornton, Scott Knight, Head of Audit, BDO, Clive Stevens, Chairman, Association of Practicing Accountants, Jac Berry, UK Head of Quality and Risk, Mazars

David Sproul, Senior Partner and Chief Executive Officer, Deloitte UK, Steve Varley, Chairman, EY UK, Bill Michael, UK Chairman and Senior Partner of KPMG, Kevin Ellis, Chairman and Senior Partner, PwC UK

Monday 4 February 2019

Sir Donald Brydon, Chair of the Independent Review of the Quality and Effectiveness of the UK Audit Market

Tuesday 5 February 2019

Stephen Hadddril, Chief Executive, Financial Reporting Council, Michael Izza, Chief Executive, Institute of Chartered Accountants in England and Wales, Maggie McGhee, Executive Director, Governance, Association of Chartered Certified Accountants
Wednesday 13 March 2019

The Rt Hon Greg Clark MP, Secretary of State for Business, Energy and Industrial Strategy, Debbie Gillatt, Director, Business Frameworks, Department for Business, Energy and Industrial Strategy, Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy
Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee’s website.

FOA numbers are generated by the evidence processing system and so may not be complete.

1. Aberdeen Standard Investments (FOA0023)
2. Association of Chartered Certified Accountants (FOA0021)
3. Association of Investment Companies (FOA0034)
4. Association of Practising Accountants (FOA0012)
5. Bacchus, Mr Malcolm (FOA0006)
6. BDO LLP (FOA0020)
7. Boscher, Paul (FOA0003)
8. Chartered Institute Of Internal Auditors (FOA0013)
9. CIMA (FOA0033)
10. Crowe U.K. LLP (FOA0010)
11. Deloitte (FOA0017)
12. EY (FOA0022)
13. Grant Thornton (FOA0029)
14. ICAS (FOA0019)
15. Institute of Chartered Accountants in England & Wales (FOA0015)
16. Investment Association (FOA0014)
17. ISACA (FOA0002)
18. KPMG LLP (FOA0009)
19. Mazars LLP (FOA0025)
20. Mithani, Vinita (FOA0016)
21. PIRC (FOA0007)
22. PIRC (FOA0032)
23. PwC LLP (FOA0028)
24. PwC UK (FOA0008)
25. Rathbone Brothers Plc (FOA0026)
26. RSM (FOA0030)
27. Sagars Accountants Ltd (FOA0004)
28. Sarasin & Partners LLP (FOA0024)
29. UKSA & ShareSoc (FOA0005)
## List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee’s website. The reference number of the Government’s response to each Report is printed in brackets after the HC printing number.

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