House of Commons

Business, Energy and Industrial Strategy Committee

The Future of Audit: Government Response to the Committee's Nineteenth Report of Session 2017–19

Eighteenth Special Report of Session 2017–19

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Business, Energy and Industrial Strategy Committee

The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Energy and Industrial Strategy.

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Publication

Committee reports are published on the Committee's website at www.parliament.uk/beis and in print by Order of the House.

Evidence relating to this report is published on the inquiry publications page of the Committee's website.

Committee staff

The current staff of the Committee are Chris Shaw (Clerk), Alison Groves (Second Clerk), Ian Cruse, Becky Mawhood and Ashleigh Morris (Committee Specialists), James McQuade (Senior Committee Assistant) and Gary Calder (Media Officer).

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Eighteenth Special Report

On 2 April 2019, the Business, Energy and Industrial Strategy Committee published its Nineteenth Report of Session 2017–19, *The Future of Audit* [HC 1718]. The response from the Government was received on 29 May 2019. The response is appended below.

Appendix

The Government welcomes the Business, Energy and Industrial Strategy Committee's inquiry into the Future of Audit.

The UK has always been a world leader in audit and accounting services, with world-class frameworks for corporate reporting, corporate governance and regulatory oversight. Our modern Industrial Strategy sets out our vision to ensure that the UK is the best place to invest, start and grow a business. The creation of the Audit, Reporting and Governance Authority (ARGA) will ensure that the UK maintains and advances its status as a place of the highest standards in audit.

We want an open, competitive audit market, delivering the high-quality product needed by its users, underpinned by a highly effective regulator.

That is why the Government commissioned three reviews to comprehensively review and update our regulatory framework for audit and corporate reporting. The outcome of all three reviews are or will be subject to public consultation by the Government, and the Government is committed to acting on their findings.

- The Independent Review of the Financial Reporting Council (FRC) by Sir John Kingman was announced in April 2018, published in December 2018, and is currently subject to Government consultation. As promised in the consultation document, good progress is already being made on some of the recommendations.
- The Competition and Markets Authority (CMA) market study on the statutory audit market began in October 2018, published its interim report in December 2018, and published its final report in April 2019. The Government will be consulting on the CMA's recommendations.
- The Independent Review into the Quality and Effectiveness of Audit by Sir Donald Brydon was announced in December 2018, and published a Call for Views in April 2019, which closes on 7 June 2019.

The Government is grateful to the Committee for providing such a comprehensive report. The Government agrees that it is important that what emerges from the three reviews is a coherent framework for auditing that regains the confidence of investors and the public. As the Secretary of State made clear in front of the Committee on 13 March 2019, the Government is determined to act by upgrading the standards and public confidence in audit so that the UK continues to be a beacon of excellence around the world in the years ahead.

The audit product

The Government has asked Sir Donald Brydon to conduct an Independent Review into the quality and effectiveness of audit. It will look at audit as a product and what audit should be in the future. It will address the audit expectation gap: the difference between what people think audit does and what it actually does. It will also look at the scope of audit, any changes that may need to be made to it and how it can better serve the public interest.

The Independent Review into the Quality and Effectiveness of Audit published a Call for Views on 10 April 2019, and is expected to provide a report to Government by the end of the year. The following recommendations from the Committee's report are relevant to the Review's Call for Views.

Recommendation

Audits must state how they have investigated potential fraud, including by directors. (Paragraph 31)

The remit letter issued to the FRC by the Government on 11 March 2019 asked the FRC to undertake work to look into whether the current auditing standards in relation to fraud are being properly applied.

In addition, Sir Donald Brydon's Call for Views has asked whether it is reasonable and feasible to expect auditors to play a greater role in detecting material fraud, as well as inviting views on whether a 'reasonable person' test should be devised in assessing the auditor's work in relation to fraud detection.

Recommendation

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)

Sir Donald Brydon's Call for Views is seeking evidence on how audit and/or other forms of assurance may address the future financial prospects and sustainability of companies.

Recommendation

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

The Government welcomed Sir John Kingman's recommendation to consider requiring further enhancement to the Independent Auditor's Report to include 'graduated' findings; and it noted that careful consideration would be needed to ensure the impact of such change ensures the promotion of positive action by audit firms.

Sir Donald Brydon's Review also seeks evidence and views on the benefits that moving to a more graduated disclosure of audit findings could bring, and in the light of that further evidence the Government will consider making graduated findings for audit mandatory.

Recommendation

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)

Sir Donald Brydon's Review is gathering evidence on a number of matters related to the scope and purpose of audit.

Recommendation

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

The Government agrees that the Stewardship Code must be improved. The FRC have recently consulted on a revised Stewardship Code and will bring forward a new Code in light of responses, also taking account of Sir John Kingman's recommendations in relation to stewardship.

Sir Donald Brydon's Review is seeking views and evidence on how investors currently make use of audit as well as their likely future needs.

Recommendation

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)

Sir Donald Brydon's Review is seeking views and evidence on how auditors might better communicate to and engage with shareholders.

Recommendation

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)

In their report, the CMA supports the Committee's recommendation and believes it could work well with their recommendation for greater regulation of Audit Committees. The Government will be consulting on the CMA's recommendations and the BEIS Select Committee recommendation will be considered in the light of that.

The delivery gap is far wider than the expectation gap and that is what must be fixed as soon as possible. (Paragraph 56)

In the last decade, since the financial crisis, efforts have been made to develop requirements, standards and guidance to narrow the expectation gap in the current scope of audit. Sir Donald Brydon's Review is seeking views and evidence around the expectation and delivery gap. The FRC will continue to monitor the performance of audit firms against existing standards and requirements and will take action where appropriate, and the Government fully intends to give effect to the Independent Review of the Financial Reporting Council's recommendations on strengthening the oversight and regulation of the quality of audit.

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)

Sir Donald Brydon's Review is seeking views and evidence on the case for audit to be more forward-looking and how this could be achieved.

Capital Maintenance recommendations

Paragraph 61: *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.*

As mentioned in the response to the recommendation in paragraph 93 (below), Government is considering whether companies should be required to disclose their available reserves and realised profits. This would make the figures subject to audit and give auditors a clearer locus to challenge management on their accounting of realised profits and distributable reserves.

Paragraphs 78 and 79: *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. 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.*

The Government recognises the need for greater clarity in the definition of realised profits and about the relationship between international accounting standards and the UK's capital maintenance regime. It will take full account of recommendations from Sir Donald Brydon's Review which is looking at the role of auditors in determining whether directors are complying with capital maintenance obligations and other requirements, and which has called for views on how perceived inconsistencies between international standards and company law capital maintenance might be resolved.

Paragraph 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 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.*

As the Secretary of State said in his oral evidence to the Committee, the Government has no intention of weakening the capital maintenance regime.

Paragraph 86: *We recommend that the Government urgently take steps to tighten the net assets test.*

The Government is clear that companies need to exercise care over the valuation of goodwill, particularly where it is significant in determining whether a proposed dividend can be paid. Auditors should be demonstrating strong professional scepticism and challenging management robustly where they believe goodwill is overvalued and needs to be impaired. The Government will consider whether additional steps should be taken to tighten the net assets test as part of its consideration of ways of strengthening the framework governing dividend payments.

Paragraph 90 and 91: *The principle of prudence should be made explicit in the law and its interpretation. 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.*

The International Accounting Standards Board (IASB) reintroduced the principle of prudence, as a qualitative characteristic of useful financial information, when it revised its Conceptual Framework for Financial Reporting in March 2018. This is the Framework for developing and revising International Financial Reporting Standards (IFRS) to ensure they are based on consistent concepts. The revision resulted from significant efforts made by the FRC and the Government.

In addition, the Government is establishing a new UK process for endorsing and adopting international accounting standards to help provide certainty of use to companies that already use those standards. This work will be taken forward by a UK Endorsement Board, which will consider and scrutinise new or amended IFRS before adoption in the UK. The Endorsement Board will be specifically tasked with providing thought leadership in financial reporting as one of its guiding principles. This provides the UK with a platform to feed into the IASB and influence the development of international standards.

Paragraph 93: *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.*

A minority of companies already disclose their distributable reserves on a voluntary basis and the Government encourages more companies to follow this good practice. The Government, however, is considering whether to go further and to make this a legal requirement and has taken careful note of the Committee's recommendation.

In its response to the Insolvency and Corporate Governance consultation last year, the Government said that it would look further at whether companies should be required to disclose the audited figure for available reserves and distributable profits. That work is ongoing. Sir Donald Brydon's Call for Views also asks whether distributable and non-distributable reserves should be disclosed in the audited accounts.

The Government intends to consider Sir Donald Brydon's Review recommendations alongside its own work, before reaching conclusions on whether and, if so, how to implement a new disclosure requirement taking account of the need for any requirement to be practical, proportionate and useful to investors.

Paragraph 96: *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.*

The Government will consider this recommendation which is focused specifically on dividends as part of its consideration of ways to clarify and strengthen the framework governing dividend payments. The Government notes, however, that the UK Corporate Governance Code already asks company boards to assess the prospects of a company over an appropriate time period and to state whether the company will be able to continue in operation and meet its liabilities as they fall due over the chosen period.

Across all the areas above, the Government looks forward to receiving the conclusions and recommendations of Sir Donald Brydon's review.

Recommendations on independence of audit and related issues

In April, the CMA published its final report with recommendations to improve resilience, quality and competition within the audit market. Although the CMA focused its attention on the audits of larger companies, both listed and private, they have remained open to evidence of views on the smaller end of the market. The CMA has made the following four headline recommendations to the Government:

- Robust regulatory oversight of the committees that run the selection process for audited companies, and oversee the audit, to make them more accountable and ensure that they prioritise quality.
- Mandatory joint audit, to increase the capacity of challenger firms, to increase choice in the market and thereby drive up audit quality.
- An operational split between the Big Four's audit and non-audit businesses, to ensure maximum focus on audit quality.
- A five-year review of progress by the regulator.

The Government will be consulting on the CMA's recommendations.

Paragraph 122: *We recommend that the CMA at the very least implements the proposed operational split to achieve the separation of economic interests.*

The CMA has proposed an operational split between the Big Four's audit and non-audit businesses. The Government will be consulting on the CMA's recommendations.

Paragraph 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.*

In his evidence to the Committee, the Secretary of State has made clear his commitment for there to be more effective competition in the audit market.

The CMA recommended an operational split for audit firms, and a five-year review of progress by the regulator. In their report, the CMA suggests re-examining the merits of a full structural split if it proves impossible to complete an operational split that delivers the expected improvements. The Government will consult on all of the CMA's recommendations as part of the consultation.

Paragraph 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.*

Sir Donald Brydon's Review is looking at audit costs, including whether more detail is needed on the composition of audit fees. The Government looks forward to receiving his recommendations on this issue. The CMA has also referenced this in their report where they mention transparency of fees, and a requirement on the auditor to present at the audited company's AGM.

At present, the FRC's Ethical Standard includes an Appendix, which sets out the reporting requirements in respect of audit fees. As part of their post implementation review, the FRC are considering a new requirement for the auditor to report in the event of the audit fee not meeting full costs, to ensure the quality of the work undertaken and the adequacy of resources made available to support the audit.

Paragraph 153: *We recommend that the FRC and its successor be given more powers over audit fees.*

The FRC's Ethical Standard currently requires that the audit engagement partner has to be satisfied and able to demonstrate that the auditor has sufficient resources to perform the audit in accordance with all applicable requirements irrespective of audit fee. The auditor also needs to consider threats to independence if they do not recover full costs of work.

Alongside his Independent Review, Sir John Kingman considered whether there was a case for change in the appointment of a company's auditors and how their fees are set. The Government is currently consulting on Sir John Kingman's proposals and will also take account of the recommendations relating to fees in the round.

Paragraph 176: *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.*

In his appearance at the BEIS Select Committee on 13 March, 2019, the Secretary of State made clear the Government's commitment and determination for reform to ensure the highest audit quality, effective competition, and genuine choice.

Alongside his independent Review of the FRC, Sir John Kingman put forward a proposed approach to change the present arrangements for the appointment of auditors in a focused set of circumstances. In addition, the CMA's Market Study recommends that the regulator should have the power and requirement to mandate minimum standards for both the appointment and oversight of auditors.

The Committee's recommendation will be considered as part of the Government response to its consultations on these two sets of proposals.

Paragraph 179: *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.*

This will be considered as part of the consultation on the CMA's recommendations.

Paragraph 182: *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.*

The CMA suggests that the regulator considers cooling-off periods in its ethical standards and this will be considered as part of the consultation on the CMA's recommendations.

Paragraph 188: *We recommend that the regulator tightens the current rules [on corporate hospitality] and applies them also to prospective audit clients and requires audit companies to publish details of all hospitality in full.*

The existing requirements are set out in the FRC's Ethical Standards, which require that gifts and hospitality cannot be received from or offered to an audited entity unless an objective, reasonable and informed third party would consider them to be inconsequential. This requirement has to be applied both individually and cumulatively where hospitality is received or provided on successive occasions.

The FRC is currently examining the Ethical Standards further, considering options for how to add additional requirements to the existing material on gifts and hospitality.

With regards to audit firms publishing details of all gifts and hospitality, the law relating to transparency reporting by audit firms is set out in Article 13 of the Audit Regulation, which will be retained EU Law, following the UK's exit from the European Union.

The Committee's recommendation will be considered in the FRC's post implementation review.

Competition, Choice and Resilience recommendations

Paragraph 205: *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.*

Joint audit by a Big Four firm and a challenger firm has been recommended by the CMA in its Market Study, and the Government will consult on the recommendations.

Paragraph 206: *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.*

At present in the UK, auditors of banks and insurance firms are obliged to report to the Prudential Regulation Authority (PRA) if, amongst other things, they believe that the company is not, or may cease to be, a going concern; but this duty does not apply to auditors of other Public Interest Entities.

The Government agrees that it is particularly important that there are strong and effective requirements and regulation of audit in the financial sector. This is covered by the current consultation on Sir John's recommendations and will be considered when setting new functions and objectives for the regulator.

Paragraph 213: *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.*

The CMA has considered a market share cap remedy as a potential alternative way to break down the barriers to non-Big Four firms, but has recommended against it. The CMA has recommended a joint audit regime for the FTSE 350, with some exceptions, and it did not conclude that joint and several liability for the joint audit would be a significant deterrent. The Government is consulting on these recommendations following the publication of the CMA's report.

Paragraph 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.*

The FRC currently chairs a group, consisting of BEIS, HMT, the CMA, Bank of England/ Prudential Regulation Authority, Financial Conduct Authority, and the ICAEW, whose mandate is to develop effective contingency and continuity plans that can be deployed in various scenarios of disruption to the audit market including in the event of an audit firm failure. The CMA's presence on the forum is specifically intended to ensure that disruption to the audit market would not result in reduced competition and that all remedies take proper account of the impact on competition in the market. The Government welcomes the views of the Select Committee. The consultation on the CMA's report also covers the question of market resilience, and the Government will consider whether further measures are needed in due course. The Government will consult on the CMA's recommendations.

Regulation of Audit recommendations

Paragraph 234: *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 [as Chair of the new regulator] will not be appointed until they have appeared before this Committee and we have reported to the House our opinion.*

In his Independent Review of the FRC, Sir John Kingman recommended that the new regulator would require a new Board, demonstrating strong leadership to achieve a major shift in tone and culture. The Government agrees and has acted quickly to recruit a new Chair, Deputy Chair and new CEO for the FRC. We expect them to be appointed this summer and for the new senior leadership to lead the new regulator once it is established. The Government's preferred candidate for Chair of the regulator, and future Chairs, will appear before the Committee for pre-appointment scrutiny.

The Government also agrees with Sir John that there should be some, but only limited, continuity in the regulator's Board. The FRC's current leadership has been clear in its commitment to work with the Government on the necessary programme of reform, which we welcome, and they have already reduced the size of their Board by four.

In future, members of the new regulator's Board will be subject to Ministerial appointment, and, going forward, new members of the FRC's Board will also be subject to Ministerial appointment. Executive and staff appointments will be matters for the regulator in order to ensure its operational independence.

Paragraph 235: *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.*

In his report, Sir John Kingman noted that the FRC's whistleblowing policy is in line with those of other regulators, and the Government has sought views on Sir John's recommendations in its current consultation. Following that exercise, the Government will decide whether this requires further action following the consultation on Sir John's proposals.

Paragraph 238: *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.*

In his evidence to the Committee, the Secretary of State has made clear his commitment for the Government to legislate as soon as possible.

Sir John Kingman's recommendation that the new regulator should have a forward-looking role in overseeing company reports, alongside its current role of reviewing company accounts, features in the consultation on his proposals.

Paragraph 248: *We recommend that while ARGA should be proportionate, in the worst cases it should not be shy of imposing tough sanctions, including large fines.*

The Government welcomes and shares Sir John Kingman's vision for a new regulator with stronger statutory powers, a new mandate and new leadership and is taking forward the recommendation to replace the FRC with ARGA. The powers and sanctions recommended by Sir John are included in the current consultation.

Paragraph 252: *We recommend that AQRs [Audit Quality Reviews] 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.*

At present, the FRC undertakes Audit Quality Review (AQR) inspections that monitor compliance with the 'Relevant Requirements' as defined in the Statutory Auditors and Third Country Auditors Regulations 2016. These Requirements include the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and the Audit Regulations issued by the relevant professional bodies.

The Government will work with the FRC to develop an appropriate way forward for publishing the full reports to help with transparency and also to improve quality. Careful consideration will be needed to ensure that information published appropriately respects confidentiality, personal data and market sensitivity restrictions.

Additionally, in the Call for Views, Sir Donald Brydon's Review asks how the auditor role in detecting fraud could be increased, and related questions on how to improve audit quality, including potentially by widening its scope and purpose.

Paragraph 259: *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.*

The CMA suggests that there is a need for considerable ongoing investment in technology, methodologies, training and quality assurance in order to support audit. This will be considered as part of the consultation on the CMA's recommendations.

In Sir Donald Brydon's Call for Views, he asks how technology could be used to provide enhanced audits and wider assurance, and Sir Donald Brydon's Review will be supported on this subject by a Technology Sub-Group. The Government looks forward to receiving his recommendations. In addition, the FRC has launched a thematic review of the role of IT in audit that will be finalised later in 2019.