Reforms to the audit market – major changes ahead

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Recent years have seen an unprecedented focus on audit and auditors in the UK. This has been driven, at least in part, by a number of high-profile corporate failures as well as the perceived widening of the 'audit expectations gap', the difference between what users expect from an audit and the reality of what an audit entails.

A significant number of reforms to the statutory audit market were introduced in 2016 as a result of the EU Audit Regulation (537/2014) and Directive (2014/56/EU). These reforms sought to address a number of issues highlighted during the global financial crisis, including competition concerns at the top of the statutory audit market; claims that auditors had not done enough to flag issues of concern in the period leading up to the crisis; and concerns that auditors may be insufficiently independent of the companies that they audit.

Notwithstanding those reforms, significant concerns remain. This has led to a number of reviews being commissioned into the statutory audit sector. These reviews are considering a number of far-reaching reforms, impacting and disrupting not only the audit firms, but also corporates.

Kingman review of the Financial Reporting Council

In December 2018, Sir John Kingman published his independent review of the Financial Reporting Council (FRC), which among other roles, is the UK's audit regulator.

The government asked Sir John to lead a review of the FRC looking at a range of areas including the structure of the FRC, its culture and processes, its powers, how accountable it is and its impact, resources and capacity.

The review discussed the strengths and weaknesses of the FRC and the constraints on its effectiveness. It sets out 83 recommendations, including that the FRC be replaced with an independent statutory regulator, accountable to Parliament, called the Audit, Reporting and Governance Authority (ARGA). A number of the other recommendations relate to the statutory audit, for example, the introduction of a duty of alert for auditors to report viability or other serious concerns.

Competition and Markets Authority

In April 2019, the Competition and Markets Authority (CMA) published its final report on its statutory audit services market study which it launched in October 2018. This proposed a number of remedies, focussing particularly on audits of companies in the FTSE 350 index. The recommended remedies include:

- An operational split between the audit and non-audit practices of the biggest audit firms in the UK.
- That FTSE 350 audits should be carried out jointly by two firms, at least one of which should be outside the Big Four.
- That audit committees should be more closely regulated by the ARGA. It recommends that there should be minimum standards prescribed for the appointment and oversight of auditors. ARGA would monitor compliance with these standards and have the power to take remedial action where necessary.

This is the second time in recent years that the CMA has focussed on the statutory audit market. In October 2014, the CMA issued The Statutory Audit Services for Large Companies Market

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Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014. This contains requirements around audit tendering and Audit Committee responsibilities for FTSE 350 companies.

Brydon audit review

In December 2018, the government asked Sir Donald Brydon to lead an independent review into UK audit market in response to the perceived widening of the 'audit expectations gap'. The review considered a range of issues including the scope and purpose of audit; the audit product; and the legal responsibilities and liabilities of the company and the auditor. The final report was published in December 2019 and made 64 recommendations including in relation to: the prevention and detection of material fraud; communication and transparency within the audit process and audit report; the role of shareholders and other stakeholders; reporting by companies on their approach to assurance and resilience; and the effectiveness of companies' internal controls over financial reporting.

What does this increased focus mean for companies?

In light of the well-publicised corporate failures of recent years, audit firms are, understandably, increasing their focus on the going concern statement contained in the annual report and accounts, as well as the longer term viability statements contained in listed company reports. This enhanced focus has been reinforced by the FRC publishing a revised auditing standard in connection with going concern statements. The FRC says that this standard means that UK auditors will follow significantly stronger requirements than those required by current international standards and will require greater work on the part of the auditor to more robustly challenge management's assessment of going concern.

Increased work in connection with going concern is just one example of the greater workload being imposed on the statutory auditor. In light of this, and the knock-on effect on audit team resourcing, and the potential reputational and other risks connected with a statutory audit, in the medium to long term it is likely that corporates will see the fee charged for the statutory audit increase.

An increase in the work required to be undertaken by the statutory auditor is also likely to lead to an increase in the workload of the audit committee, in particular the chair of the audit committee. This is likely to mean an increase in the time commitment required for these roles. When combined with the potential political and media scrutiny if things do go wrong, recruiting appropriately experienced and qualified candidates for audit committee roles may become more challenging, putting pressure on the nominations committee and possibly board make-up and composition more generally.

It is not only investors who may influence a change in statutory auditor. Increasingly, audit firms themselves are stepping down from existing engagements as they more carefully consider issues including: the risk profile of their audit client portfolio; their ability to effectively conduct the statutory audit given increased scrutiny and their resources; and the reputational issues that may arise in connection with an audit engagement. There were several examples of auditors resigning from audit engagements in 2019 following concerns raised with their corporate clients not being dealt with satisfactorily from the audit firm's perspective.

Compliance with the existing audit tendering and auditor rotation requirements can also create complication for companies and any proposed change of auditor requires careful choreography. Meticulous planning is required if prospective audit firms provide any of an increasingly long list of non-audit services which precludes them from undertaking a statutory audit within a prescribed period. Complications may also arise if not all eligible audit firms choose to participate in a tender process. Participation is by no means certain these days and there has been a noticeable trend of audit firms being reluctant to participate in certain audit tender processes. The transition from one audit firm to another is also an increasingly intricate process, and transition can take several years for the most complex, international businesses.

It is not only politicians and regulators that are focused on audit. Institutional investors are also increasingly focused on audit-related issues and are more readily using their voting rights at company Annual General Meetings (AGMs) to express dissatisfaction at audit-related matters. In 2018, investors at one listed company voted against the reappointment of the incumbent auditor. It is not only institutional investors that are making their voice heard. Increasingly, individual private shareholders are asking questions of the statutory auditor at AGMs, querying issues such as the scope of the statutory audit and the approach it has taken in relation to particular aspects of the financial statements.

During the course of 2020, it will become clearer which of the proposed reforms to the statutory audit market will be taken forward by government and regulators. What is clear is that the statutory audit process is becoming more and more challenging for corporates to navigate, a trend that is only likely to continue. ■