

## CMA PROPOSALS TO REFORM THE STATUTORY AUDIT MARKET

The future of auditing and of audit firms is very much in the spotlight at the moment and this has potentially far reaching implications for companies and their boards and Audit Committees. The Competition and Markets Authority (CMA) has recommended that the Government legislates to empower a new regulator, the Audit, Reporting and Governance Authority (ARGA) (which will replace the Financial Reporting Council (FRC)) to scrutinise and hold to account Audit Committees and to require FTSE 350 companies to be subject to a joint audit by two audit firms (one of which must not be one of the 'Big Four' accountancy firms). It has also proposed a major shake-up of audit firms with the operational separation of audit and non-audit activities.

On 18 April 2019, the CMA published its [final report](#) (together with a [summary](#)) setting out recommendations to address what it has identified as serious competition issues in the UK audit industry. The final report follows the CMA's [update paper](#) on its market study of the statutory audit market in the UK that it undertook last year, which proposed legislative amendments to address competition concerns in the audit industry. The final report follows the CMA's consultation on its update paper and takes into account the recommendations of Sir John Kingman following his [independent review of the FRC](#) last year. Separately, Sir Donald Brydon has been commissioned by the Government to conduct an [independent review](#) into the quality and effectiveness of audit in the UK.

The CMA's recommendations are part of a wholesale review of the audit market following the high-profile failures of companies such as Carillion and BHS. The CMA acknowledges that audits by audit firms are not expected to prevent company failures, but it is of the view that audits should act as part of the warning system as to the financial performance of a company.

The CMA is also concerned about the lack of resilience of the audit sector because it is particularly vulnerable if one of the Big Four audit firms collapses and the current lack of choice and competition in the audit industry. Its recommendations include:

- greater scrutiny, and increasing accountability, of Audit Committees through enhanced regulatory oversight;

### Key issues

The CMA's final report on its statutory audit services market study sets out several recommendations for reforming the audit market including:

- greater scrutiny of Audit Committees
- mandatory joint audits
- measures to mitigate against the failure of one of the Big Four
- an operational split in audit firms between audit and non-audit services
- a five-year review of progress by the new regulator

- a new requirement for mandatory joint audits;
- measures to mitigate the effect of the demise of one of the Big Four;
- an operational split within audit firms between audit services and non-audit services; and
- a five-year review by the regulator following the full implementation of the CMA's proposals.

Implementation of these reforms requires Government legislation, including to replace the FRC with the ARGA.

### **What is the ARGA and what other developments are there in the audit sphere?**

On 11 March 2019, Business Secretary, Greg Clark, [announced](#) that the FRC will be replaced by the ARGA and, on the same day, the Department for Business, Energy & Industrial Strategy launched an initial [consultation](#) (which closes on 11 June 2019) on the recommendations made by Sir John Kingman in his independent review of the FRC which included a recommendation in favour of this change.

The ARGA will be an independent statutory body, accountable to Parliament, with a new mandate, new leadership and new powers, including enforcement, corporate reporting and corporate governance review. It will have a duty to promote competition and innovation and 'an overarching duty to promote the interests of consumers of financial information, not producers'.

The [BEIS committee report on the future of audit](#), published on 2 April 2019, recommended that legislation to replace the FRC with the ARGA be introduced in the next Parliamentary session.

In its final report, the CMA supports the creation of the ARGA and many of its recommendations rely on the additional powers that the ARGA would have.

In addition to the Sir John Kingman and CMA reviews, Sir Donald Brydon's independent review into the quality and effectiveness of audit is currently underway. That review examines, among other things, the scope and purpose of an audit, what the standards and requirements for UK audit firms should be going forward, possible reforms and the audit 'expectation gap', i.e. the difference between what people think an audit does and what, in reality, it does. A [call for views](#) was launched on 10 April 2019 and remains open until 7 June 2019.

### **Details on the CMA's key proposals**

#### ***Audit Committee scrutiny***

The CMA is concerned that companies, acting through their boards and Audit Committees, choose their own auditors. Therefore, the CMA is proposing that Audit Committees should be subject to greater scrutiny by the ARGA which should increase their accountability. Audit Committees should focus their selection and oversight of auditors on audit quality which should also assist in mitigating any bias against non-Big Four firms.

The CMA recommends that the Government legislates to empower the ARGA to:

- mandate minimum standards for the appointment and oversight of auditors;

- monitor compliance with such standards — together with the ability to require information and/or reports from Audit Committees and, if necessary, place an observer on an Audit Committee; and
- take remedial action where Audit Committees have failed to meet the minimum standards regarding the appointment and oversight of auditors or failed to co-operate with / report to the ARGA — remedial action could include making direct statements to shareholders where the ARGA is not satisfied with the relevant Audit Committee, issuing public reprimands, ordering audit re-tendering or suggesting changes to the Audit Committee Chair.

The CMA also encourages enhanced engagement between Audit Committees and shareholders e.g. by requiring greater transparency on audit fees and requiring the auditor to present at the company's annual general meeting.

Although the CMA decided not to pursue the far more radical option of transferring the responsibility of appointing an auditor from Audit Committees to an independent body because of legal barriers, this is still a possible option for future reform should the current proposals fail to achieve the CMA's goals.

#### **Mandated joint audits and peer review**

The CMA is recommending that FTSE 350 companies be subject to a mandatory requirement for a joint audit by at least two audit firms, including at least one non-Big Four firm. The CMA recommends that exceptions to this joint audit regime should (initially at least) include where a company appoints a non-Big Four firm as its sole auditor or where it is more appropriate for peer review instead of the audits of some of the largest and most complex companies (see below).

Under a joint audit system, both audit firms would divide the work between themselves, check each other's work, be jointly and severally liable and sign the audit opinion. The CMA sees this as having significant benefits over shared audits with the firms dividing up the work and having several responsibility.

The CMA recommends that the Government legislates to give the ARGA flexible powers to implement a joint audit regime, and that such regime be adapted over time.

Joint audits are intended to enable firms outside of the Big Four to develop the capacity, capability and reputation to review the UK's largest companies and thereby lead to greater choice and competition for the audits of large companies, which should, in turn, increase audit quality. The CMA notes that in France, joint audits are mandatory, and the system operates effectively to reduce the concentration of audits of the largest companies by the Big Four.

However, in the UK, very few non-Big Four audit firms have exposure to auditing listed companies and they would face significant practical challenges, including lack of capacity and experience, in auditing FTSE 350 companies, albeit jointly with one of the Big Four firms. The CMA has proposed that FTSE 350 companies be required to appoint a joint auditor when their next audit tenders arise, the dates of which will vary from company to company. This 'staggering' should enable the non-Big Four firms to cope with additional workload — non-Big Four firms would be exposed to such work gradually, on a staggered basis, enabling them to build their capacity and expertise adequately.

The CMA recommends that the ARGA monitor the effectiveness of the joint audit regime and be empowered to adapt the regime over time, potentially ending the regime at some future date if there is greater choice and resilience in the audit market, i.e. when there is a sufficient number of additional audit firms with the capacity to effectively challenge the Big Four for audit work for the largest companies.

Regarding peer review, the CMA recommends the ARGA should have the power to appoint peer reviewers for FTSE 350 companies not falling within the scope of joint audit. In particular, the CMA suggests that peer reviews may be more appropriate than joint audit for the largest and most complex companies. It sees this system as keeping the appointed statutory auditor 'on its toes' while exposing non-Big Four firms to more complex companies than they audit currently.

The peer review is proposed to be a 'real-time' review, reportable to the ARGA only. The peer reviewer should not:

- be a Big Four firm, except in exceptional circumstances at the ARGA's discretion (e.g. where a non-Big Four firm is the sole auditor); or
- sign the audit opinion or be liable for the accuracy of the accounts.

The CMA also considered, but rejected, the option of a market share cap as an alternative way to break down the barriers to non-Big Four firms. The CMA highlights that while share caps present certain problems (e.g. they may lead to 'cherry-picking' of the lowest-risk and highest-profit audit clients by the Big Four which could undermine overall audit quality and the position of non-Big Four firms), this option may be a future solution if the current proposals fail to deliver.

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

The CMA sees that the primary way of mitigating the risk and impact of a Big Four firm failing is to increase the number of credible audit firms and it sees the joint audit proposal as being key to this. In the meantime, the CMA wishes to preserve auditor choice and, in the event of a Big Four firm approaching failure or being in distress, it would want to limit the extent to which clients and staff of that firm move to another Big Four firm, thereby increasing concentration in the audit market further. Instead, the CMA would prefer for clients of the failing or distressed firm to be transferred to a new firm or a non-Big Four firm or remain with the same firm during a turnaround.

The CMA recommends that the ARGA be given powers to monitor the health of audit firms to act as an early warning of any imminent demise and to intervene where necessary.

#### ***Operational split between audit and non-audit services***

The CMA is concerned that audit firms are increasingly concentrating on the provision of more lucrative non-audit services at the expense of the quality of audits and with a reduction in choice and competition. The provision of both audit and non-audit services is also seen as potentially resulting in conflicts of interests which prevent the firm from competing in audit tenders.

The CMA considered both structural and operational separation options but recommends at this stage an operational split initially for only the Big Four in the UK and recommends that the ARGA should be empowered to design the specific details and amend them over time.

However, the CMA has indicated that key elements are likely to include:

- no profit sharing between the audit and non-audit practices;
- a separate CEO and board (the majority of which are to be independent non-executives) for the audit-practice answerable to investors of audited companies and to the public interest via the ARGA; and
- transparent transfer pricing over the use of non-audit specialists (e.g. tax) on audits.

In addition, a 'cooling-off' period could be introduced following the cessation of an auditor's tenure during which time it would be prohibited from conducting any non-audit work for the company.

If the proposed operational split does not achieve the intended results, the option of a structural split may be revisited in the future.

#### ***Five-year review of progress by the ARGA***

The CMA recommends that the ARGA reviews the progress of the effectiveness of the reforms five years from full implementation. In particular, the ARGA should consider:

- whether to require independent appointment of auditors, depending on the effectiveness of the regulatory scrutiny of Audit Committees — the CMA notes that this would require departure from EU legislation;
- whether a structural split between audit and non-audit services provided by audit firms is required, depending on how effective the operational split has been; and
- how to fine-tune the joint auditor regime and adapt it to market developments.

The CMA is pressing for early implementation of its recommendations but the precise timeframe remains unclear.

#### **Are there any actions you need to take now?**

The specific details of any upcoming changes will be set out in legislation, which may of course differ from the CMA's proposals and which will be the subject of consultation. While there are not any preparatory steps that need to be taken at this stage, proposed reforms in this area should serve to remind Audit Committees of their duties and responsibilities when appointing or re-appointing auditors. Audit Committees will be subject to scrutiny by the ARGA when it comes into existence and should use this time for self-reflection and evaluation: How have they been performing to date?

Audit Committees should continue to ensure that auditors are selected on merit and consider the quality of audit: Is the Audit Committee satisfied with the provision of audit services by the current auditor? Has there been adequate transparency as to audit fees (e.g. audit hours, staff mix and rates per hour)? Does the Audit Committee adequately challenge the appointed auditor? Are non-Big Four firms given the opportunity to compete on a level playing field in audit tender processes?

FTSE 350 companies should check when their next audit tenders are due and:

- be prepared to appoint either two audit firms (one of which should be a non-Big Four firm), or a non-Big Four firm as the sole auditor; or
- be aware that even if the company falls outside the scope of the joint auditor requirement, the audit may be subject to peer review (however, this will be of primary importance to the audit firm rather than the company

being audited, but the cost of the peer review would be borne by the company being audited).

#### **FURTHER INFORMATION**

For further information about any of the issues discussed above, please contact either your usual Clifford Chance contact or any of the authors of this briefing. You can also find additional information on some of the matters referred to above, in the briefing linked to below:

[Your 2019 AGM update and beyond](#) (14 January 2019)

## CONTACTS

**David Pudge**  
Partner

**T** +44 207006 1537  
**E** David.Pudge  
@cliffordchance.com

**Kath Roberts**  
Knowledge Director

**T** +44 207006 1308  
**E** Kathryn.Roberts  
@cliffordchance.com

**Robert Crothers**  
Partner

**T** +44 207006 1427  
**E** Robert.Crothers  
@cliffordchance.com

**Kavita Bassan**  
Senior Associate Knowledge Lawyer

**T** +44 207006 5826  
**E** Kavita.Bassan  
@cliffordchance.com

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London, E14 5JJ

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