

BEIS RESPONDS TO CMA'S PROPOSALS TO REFORM THE STATUTORY AUDIT MARKET AND LAUNCHES CONSULTATION

The Department for Business Energy & Industrial Strategy (BEIS) has published its [initial consultation](#) on the recommendations made by the Competition and Markets Authority (CMA) to improve competition and resilience in the statutory audit market as set out in its [final report](#) published in April 2019.

The CMA's proposals for reform represent one strand of BEIS' endeavour to strengthen and improve the quality and regulatory oversight of the audit market in the UK and sit alongside the recommendations made by Sir John Kingman following his [independent review of the Financial Reporting Council \(FRC\)](#) and Sir Donald Brydon's [independent review into the quality and effectiveness of audit](#).

The briefing looks at BEIS' response to the CMA's proposals and the key areas on which it is now consulting.

Key CMA recommendations

One of the key recommendations coming out of the Kingman Review was the need for a new independent regulator with clear statutory powers and objectives (the Audit, Reporting and Governance Authority (ARGA)).

The CMA's recommendations rely on the establishment of the ARGA who will administer the CMA's recommendations which include:

- enhanced regulatory scrutiny of audit committees
- mandatory joint audits of FTSE 350 companies
- measures to mitigate against the failure of one of the Big Four
- an operational split in audit firms between audit and non-audit services

For details on the CMA's proposals, see our client briefing [CMA Proposals to Reform the Statutory Audit Market](#).

Key issues

BEIS has published its initial consultation on, and seeks views on, the CMA's proposals for reforming the statutory audit market, including:

- enhanced regulatory scrutiny of audit committees
- mandatory joint audit of FTSE 350 companies or peer review
- measures to mitigate against the failure of one of the Big Four
- operational split between audit and non-audit practices in audit firms
- other possible measures, such as improving information for shareholders and increasing transparency of audit committees and amending requirements on PIEs in relation to audit tendering and auditor rotation periods

The consultation closes on 13 September 2019.

BEIS response to CMA recommendations

The consultation paper sets out BEIS' response to the CMA proposals and seeks views on the effectiveness and impact of those recommendations.

Audit Committee scrutiny

The CMA recommends that the role and effectiveness of audit committees should be subject to greater scrutiny by the new regulator to ensure that audit committees select auditors based on quality of audit rather than any other criteria.

In its response, BEIS states that it agrees with the CMA that the audit committee plays an important role, that there should be clear expectations and standards for audit committees to ensure they deliver the best results for shareholders, and that there should be a role in this for the regulator.

In particular, BEIS is seeking views on whether respondents agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, monitor compliance with such standards (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 (which could include making direct statements to shareholders where the new regulator is not satisfied with the relevant audit committee, issuing public reprimands, ordering audit re-tendering or suggesting changes to the audit committee chair). It is also seeking views on the nature of such powers and how they would sit alongside the proposals in the Kingman Review. BEIS also asks how the regulator should engage with a company's shareholders in monitoring compliance and taking remedial action.

Mandatory joint audit and peer review

The CMA recommends the introduction of a mandatory joint audit regime for FTSE 350 companies (subject to certain exemptions), under which the company would be subject to audit by at least two audit firms (responsibility for the audit opinion and audit liability would be shared by the auditors), one of which must be a non-Big Four firm. The CMA believes that the introduction of such a regime should address concerns regarding a lack of choice and competition within the audit market and remove barriers to challenger firms and increase credible auditor choice. The CMA acknowledges that audit fees would increase as a result of the joint audit regime, but believes that the cost increase is proportionate to the objectives of the proposed new regime.

In addition, the CMA envisages that where a FTSE 350 company falls outside the scope of the joint audit regime (e.g. because of complexity issues), the new regulator should have the power to appoint peer reviews of audit engagements of such companies. The peer reviewer would come from one of the challenger firms but the firm would not be required to sign the audit opinion, nor be liable for the accuracy of the accounts. The cost of any peer review would be borne by the company being audited.

BEIS acknowledges the importance of providing meaningful and effective competition and choice for audit clients in the statutory audit market and that previous reforms have not significantly enhanced competition.

In particular, BEIS is seeking views on whether respondents agree with the joint audit proposals and whether challenger firms currently have the capacity to provide joint audit services to FTSE 350 companies and, if not, how quickly expertise could be built to enable joint audit to be practiced across the whole of the FTSE 350. BEIS is also seeking views on whether the joint audit

proposal is likely to lead to increased costs for companies of approximately 25-50% (as cited in the CMA's report).

Measures to mitigate against the failure of one of the Big Four

The CMA recommends that the new regulator be given powers to obtain the information necessary to monitor the health of audit practices and intervene where a firm is likely to fail, which should help to increase market resilience.

BEIS agrees with the CMA that there is more that the regulator could do to monitor and act on the health of audit firms, especially while the statutory audit market remains so concentrated and that it is eager to implement a monitoring function that supports the market effectively. BEIS is seeking views on the factors that the regulator should take into account when considering action in the case of a distressed statutory audit practice and the powers of intervention that the regulator should be granted.

Operation split between audit and non-audit practices

The CMA's recommendation of an operational split between an audit firm's audit and non-audit practices aims to ensure that auditors focus on conducting high quality audits (as the CMA believes that audit firms have been more focused on the greater revenue and profits that are generated by the provision of non-audit services).

In its response, BEIS states that it recognises the high risk of actual and perceived conflicts of interest that can occur where audit firms provide non-audit services to their audit clients which is why the UK implemented the EU's Audit Directive to increase restrictions on provision of non-audit services by audit firms to public interest entities (**PIEs**). BEIS also acknowledges that due to the multi-disciplinary nature of the Big Four, they can be prevented from tendering for a company's audit because of past consultancy work they have undertaken which further reduces choice for clients.

As part of the consultation, BEIS is seeking views on whether respondents agree with the CMA's analysis of the impacts on audit quality arising from the tensions it identifies between audit and non-audit services and ask for views on the manner and design of the operational split recommended by the CMA.

Other possible measures

In its final report, in addition to the core recommendations considered above, the CMA noted several other measures that it had considered which may merit further consideration, including:

- measures to improve information for shareholders and increasing transparency of audit committees, in particular during tendering — possible measures include disclosure of audit staff hours and fee breakdowns; and
- requirements on tendering and rotation periods — while PIEs are currently required to carry out an audit tender at least every ten years and to change audit firm at least every 20 years, the BEIS Select Committee recommended (in its report, [The Future of Audit](#)) that the CMA revisit the frequency of audit rotations, which should be reduced to seven-year non-renewable terms which can only be terminated in exceptional circumstances so as to disrupt the familiarity that can arise between the auditor and the audited company over a long audit tenure.

BEIS will consider these and other recommendations (which are of relevance to audit firms rather than companies, such as liberalisation of audit firm ownership rules), alongside the CMA's core recommendations, and seeks

views on whether respondents agree with the CMA's suggestions noted above, how they would interact with the CMA's core recommendations and what impact they would have on the market.

Next steps

Given the overlapping subject matter of the Kingman, Brydon and CMA reviews, it is reassuring to note that in the introduction to the consultation, BEIS states that it intends to take forward a set of proposals which draw on all three of these reviews, in order to build a coherent regulatory framework for the statutory audit market in the UK.

The paper also states that, following this consultation, it is BEIS' intention to bring forward detailed proposals later this year, in addition to further consultation on the detailed FRC review recommendations.

It is also worth noting that in the Foreword to the consultation, there is also a call for proposals from the audit sector outlining what they believe could be done to address the CMA's concerns on a voluntary basis prior to legislation.

The consultation paper itself sets out 32 questions and seeks views on each of the core CMA proposals (including the proposed remit of the new regulator's powers in the context of those proposals) and other measures which do not form part of the CMA's core recommendations.

The consultation closes on 13 September 2019. Companies may wish to respond to the consultation to ensure that their views are included so as to inform BEIS of their position.

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 find additional information on the CMA's proposals in the briefing linked to below:

[CMA Proposals to Reform the Statutory Audit Market](#) (24 April 2019)

CONTACTS

David Pudge
Partner

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

Robert Crothers
Partner

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

Kath Roberts
Knowledge Director

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

Kavita Bassan
Senior Associate Knowledge Lawyer

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

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street,
London, E14 5JJ

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London, E14 5JJ

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