



# Audit profession – a year of reflection

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In this legal update we look back at some of the key developments for the audit profession in 2018 and consider what the rest of 2019 may hold for the industry.

## 2018 – A year to forget?

The start of 2018 saw the FRC subject to criticism from the Department for Business, Energy & Industrial Strategy (BEIS) and Work and Pensions Committees. Chief Executive for the FRC, Stephen Hadrill, faced some difficult questions having been on the receiving end of accusations from MPs suggesting the Financial Reporting Council (FRC) was “toothless” and “ineffective”. This early exchange brought into focus the question: what is the role of both auditors and the FRC?

The first quarter of 2018 was also a testing time for the Big Four accountancy firms following the collapse of Carillion in January 2018. KPMG had been Carillion’s auditor since its inception in 1999 and the extreme circumstances of the company’s demise inevitably resulted in the public spotlight being turned on KPMG. The FRC duly announced an investigation, which is ongoing.

The International Standards on Auditing (UK and Ireland) (ISA) provide that an auditor’s objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. The enquiries into the practices of the Big Four in 2018 brought into question the level of enquiries that should be made into a company’s accounts. As former chairman of KPMG (and founding chairman of the Financial Conduct Authority) John Griffith-Jones reported in an interview to the ICAEW back in [2012](#),

*“You can’t check 100% of everything. This is where trust and the nose come together. There has to be a reliance on the client up to a point. There is a degree of honesty that you have to take for granted. This nose is for when something is wrong, or if there is something you can’t pin down about someone. But just as detectives don’t solve every crime, you’ll never get 100% detection of fraud.”*

In March of last year the dominance of the Big Four was highlighted by fifth largest accountancy firm, Grant Thornton’s, strategic decision to withdraw from the auditing of FTSE 350 companies. This was said to be down to the “competitive landscape” and that the firm was finding it “extremely difficult to penetrate the market in its current form”. The Big Four was reported by the ICAEW last year as auditing 97% of the FTSE 350 companies. This dominance has not passed unnoticed. However, as we consider in more detail below, 2018 may have been a catalyst for change.

The summer of 2018 saw the FRC take action against another of the Big Four (Deloitte) and awarded a fine against the lead audit partner in connection with the audits of BHS and the Taveta Group. PwC was fined £10m but reduced the fine to £6.5m for early settlement in connection with its audit of BHS. The senior auditor was fined £350,000 and has been removed from the register of statutory auditors for 15 years. The fallout from the collapse of BHS had been widely publicised given the company’s £570m pension deficit at the time of its collapse.

## Any comments or queries?

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However, in a statement released by PwC last year, those carrying out the audit and not the audit process itself was said to be at fault, noting,

*“We have agreed this settlement, recognising that it is important to learn the necessary lessons. At its core this is not a failure in our audit methodology, the methodology simply was not followed.”*

This statement sought to distinguish the normal practices of the accountancy firm from the individual steps taken by those involved in the BHS matter. It also seems apparent that the Big Four firms have not sought to place the blame for the recent events upon the legislative perimeters within which they operate. This also appeared to be echoed by the FRC in its [assessment](#) of audit quality in June 2018.

The issue surrounding the Big Four’s dominance in the auditing market was also brought into focus again in July of last year. The Bank of England commented at the start of July that there was “an issue with the ever more concentrated pool of large auditors”. Listed firms are required to “rotate” their auditors at least every two decades and it seems that only the Big Four firms are perceived as having the capabilities to offer a global basis by which to offer their auditing services. Sharing some of the work on a large audit to a smaller audit firm (known as “top-slicing”) as an alternative has, however, been [criticised](#).

In autumn of last year it was widely publicised that the company that owned Patisserie Valerie was considering taking legal action against its auditors for an alleged failure to identify “secret” company bank overdrafts to the sum of £9.7m. It was also around this time that Patisserie Valerie’s Finance Director was arrested following the company’s discovery of “significant and potentially fraudulent” accounting irregularities.

October of 2018 also saw the Competition and Markets Authority (CMA) launch a review into the auditing professions following concerns as to whether the sector is sufficiently

competitive to maintain high standards. The FRC in support of this review in a press statement noted,

*“We have expressed concern about concentration at the top of the audit market so we welcome this announcement. It is essential that there is widespread confidence in the quality of company audit in UK.”*

Some commentators have suggested that the small concentration of firms within the Big Four has meant that the regulator’s powers of penalising offending firms have been hampered. Liz Murrall, director of stewardship and reporting to the Investment Association commented last year that,

*“There is a serious risk with such a small pool of auditors dominating the market that regulators feel unable to impose significant sanctions without risking driving one of the key players out altogether. The prospect of the Big Four becoming the Big Three risks [is] making the audit sector too big to fail.”*

A week before Christmas the CMA released its review paper which set out a number of proposals that would aim to improve the “independence” and “quality of audits”. The CMA identified a number of reasons why it considered there had been a decline in audit quality. Some of the key issues identified were as follows:

- As companies are able to choose their own auditors the CMA considered there was evidence of companies picking those auditors “with whom they have the best ‘cultural fit’ or ‘chemistry’ rather than those who offer the toughest scrutiny”;
- Somewhat predictably, the Big Four’s dominance in conducting over 95% of the audits of the biggest companies was a key concern; and
- The review also suggested that auditors’ focus on quality appears diluted by the fact that at least 75% of the revenue of the Big Four comes from other services like consulting.

The CMA's proposals include separating audit from consultancy services, introducing measures to increase the accountability of those chairing audit committees in firms and imposing a "joint audit" regime giving those firms outside the Big Four a role in auditing the UK's biggest companies.

The most significant proposal is to separate the audit and advisory arms of the largest firms. The CMA suggests that, "to get higher quality, auditors should focus exclusively on audit – not on also selling consulting services". This assessment is based on the assumption that the reason for the perceived decline in audit quality is due to a lack of focus. Some critics suggest that the decline is not down to a lack of "focus", but that the existing independence rules are not enough to avoid creating unintentionally a culture where it does not pay to ask too many probing questions. The concept of "professional scepticism" forms part of the ISA rules which expects auditors to "exercise professional judgment and maintain professional scepticism throughout the planning and performance of the audit". It remains to be seen whether the CMA's (or the critics') diagnosis of the problem is correct and whether the proposed changes will result in auditors exercising a greater degree of professional scepticism.

The CMA proposes a structural break-up of the Big Four whereby the firms' audit and non-audit services are split into separate operating entities. These entities would have separate management and accounts. The additional transparency this would introduce might lead to more informed debate as to the appropriate framework for audit regulation and concomitant sanctions. This proposal may also alleviate the perception of the close relationship between the Big Four's audit and non-audit services. No doubt some may argue that such separation is likely to be somewhat artificial in practice if the separate operating arms ultimately remain part of the same company group, but equally pushing separation too far may lead to audit firms that are less financially robust.

Another outcome could see the Big Four move away from providing both audit services and consultancy services to some of their existing clients altogether. In November of last year KPMG and Deloitte indicated they will no longer carry out non-essential consultancy work for the UK's largest companies if they are also auditing them. KPMG's chairman noted that this was in an effort to "remove even the perception of a possible conflict" of interest. This may result in difficult decisions being taken as to where the future of professional services firms lies.

It will also have to be seen whether the proposed separation of services may give those firms that had withdrawn from auditing FTSE 350 reason to re-engage with the tendering purpose for audits of the UK's largest companies.

### The FRC comes under fire

The end of 2018 brought the FRC's role and powers into focus following the publication of the [Kingman Review](#). On 18 December an independent review of the FRC led by Sir John Kingman released a critical appraisal of the regulator labelling it as a "hangover from a different era". The review criticised the FRC for having followed instructions from successive governments to rely on professional self-regulation to the maximum extent possible. The FRC has also been criticised for having failed to establish a relationship with the senior decision-makers in the investor community which was not "of the depth or breadth" expected of a regulator.

The paper lived up to its promise of being a "root-and-branch" review of the FRC resulting in 83 recommendations. The most significant proposal was that the FRC should be replaced by a new regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers. The new regulator would be called the "Audit, Reporting and Governance Authority". The review made clear that the proposed changes could not be achieved without the implementation of new legislation.

The report did not pull any punches when it came to commenting on the FRC's current inadequacies with a number of analogies to explain these concerns. For example the report noted:

*“What this spotlight has revealed is an institution constructed in a different era – a rather ramshackle house, cobbled together with all sorts of extensions over time. The house is – just – serviceable, up to a point, but it leaks and creaks, sometimes badly. The inhabitants of the house have sought to patch and mend. But in the end, the house is built on weak foundations.”*

One of the fundamental concerns with the FRC was that the body has only recently come to be seen as a regulator at all and it is unique among the major UK regulators in that it has no meaningful statutory base. This is said to have created an environment whereby some of the largest economic actors in the UK “are still regulated not by an independent body but, in effect, by their trade association”.

The main recommendations from the report in addition to the proposal for an entirely new regulator include:

- The duty of the new regulator should be to promote the interests of consumers of financial information and not those companies which are being audited;
- A new board shall be created which will exercise “significantly stronger ownership and oversight of the regulator’s investigation and enforcement functions”;
- The new regulator will need to work towards a position where independent audit quality and inspection reports are published in full upon completion of Audit Quality Reviews; and
- The regulator will move from being funded on a voluntary basis and a statutory levy should be put in place.

### What can we expect to see for the audit profession this year?

The start of 2019 has continued where 2018 left off following reports that the FRC monitored Patisserie Valerie’s audit 6 months prior to the business identifying issues with its accounts. The FRC commented that, the “audit of Patisserie Valerie was selected as part of our routine monitoring activity and completed before the company itself identified ‘potentially fraudulent, accounting irregularities’”. However, this recent development is likely to place further pressure for reform to be implemented following the Kingman Review’s proposal to ensure a new regulator has greater powers.

We anticipate that the auditing profession will remain in the spotlight this year as we see the fall out of the CMA and the Kingman reports. It is notable that the BEIS Committee has opened a consultation seeking views on the recommendations as set out in the Kingman Review to create a new regulator. The real question is likely to be whether the Government will have the time (or appetite) whilst Brexit remains up in the air to implement some of the wide scale changes that the recent reviews into the auditing profession have called for. It does seem that the FRC is on borrowed time and that at the very least some of the 83 recommendations put forward in the Kingman review will be implemented sooner rather than later.

The outcome of Brexit will also have an impact on the audit profession. For instance, those auditors of UK PLCs with a presence in Ireland are likely to face turbulent times over the next 12 months depending upon the outcome of the UK’s post-Brexit relationship with the EU. In January this year Ireland’s accounting watchdog is understood to have written to the largest audit firms in the UK encouraging them to prepare for a “no-deal” Brexit. Notably, the Irish Auditing and Accounting Supervisory Authority has made clear that

a hard Brexit will result in UK audit firms becoming classed as “third country” auditors in Ireland. As a result these firms will have to register with the Irish authorities to continue the auditing of Irish based companies.

The start of this year has also seen agreement between leaders of the Big Four that their audit work is “not good enough” as [reported](#) by the ICAEW. Before the BEIS committee senior members of the largest accountancy firms indicated they could see the benefits of a number of recommendations as set out in the Kingman Report and the proposals as set out in the CMA’s review. There was also a broad consensus that a market share cap may be a workable idea. In addition, it seems that all of the Big Four are likely to follow KPMG’s approach of no longer performing non-essential non-audit work for their FTSE 350 audit clients in the future.

The developments of 2018 have created a situation whereby the audit profession has been forced to take a sobering look at itself. Both the FRC and the Big Four firms have faced criticism for their approach to audits. However, the next question is what steps will be taken to address these criticisms. It was suggested during the recent BEIS Committee meeting there is now a “once-in-a-generation” opportunity to improve the audit market. We will have to watch this space as to whether 2019 is a year of change.

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