

BEIS White Paper on Audit Reform

Implications for Audit Firms and Auditors

In this publication, we focus on the regulatory implications particularly for mid-tier audit firms and auditors arising from the Secretary of State for Business, Energy and Industrial Strategy's (BEIS) recent consultation, entitled "[Restoring trust in audit and corporate governance \(the "white paper"\)](#)". The consultation is open for responses until 8 July 2021.

The proposals contained within the white paper are detailed and wide-reaching. We will be responding to the white paper to set out our views on the proposals' implications. We would strongly encourage those affected in any way by the proposals to submit their views, as many of the suggestions need further consideration and considerable elaboration on how they would work in practice.

The white paper makes several proposals which will have significant ramifications for the audit profession as a whole. We focus specifically, however, on how some of the proposals will impact not only the regulatory obligations of mid-tier audit firms, but also how in practical terms, it seeks to change the way they practise. Relevant sections of the white paper are referenced throughout.

More mid-tier firms entering the PIE market

The white paper proposes to extend the definition of Public Interest Entities (PIEs) in one of two ways (**section 1.3**), either

1. to include large non-listed companies which have more than 2,000 employees (or a turnover of more than £200 million and a balance sheet of more than £2 billion); or
2. to include large companies with over 500 employees and a turnover of more than £500 million.

Both options will have the effect of expanding the PIE market to incorporate a much larger number of companies. In addition, the white paper is seeking views on whether the PIE market should be expanded further to include AIM companies, private companies listed on a regulated market, Lloyd's Syndicates, and third sector companies.

Currently it is estimated that around 30 audit firms carry out PIE audits. Focusing on the options provided in the white paper, if option (1) is implemented, the number of firms will increase to approximately 120 firms, and under option (2), the number will increase to approximately 50 firms. Either option will therefore mean a greater number of audit firms will fall within the net of the new regulator (the Audit, Reporting, and Governance Authority; ARGA).

This will of course present a significant change predominantly for mid-tier firms that are new to the PIE market and one that will require them to carefully review their future plans. For firms that have previously opted to avoid the PIE market because of the additional level of regulation that comes with it, a proposal which will inadvertently push them into the market may raise concerns. However, it is hoped that rather than acting as a deterrent to these firms, the expansion of the PIE market will instead be viewed as creating an opportunity to learn, develop and grow, and ultimately to break into a market once heavily ring-fenced to the top few firms.

Introducing the Corporate Auditor - an extension of regulation or an exciting new development?

One of the key proposals underpinning the white paper is the widening of the current definition and scope of audit to include, in addition to statutory audits of financial statements, non-statutory 'wider audit' services, which may encompass services provided by audit firms and auditors relating to a PIE's Audit and Assurance Policy. These may include audits of the PIE's internal controls, cyber processes, or culture. The white paper refers to this wider definition of audit as Corporate Auditing (**section 6.2**).

In line with this idea of a unified Corporate Auditing profession, the white paper further proposes a list of Principles that should apply to Corporate Auditors (**section 6.3**), with the intention that these will be statutorily binding to both statutory auditors and those providing 'wider audit' services, and will be enforceable by ARGA. Aside from having statutory footing, the new Principles are more specific than the ethical Fundamental Principles which currently apply to members of the professional accountancy bodies, and which the FRC currently refers to when imposing sanctions.

Proposals are also made to establish a new (and single) professional body for Corporate Auditors (**section 6.9**). This will change the current regulatory framework significantly – currently, all auditors have to possess an audit qualification from one of the 5 professional accountancy bodies as Recognised Qualifying Bodies, and firms must likewise be registered with one of the 4 Recognised Supervisory Bodies. The white paper suggests a single professional body that is focused solely on Corporate Auditors will increase cohesion across the profession and simplify oversight of competency and training, ensuring consistency in standards is achieved.

Altogether, these proposals seek to draw a more pronounced dividing line between audit and accountancy by creating a separate audit profession, and indeed one that is much wider than it is currently. This will have practical consequences.

Particularly relating to the proposed establishment of a new professional body, the proposals suggest a removal of some of the functions of the current professional accountancy bodies, concerning training and the setting of skills and competency standards. ARGA is proposed to have responsibility for the approval and registration of audit firms and auditors that provide Corporate Auditing services to PIEs (**section 9.1**). This function is currently delegated by the FRC to the professional accountancy bodies, and the proposals seek to reclaim this.

These proposals will not affect members of the professional accountancy bodies that do not provide Corporate Auditing services to PIEs; however, the expansion of the definition of a PIE will mean a greater number of mid-tier audit firms may find themselves falling within the new Corporate Auditing profession. In practical terms, this appears to suggest that those firms will have to seek approval and registration from both their professional accountancy body (for their non-PIE services) and from ARGA (for their services to PIEs), while also maintaining membership of their professional accountancy body (for their non-PIE services) and the new professional body (for their PIE work). This seems to be excessively complicated, and may lead to two-tier regulation. This is a particular area of the white paper in relation to which further thought needs to be given as to how this will work in practice.

A greater duty to prevent and detect fraud

The detection of fraud has been firmly on the government's agenda when deciding upon what measures should be put in place as part of the review of audit. As part of a package of measures to detect fraud, the government proposes to legislate to require directors of PIEs to report on the steps they have taken to prevent and detect material fraud, when preparing a company's accounts. As a further step in the pack of measures, it is suggested that auditors of PIEs, as part of their statutory audit, should report on the work they performed to conclude whether the proposed directors' statement regarding actions taken to prevent and detect material fraud is factually accurate (**section 6.4**).

This duty is in addition to the specific obligations placed upon auditors in the 2021 revised International Standard on Auditing (UK) 240 (ISA 240). Indeed, the revision of this standard is referred to in the white paper as an action which the FRC has already consulted on and implemented. We of course do not as yet know how extensive the legislative change in relation to fraud detection will be; that will become clear after the close of the consultation period, when the government finalises its views on what features it has suggested should be encapsulated in the new statutory regime. Notwithstanding this, firms should now be focussed on the steps detailed under the revised ISA and the white paper proposals, and should be ensuring that their procedures are sufficient, given that fraud detection, and the adherence to the revised ISA are very likely to be the subject of AQR or QAD reviews in the future.

The managed shared audit requirement

An estimated 97% of audits of FTSE 350 companies are carried out by the Big Four firms. While mid-tier firms do operate in the PIE market, their share of it is significantly smaller. One of the core underlying aims of the white paper is to create greater competition in the PIE market and break down the monopoly of audits being carried out by the Big Four. To some extent, the white paper seeks to do this by expanding the definition of a PIE, which we talked about earlier. But as we saw, this will expand the PIE market, but will not necessarily increase competition for the audits of the largest firms, which have fallen within the domain of the Big Four for a long time. To create a bigger opening of the PIE market to mid-tier firms, the proposals suggest something more radical – a new managed audit regime (**section 8.1**).

This proposed regime aims to give FTSE 350 companies greater choice in their auditors and support mid-tier firms entering the FTSE 350 audit market. It will allow a 'challenger firm', being one that provides statutory audits to PIEs and whose audit revenues in the previous two years did not represent 15% of the FTSE 350 audit market, to be appointed alongside a larger audit firm which will lead the audit and bear its overall liability. The role of the challenger firm will be to conduct a meaningful proportion of the statutory audit, for example, by auditing one or more of a PIE's subsidiaries. Where a company has opted to be solely audited by a challenger firm, the regime will not apply.

The regime will of course come with additional regulatory scrutiny, though exact details of what this may look like will ultimately be set out in the regulations or rules made by ARGA. The paper proposes to give ARGA powers to request information from and engage with audit firms relating to audit tenders and how the audit work is split between the lead auditors and the challenger firms. ARGA will also have powers to enforce and sanction against non-compliance with the regime.

Increased monitoring of firms by the regulator

The white paper sets out a suite of proposals to strengthen the new regulator's monitoring of audit firms in the PIE market (**section 8.3**). These include giving ARGA the power to:

- take enforcement action to address anti-competitive practices and abuse of dominant position within the statutory market;
- make it a statutory requirement for the seven largest audit firms to sign up to the FRC's existing (and currently voluntary) firm monitoring arrangement;
- commission an expert review of a PIE audit firm if it has concerns, with the report being payable by the firm;
- secure information on audit firms' wider insurance arrangements as well as their capital reserves;
- require audit firms to address viability concerns by requiring firms to put in place appropriate risk management plan (e.g., modelling distress scenarios and maintaining and testing effective contingency plans); and
- (potentially) mandate minimum insurance levels and capital requirements of audit firms.

These powers aim to ensure that ARGA is formulated as a fit-for-purpose regulator, but the proposals stop short of the full range of powers recommended by the Competition and Markets Authority (CMA) review. In particular, the Government disagrees with the recommendation that ARGA should have the power to take over control of a failed audit firm, instead suggesting that in the event of an acute audit firm collapse, ARGA should be able to introduce a market share cap to limit the number of clients that remaining firms can take on.

Commentary

With the proposed expansion of the PIE market, more mid-tier firms may find themselves under the additional regulations proposed. A reflex response by some may be to retreat from the spotlight that the extra regulation will create. However, we hope this will not be the case. Indeed, our survey of the top 50 accountancy firms showed a widely held belief across mid-tier firms that some form of audit reform is necessary. The question is whether the proposals set out in the white paper strike the right balance.

The Government is clearly intent on increasing choice and competition in the PIE market and supporting mid-tier firms to enter an arena historically dominated by the Big Four. The vision to create a new professional body with ARGA as the regulator points to a keen focus on increasing professionalism and ensuring high standards of competency and quality are met. The widening of the purpose of audit to include non-statutory audits of PIEs indicates a move towards a more holistic Corporate Auditing profession. These proposals may therefore mark the birth of a more modern audit profession with a renewed reputation. The question is whether this will come as a welcome new lease of life for all firms, or whether firms see this as an unwelcome example of 'regulatory creep'. The potential for regulatory intervention if things go wrong may be a significant concern for the firms in relation to which the reforms are intended to benefit.

To mitigate some of these concerns, it may be comforting for firms to know that, contrary to the view one might have from following the high-profile cases in recent times, the FRC does not adopt a heavy-handed approach to all audit failures. In its 2020 Enforcement Review, the FRC reported a 58% increase in early resolution of concerns through the 'Constructive Engagement' route within its Audit Enforcement Procedure. We have seen a greater focus by the regulator on trying to resolve issues by way of audit improvement rather than intensive and costly investigation. Of course, there will be cases where the FRC takes a more rigid approach; however, there does appear to be a noticeable and more concerted focus on continuous improvement as opposed to punitive action.

It is this focus on constructive engagement and improvement that we would expect to continue when the FRC transforms into ARGA – only by ensuring this genuine relationship continues will mid-tier firms feel supported as they step into the PIE market, and seek to expand their roles within it. Carrying out managed shared audits may ultimately allow mid-tier firms to grow their reputation and revenue at a faster pace, and gain confidence in the regulatory landscape that surrounds the FTSE 350 market. Effective and supportive supervision of mid-tier firms will be critical to ensure that ARGA, when it comes into being, is fit-for-purpose, and is viewed as a facilitator rather than an enemy.

Responses to the white paper are requested by 8 July 2021.

FURTHER INFORMATION

If you have any questions or concerns about the content covered in this blog, please contact a member of the [Kingsley Napley Regulatory team](#).

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