



Governance in brief

Government consults on the CMA's proposals for statutory audit services

Headlines

- This consultation represents the latest in the Government's programme to strengthen and improve quality and regulatory oversight of the audit market.
- The majority of the proposals will require legislation and the intention is that these proposals would be administered by the new regulator.
- Given the current challenges with the legislative timetable, the Government is strongly encouraging proposals from the sector outlining what they believe could be done to address the CMA's concerns on a voluntary basis prior to legislation.
- The consultation asks for stakeholder views on the CMA's recommendations in the following areas:
 - Enhanced regulatory oversight of audit committees
 - Mandatory joint audits of FTSE 350 firms
 - Peer reviews of audits conducted for firms not in scope of the joint audit proposals
 - Mitigating the effects of the distress or a failure of a 'Big Four' firm
 - An operational split between audit and non-audit practices of 'Big Four' firms
- The deadline for comment is Friday 13th September 2019.

Audit Committee Scrutiny

What did the CMA recommend?

- The regulator would have powers to mandate minimum standards for the appointment and oversight of auditors, monitor compliance with minimum standards and take remedial action where necessary.
- This greater regulatory scrutiny would apply initially to FTSE 350 audit committees, with a view to expanding scrutiny at a later stage.
- The new regulator should draft new standards for audit tenders that would encourage and require audit committees to prioritise independence and sceptical challenge, avoid management influencing audit committees on their recommendation of auditor, encourage non-Big Four firms to participate in tenders, and manage conflicts of interests arising from auditors' provision of non-audit services.
- The regulator should request information and reports from audit committees and, if necessary, place an observer on an audit committee or another part of the audit process in order to oversee compliance with the new standards.
- The regulator should publish its findings (or summaries of findings) on poor-performing and high-performing audit committees, write to audit committees to highlight deficiencies and write to shareholders to give them the information they need to challenge audit committees and auditors.
- An alternative proposal for the selection of auditors to be moved to an independent body should be kept under consideration in the long term.

The Government seeks views on the following questions:

- Do you agree that the new regulator should be given broad powers to mandate standards for the appointment and oversight of auditors, to monitor compliance and take remedial action?
- What should those powers look like and how do you think those powers would sit with the proposals in Sir John Kingman's review of the Financial Reporting Council for the appointment of auditors by an independent body representing the public interest?
- What comments do you have on the ways the regulator should exercise these new powers?
- How should the regulator engage shareholders in monitoring compliance and taking remedial action?
- What would be the most cost-effective option for enabling greater regulatory oversight of audit committees?

Mandatory Joint Audit

What did the CMA recommend?

- A joint audit would require two audit firms to sign off the accounts of an audited entity. The two audit firms would divide the necessary fieldwork between them, and both firms would audit areas that are highly material and/or involve a high level of judgment.
- The regime would apply to audits of FTSE 350 companies, with the following exemptions:
 - For the audits of the largest and most complex companies, where there may be insufficient capacity from challenger firms to participate in joint audits;

- For the audits of investment companies and companies that do not prepare consolidated accounts; and
- For audits where an audit committee has appointed a challenger firm as its sole auditor.
- The regulator should have the power to grant specific exemptions to the proposed joint audit requirement in exceptional and limited circumstances.
- Each FTSE 350 company within the scope of joint audit should appoint a joint auditor no later than when it next re-tenders its audit engagement.
- No joint auditor should be allocated less than 30% of the total audit engagement fees.
- No change to the UK's current liability regime, meaning that both firms within a joint audit would be jointly and severally liable for the overall audit.

The Government seeks views on the following questions:

- Do you agree with the CMA's joint audit proposal?
- Do you agree with the CMA's proposed exemptions to the joint audit proposals? How should the regulator decide whether a company should qualify for the proposed exemption for complex companies?
- Do you agree that challenger firms currently have capacity to provide joint audit services to the FTSE350? If a staged approach were needed, how should the regulator make it work most effectively? If not immediately, how quickly could challenger firms build sufficient capacity for joint audit to be practised across the whole of the FTSE350?
- Do you agree with the CMA's recommendation that the liability regime would not need to be amended if the joint audit proposal were implemented?
- Do you have any suggestions for how a joint audit could be carried out most efficiently?
- The academic literature cited in the CMA's report suggests the joint audit proposal would lead to an increased cost of 25-50%. Do you agree with this estimate?
- Do you agree with the CMA's assessment of the alternatives to joint audit, including shared audit?
- How strongly will the CMA's proposals improve competition in the wider audit market, and are there any additional measures needed to ensure that those impacts are maximised?

Peer review

What did the CMA recommend?

- The regulator should have the power to appoint peer reviews of the audit engagements of those companies not subject to the joint audit requirement.
- The peer reviewer would be appointed from a challenger firm in order to improve audit quality by introducing an additional, independent quality check. The reviewers should not be one of the Big Four apart from in exceptional circumstances.
- The peer reviewer should not sign the audit opinion, and should not be liable for the accuracy of the accounts.

- The regulator should consider how to select which companies to peer review.
- The regulator should consider whether and how to make the results of peer reviews public.

The Government seeks views on the following question:

- Do you agree with the CMA's proposals for peer review? How should the regulator select which companies to review?

Measures to Mitigate the Effects of the Distress or Failure of a Big 4 firm

What did the CMA recommend?

- The regulator should be given powers to obtain the information it needs to monitor the health of audit practices and intervene where a firm is likely to fail.
- The regulator should require audit committees to inform it of upcoming tenders and any other information that the regulator considers necessary;
- The regulator should obtain, and then review, the modified contingency plans from large audit firms, which should encompass their turnaround plans;
- The regulator should require non-Big Four firms to draw up plans for how they could if required take on migrating auditors and/or audit clients from a distressed Big Four.

The Government seeks views on the following questions:

- What factors do you think the regulator should take into account when considering action in the case of a distressed statutory audit practice?
- What powers of intervention do you think the regulator should have in those circumstances, and what should be their duties in exercising them?

Operational Split between Audit and Non-Audit Practices

What did the CMA recommend?

- The Secretary of State would empower and require the regulator to establish an operational split for the 'Big Four' firms and refine it over time.
- Whilst the split would initially apply to the Big Four, the regulator should consider extending elements of the split to challenger firms.
- The key elements of the operational split would be:
 - A. A separate CEO and board for the audit practice, populated by a majority of independent non-executives, who would be accountable to shareholders of audit clients, and to the public interest (subject to the conclusions of the Brydon review) via the regulator;
 - B. The audit board should be responsible for all remuneration and career progression decisions within the audit practice, including recommendation of promotion to partnership;
 - C. Remuneration and career progression should be strongly linked to audit quality, with the audit board setting and overseeing quality standards;

- D. The audit board should conduct an annual general meeting and produce an annual report, with disclosures to be determined by the regulator, but including reporting on audit quality measures;
- E. Separate financial statements for the audit practice, consisting of an income statement and associated notes;
- F. Transparent transfer pricing, checked by the regulator, e.g. for the use of non-audit specialists on audits;
- G. No profit-sharing between the audit practice and the non-audit practice;
- H. The audit practice for the purposes of this remedy includes audit and essential non-audit services closely related to audit.

The Government seeks views on the following questions:

- Do you agree with the CMA's analysis of the impacts on audit quality that arise from the tensions it identifies between audit and non-audit services?
- What are your views on the manner and design of the operational split recommended by the CMA? What are your views on the overall market impact of such measures?
- Are there alternative or additional measures which would meet these concerns more effectively or produce a better market outcome?
- Do you agree with the CMA's proposal to keep a full structural separation in reserve as a future measure?
- What implementation considerations should Government take into account when considering the operational split recommendations? Please provide reasoning and evidence where possible.

Other Possible Measures

Other recommendations considered in this consultation

- Remuneration of audit partners could be deferred, with a portion vesting in subsequent years.
- Reconsidering the requirement for audit firms to be majority owned by qualified auditors.
- Cross-industry technology licensing, potentially facilitated by the regulator, could remove barriers to competition in the future.
- Measures to improve information for shareholders, and increasing transparency of audit committees including disclosing audit staff hours and fee breakdowns, and a requirement to provide a public database of audit partners and firms.
- The regulator should consider whether Big Four firms should limit their notice periods to six months.
- The BEIS Select Committee recommended revisiting this, moving to a fixed term of seven years, in order to disrupt the 'familiarity' that can arise between auditor and audited company.

The Government seeks views on the following questions:

- Do you agree with these other possible measures?
- How would these suggestions interact with the main recommendations?
- How would these additional proposals impact on the market?

For further information:

The full consultation is available at:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/818667/statutory-audit-services-consultation-cma-recommendations.pdf

The CMA's final report is available here:

https://assets.publishing.service.gov.uk/media/5cb89b2bed915d74fed24206/CMA_final_audit_market_report_A.pdf

Sir John Kingman's letter to Greg Clark on the appointment of auditors is available here:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf

Deloitte LLP response to the CMA proposals dated 21 January 2019

https://assets.publishing.service.gov.uk/media/5c59bde540f0b676b6f54037/deloitte_response_to_update_paper.pdf

Deloitte view

- This consultation marks a significant juncture in the audit debate and provides an important opportunity for all companies, investors and broader stakeholders to contribute their views.
- We would encourage all stakeholders to feed into this process, given the wide-ranging implications it will have on the audit market, the quality of audits and potentially the long-term attractiveness of the UK as a capital market.
- We have been consistent in our support for change, and positive about many of the proposals that have been put forward by the CMA. Where we disagree we have made suggestions for effective and durable alternatives.
- Ultimately we want to see reforms that incentivise high quality audits, increase choice and improve resilience in the market, while strengthening the reputation of the UK as a leading capital market.
- Stephen Griggs – Deloitte's Deputy UK CEO, Managing Partner Audit & Assurance and Public Policy – has written to FTSE 350 Audit Committee Chairs and CFOs to highlight those measures where we have greatest concern: Joint Audits with Challenger Firms and Operational Separation. In our opinion, the introduction of these measures would effectively constitute an experiment in the world's second largest capital market, bring significant increases in cost and complexity for UK businesses at a crucial time for our country, and threaten the long-term, sustainable delivery of quality audits. In particular:
 - i. Mandatory joint audits** – there is a lack of evidence that joint audits positively impact either audit quality or increase market entry for challenger firms. Market participation of non-big four firms cannot be mandated. We have serious concerns relating to capacity within the market to meet demand and the liability framework;
 - ii. Operational separation between audit and non-audit** – we believe this would hinder the ability of firms to invest in audit quality, weaken their resilience and reduce the attractiveness of the audit profession. Engagement and accountability of specialists involved in an audit would be more complex, at a time when the need to access a range of expertise is becoming ever more crucial to high quality audits as companies themselves become more complex and reliant on emerging technologies.
- We have developed and suggested effective and durable alternatives to both of these that we believe meet the overall objectives of the CMA of building choice in the audit market and addressing perceived independence issues. These include proposals for market share caps, shared audits and a governance and performance framework for audit businesses, which we set out in our response to the CMA.

- Alongside the BEIS consultation, we also have the ongoing review by Sir Donald Brydon on the audit of the future. In our view, this will be a key element of the current debate, particularly answering the questions of what the audit product of the future looks like and whether its scope needs to be widened. Key to this will be considering whether the audit and assurance landscape needs to be the holistic, forward-looking analysis of a company's health that many expect it to be. This could play a key role in restoring trust and public confidence in not just the auditors themselves, but in business as whole and capitalism itself.
- We would encourage all companies, investors and stakeholders to feed into this process. Truly sustainable, workable and proportionate reforms require the voice of all interested parties to contribute to this debate.

The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website www.deloitteacademy.co.uk which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email enquiries@deloitteacademy.co.uk.

Contacts – Centre for Corporate Governance

Tracy Gordon	020 7007 3812 or trgordon@deloitte.co.uk
Corinne Sheriff	020 7007 8368 or csheriff@deloitte.co.uk
William Touche	020 7007 3352 or wtouche@deloitte.co.uk



This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NSE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NSE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2019 Deloitte LLP. All rights reserved.

Designed by CoRe Creative Services. RITM0306968