

# NEWS BRIEF

## Reform of the audit industry: it's time to split

Audit has been the subject of intense scrutiny over the past few years in the wake of a series of high-profile business collapses such as Carillion, Patisserie Valerie and Thomas Cook in the UK and, more recently, Wirecard in Germany, and there is no shortage of calls for reform of the audit industry (see *News brief "Carillion liquidation: questions to answer"*, [www.practicallaw.com/w-012-8830](http://www.practicallaw.com/w-012-8830)).

The Financial Reporting Council (FRC) has recently taken a major step in audit reform by announcing its principles for operational separation of the audit practices of Ernst & Young, Deloitte, KPMG, and PricewaterhouseCoopers (together, the Big Four), so that their audit practices will, as far as possible, be ring-fenced and run separately from the rest of the firms' operations.

### Origins of separation

The FRC's proposal for an operational split is rooted in a concern that the interests of the consultancy side of the Big Four's businesses might adversely influence their audit conclusions. The amount of non-audit services that can be provided to audit clients is already restricted by EU legislation such as the Audit Regulation (537/2014/EU) and the Audit Directive (2014/56/EU). In addition, by January 2019, three of the Big Four had indicated that they would voluntarily restrict their non-audit services to audit clients even further. Nevertheless, citing concerns about the potential for conflicts of interest, in April 2019 the Competition and Markets Authority (CMA) recommended an operational split of the Big Four's UK audit work ([www.practicallaw.com/w-020-4997](http://www.practicallaw.com/w-020-4997)).

The Business, Energy & Industrial Strategy Committee (BEIS Committee) went even further in its report of April 2019, advocating full structural separation over operational separation (<https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171802.htm>). However, the FRC's proposal for operational separation of the audit practices among the Big Four, in practice adopting a form of the CMA's proposal, is a further step along this journey.

### Operational separation

The FRC has described the objectives of operational separation as ensuring that audit practices are focused on the delivery of high-quality audits in the public interest, and do not rely on regular subsidy from the rest of the firm. In particular, it seeks the following four outcomes:

- Audit practice governance should prioritise audit quality and protect auditors from influences from the rest of the firm that could divert their focus away from audit quality.
- The total amount of profits distributed to the partners in the audit practice should not persistently exceed the contribution to profits of the audit practice.
- The culture of the audit practice should prioritise high-quality audit by encouraging ethical behaviour, transparency, teamwork, challenge and professional scepticism.
- Auditors should act in the public interest and work for the benefit of shareholders of audited entities and wider society.

### Timetable for change

The FRC has asked the Big Four to agree to operational separation of their audit and non-audit functions, with the firms asked to send their implementation plans to the FRC by 23 October 2020. The FRC will agree a transition timetable with each firm but is working to an implementation date of 30 June 2024.

### Direct consequences

Operational separation will affect the Big Four, and other large audit firms which follow suit, structurally and the FRC certainly hopes that it will lead to more challenge to companies' accounts by auditors, with the potential for more difficult conversations. However, it is unlikely to have direct consequences for the companies they audit. These will face much more direct impact from the implementation of the Brydon review's recommendations for obligations on directors to take on more personal responsibility (for example, by providing Sarbanes-Oxley-style

attestations), to ensure greater transparency (such as disclosing material failures of internal controls) and to engage more with employees and shareholders (see *News brief "Brydon report on audit: not just for auditors"*, [www.practicallaw.com/w-023-7748](http://www.practicallaw.com/w-023-7748)).

While some have welcomed the FRC's approach, inevitably some critics maintain that operational separation is not enough and will do little to improve the accountability of audit firms. This may be because the FRC has stopped short of requiring auditors to be paid from a separate pool of profits and certain personnel will still be able to work on both sides of the business. Nevertheless, within a week of the announcement, BDO LLP became the first firm outside the Big Four to indicate to the FRC that it plans to join its larger competitors in implementing an operational separation. It seems likely that operational separation will become the accepted norm among larger firms in the UK market.

### Further reforms

In any event, it seems likely that there will be further reforms to the audit market to come. Wide-ranging reforms to audit process and regulation were recommended in the Kingman review in December 2018 and the Brydon review in December 2019 ([www.practicallaw.com/w-018-7138](http://www.practicallaw.com/w-018-7138)).

In the light of those reviews, in the Queen's Speech in December 2019, the government stated that it would develop proposals on company audit and corporate reporting, including a stronger regulator to succeed the FRC (to be known as the Audit, Reporting and Governance Authority (ARGA)) with all the powers necessary to reform the sector. Although the government has not yet taken any formal steps toward primary legislation to create ARGA and give it formal powers or any other legislation required to implement the recommendations in the Brydon review, it is under political pressure to do so. The BEIS Committee is currently conducting an inquiry into delivering audit reform and has issued a call for evidence, with a deadline for submissions of 31 July 2020 ([www.practicallaw.com/w-025-1699](http://www.practicallaw.com/w-025-1699)).

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In the meantime, the FRC is pressing ahead with the changes recommended in the Kingman and Brydon reviews that are within its powers to make. In preparation for the FRC's transformation into becoming ARGA, the FRC has appointed a new CEO, Sir Jon Thompson, to oversee and drive the necessary changes. The FRC has also appointed Elizabeth Barratt, the former head of dispute resolution at Slaughter and May, as executive counsel, and Jamie

Symington, former director of investigations at the Financial Conduct Authority, as her deputy, in order to strengthen its enforcement capability. In addition, the FRC has said that it continues to work closely with the Secretary of State and BEIS to find ways to take forwards many of the recommendations without legislative changes. Operational separation is one aspect of audit reform that it feels it can pursue now, particularly as it is

implementing this change with the co-operation of the Big Four.

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*The FRC's principles for operational separation are available at [www.frc.org.uk/getattachment/281a7d7e-74fe-43f7-854a-e52158bc6ae2/Operational-separation-principles-published-July-2020.pdf](http://www.frc.org.uk/getattachment/281a7d7e-74fe-43f7-854a-e52158bc6ae2/Operational-separation-principles-published-July-2020.pdf).*

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