Recent Events

Brydon Auditing Review

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The Brydon Review [2]was released in late December 2019. This follows the CMA and Kingman reviews (December 2018). However, it is radical though the list of recommendations including the ones below are a little messy:

1) First, a separation of the audit and accounting professions into two distinct groups (a first for English speaking countries but more common in continental Europe). Included in this is the disclosure of annual pay for senior auditors. And a new attitude of suspicion and skepticism – existing professional skepticism was not enough. With a new emphasis on forensic accounting and actions to prevent and detect 'material' fraud. Together with higher auditor remuneration and fees but reported as profits from statutory work and audit work separately by the audit firms.
2) Second a change to what is audited and why. Essentially recommended a redefinition of audit that adds greater value to stakeholders than simply confirming and verifying financial statements. Auditor's opinion should be open and understandable and that auditors should provide "greater granularity of information" about the estimates they use in the audit. He also wants shareholders to engage more with the audit team during the audit process and for them to be able to question the auditors at the AGM.
3) Third a renewed focus on the liability of directors and management of the company issuing any reports. The review recommends new reporting requirements for directors about resilience, public interest and audit policy, as well as an obligation to explain what they have done to prevent material fraud and to report on internal controls. This covers several issues expanded below:
    - Significant new requirements for directors which includes a duty to declare actions they have taken each year to prevent and detect 'material' fraud.
    - Directors might also have to present an annual 'public interest statement' to explain how the company they govern serves the wider public interest.
    - The introduction of a British version of the Sarbanes-Oxley Act - the US law passed in 2002 after the collapse of Enron, WorldCom, and other high profile US cases. The US created such legislation to help protect shareholders, employees and the public from accounting errors and fraudulent financial practices. It has worked well in the US. Basically such an act formalises oversight bodies, auditor independence, directors corporate responsibly, enhanced financial disclosures including off-balance sheets transactions, and other Brydon review recommendations.
    - Such an act could ask CEOs and CFOs to vouch annually for the effectiveness of the company's internal controls.

[1] Brydon Review, Assess, assure and inform: improving audit quality and effectiveness - final report of the independent review, December 2019.
Available at:
https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review
Accessed December 2019.
[2] Op. Cit. Brydon 2019.

In essence, Brydon has proposed changes to the law on the way auditors report to the public, and a new focus on providing assurance to users of accounts, strengthened standards for auditors, and a commitment to inform as well as check. The purpose of a company audit should help establish and maintain confidence in a company, in its directors and in the information for which they have responsibility to report. ARGA (the FRC replacement), should it come into existence, or else an enhanced FRC, should fill the training and certification role.

Judgement of whether there is a 'true and fair' view is to be modified to an equally vague term/ The new term should be enshrining in law and places a requirement to assure that the accounts present a company's situation 'fairly in all material respects'. Of course, what is material is a something that has caused auditors and directors many headaches over time – including the Tesco case (see https://www.fin-rep.org/which-book/financial-failures-scandals-from-enron-to-carillion/post-publication-discussion/

The Brydon review also contains new requirements for disclosures in company accounts: the "going concern" statement should be expanded into a "resilience statement" reviewing not only the near-term viability of the company but also including a wider stress test and statements regarding the long-term threats to the business. The report recommends replacing the existing going concern and viability statements with a resilience statement that incorporates a going concern opinion for the short term, a statement of resilience in the medium term, and a consideration of risks to resilience in the long term, such as climate change.

One retrograde step (in our view) by Sir Donald Brydon may be to question whether the idea that auditors cannot be expected to act as "bloodhounds" by sniffing out fraud at companies. That said his report does include a requirement for auditors to act on their suspicions if they do not believe directors are being candid with information. In addition, he recommended that a new panel should be created that would review frauds to see whether auditors were culpable.

Critique of Brydon

The whole question of intangibles is not appropriately discussed or tackled. Sure the recommendations may mean some of the issues are resolved but not all. Jonathan Ford of the FT makes this point[3]. A discrepancy can arise between the consolidated accounts and the parents company's accounts. The importance of this this discrepancy between the consolidated accounts and the parent company accounts is that dividends are paid out of the parent company accounts.

Case A where the consolidated accounts balance sheet is much stronger than the parent company's one. This can be created where a group's subsidiaries could accumulate profits they do not pay to the parent as dividends. Hence, while the consolidated balance sheet enlarges, the parent might still prudently record its investment in subsidiaries at their historical cost, thus allowing a gap between them to develop.

Case B where the consolidated accounts balance sheet is much weaker than the parent company's one. One example is, for instance, where the consolidated accounts are not impairing investments in lossmaking or liability-ridden subsidiaries (as in the case of Carillion and Thomas Cook). Over-valuing the intangible assets, (especially goodwill on brands taken over and subsidiary values), is a continuing and chronic issue in financial reporting.

Ford[4] cites another case that of GlaxoSmithKline (GSK). In the GSK case, the parent's balance sheet grows much stronger than its consolidated counterpart does – this is another Case B where the consolidated is weaker than the parent accounts. In fact the GSK consolidated accounts show significant retained losses whilst the company accounts show large positive retained earnings. Substantial dividends were paid by the parent company despite the consolidated accounts showing a worse financial position. Of course, there are many possible explanations.

As stated above, the reason why parent company balance sheets are important is that it is the parent company that pays dividends to shareholders out of its retained profits or distributable reserves. Overstate them, or fail to reflect foreseeable liabilities, and it becomes possible for companies to pay out unearned dividends and bonuses when the consolidated accounts show losses. And prudency would normally dictate that there is no plausible justification for such pay-outs.

B FRC, ARGA, and new audit market regulations

The enhanced FRC/ARGA much of the same staff will be carried over and all the regulations issued by the FRC will be carried over to the new ARGA – currently aimed to be legislated during 2020 but probably delayed until much later – the political will exists but other priorities are more important (Brexit trade deals, post-pandemic crisis, economy, government

[3] Ford, J., The opportunity missed by Donald Brydon's audit review, Financial Times, 22 December 2019. Available at:
https://www.ft.com/content/a3df4cd6-2494-11ea-9a4f-963f0ec7e134
Accessed January 2020.
[4] Ibid.

borrowing)[5]. The FRC has published a new Stewardship Code[6], a review of governance[7] which may yet form a new set of rules, and their Annual Review of Corporate Reporting[8], among others. We disagree with many of their conclusions of their annual review of corporate reporting.

The FRC is on a new proactive path and is issuing new guides, comment, regulations and standards on a continuing basis. The FRC's new edict on going-concern (discussed in the next chapter) is but one example. Of course, the FRC is worried about possible manipulation of reports in a crisis driven year when results are mostly bound to be poor and the future more uncertain than ever before.

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5 White, S., Plans for ARGA audit regulator due by end March, Accountancy Daily, 6 February 2020.
Available at:
https://www.accountancydaily.co/plans-arga-audit-regulator-due-end-march
Accessed February 2020.

6 The UK Stewardship Code 2020, *FRC,* October 2019
Available at
https://www.frc.org.uk/investors/uk-stewardship-code
Accessed July 2020

7 Annual Review of the UK Corporate Governance Code, *FRC*, January 2020.
Available at:
https://www.frc.org.uk/getattachment/53799a2d-824e-4e15-9325-33eb6a30f063/Annual-Review-of-the-UK-Corporate-Governance-Code,-Jan-2020_Final-Corrected.pdf
Accessed July 2020

8 Annual Review of Corporate Reporting 2018/19*, FRC*, October 2019.
Available at:
https://www.frc.org.uk/getattachment/b3b6cd43-7ade-4790-959e-3b84d59a7253/Developments-in-Corporate-Reporting-2019-Final.pdf
Accessed July 2020

Some of the other auctions that may occur under the aegis of the FRC/ARGA:

1) The capping and controlling pay of audit partners by the FRC/ARGA.
2) Further growth of the mid-tier **challenger firms** will occur through a simple lack of choice and conflicts of interest (applies to BDO, GT, Mazars, RSM and smaller firms). Though all the mid-tier firms seem to be running into their own issues and growing pains - especially the impact of the pandemic on their finances and their inability to be as resilient as the Big Four. So the problem of lack of sufficient well qualified audit firms with the necessary expertise and experience remains basically just the Big Four with some work trickling over to the mid-tier firms.
3) The FRC (in 2020) issued new regulations, guides, suggestions, and standards (many dealing with the uncertainty of the pandemic):
    - Tightened its instructions on going-concern and for auditors proof from clients. Company auditors have been ordered to be more sceptical and ask for more evidence before signing off "going-concern" verdicts in annual reports. Because of the unprecedented level of uncertainty, more companies would have to qualify their going concern statements.
    - Guidance on going-concern for interim financial statements (FRED 75).
    - New rules and exposure drafts on dealing with material uncertainties in their reports (FRED 76).
    - New rules for dealing with rent concessions.
    - The IFRS and the FRC are examining new rules for the layout of the Profit and Loss (Income) statements and Balance Sheet headings under a general new set of general presentation and disclosures
4) Some (but not all) of the recommendations of the **Brydon review** dealing with the process of audit, and what is audited may be implanted by an enhanced FRC (or ARGA if it comes into existence).

Banning of consultancy work for audit clients

The FRC issued (17 December 2019) a radical update to its ethical standards for audit firms. The update in effect has banned audit firms from providing a number of advisory services and consultancy services to listed companies and financial institutions – so called PIEs (public interest entities). The FRC fears offering these non-audit services may cloud judgment and make firms less independent. So this move is an attempt to strengthen auditor independence. The new guidelines set out a list of permitted non-audit services for auditors. They are a departure from the old standard, published in 2016, which instead told them which services were black-listed and thus prohibited. This narrows the field.

Non-audit fees – i.e. consultancy – is a large earner for the Big Four with more than 80% of their fee income coming from non-audit work. If you take the Big Nine (includes GT, BDO, RSM, Mazars and Crowe) then the ratio is still 79% with the middle ranking Five earning around 71% of their fee income from non-audit work.

The watchdog allows some exemptions – as always. Auditors will still be able to provide advisory services where the reporting is required by law or regulation, on the certain reviews of interim financial information, which do not count as part of the audit, and reporting on regulatory returns, client assets, government grants and internal financial controls. These exemptions are a little unclear and are often self-assessed and reviewed by the firm in question. That seems to be a mistake given the firms current track record.

Banning not the same as an operational split of audit and consultancy divisions

However, let us make this clear: banning audit firms from undertaking consultancy work for the same client is a very different type of regulation from splitting the audit and consultancy divisions as in the next section.

FRC dictates operational split of Big Four

The FRC announced (July 2020) the principles for operational separation of audit practices of the Big Four firms. A first in the world. The objectives of operational separation are to ensure that audit practices are focused above all on delivery of high-quality audits – in theory anyway.

Interesting that the existing FRC is initiating this split rather than the new replacement ARGA[9]. This am mean that the enhanced FRC will continue – perhaps. The timetable is an implementation plan should be submitted to FRC by October 2020 (which may slip), and a transition timetable showing the complete implementation of an operational split by 30 June 2024 at the latest.

The FRC 22 point plan[10] lays out the details of the operational split of the Big Four (PwC, Deloitte, KPMG and EY) audit/accounting firms – though their consulting divisions far exceed

[9] FRC News, FRC principles for operational separation of audit practices, 6 July 2020.
Available at:
https://www.frc.org.uk/news/july-2020/frc-principles-for-operational-separation-of-a-(1)
Accessed July 2020

[10] FRC, Operational Separation Principles: Objectives, outcomes and regulation. July 2020.
Available at:

their audit counterparts (being only around one fifth of the total). There have been a series of reviews (CMA, Kingman and Brydon) since the collapse of Carillion in 2018 which has led the severe criticism of the Big Four.

The FRC's plan seeks to ensure the Big Four pay auditors in line with the profits of their audits, ringfencing the finances of the audit division with a separate profit and loss account, and introduce an independent audit board to oversee the practice. This will significantly increase the cost of audits as there can be no cross-subsidy from the more lucrative consulting divisions.

The FRC stopped short of a full break-up of the firms such as the spinning off audit teams into independent legal entities that had been mooted by some politicians in the wake of the collapse of Carillion. Since then there have been further high-profile corporate collapses, such as Thomas Cook, Patisserie Valerie, NMC Health, LCF, Kaloti (Dubai) and, most recently, German payments processor Wirecard. The challenger mid-tier firms GT was the auditor for Patisserie Valerie and another failure Conviviality,

We fell that this however does not provide a sufficient number of auditors to provide choice – See our book *Disruption in the Audit Market: The Future of the Big Four*.[11] We simulated the audit markets under a variety of different splits of the audit firms and tested for independence and quality. Our conclusions were that such an operational split is insufficient to improve audit quality.

Also such an operational split still maintains the inherent conflict of interest in audit market structure where auditors are paid by the very groups that hire them.

Tabby Kinder in the FT noted that[12]:

> But some commentators said the measures did not go far enough. "It is a semi-split that is unlikely to be the last reform that will be needed," said Erik Gordon, professor at the University of Michigan.
> Others criticised the four-year "lag" for implementing the changes. "If this is held out as the solution to audit quality then we're all kidding ourselves," said one senior industry executive.
> An individual at a Big Four firm pointed to the logistical challenges, calling the requirement for separate audit balance sheets a "nightmare" as it would require the firms to "untangle" central administrative costs.

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https://www.frc.org.uk/getattachment/281a7d7e-74fe-43f7-854a-e52158bc6ae2/Operational-separation-principles-published-July-2020.pdf
Accessed July 2020

[11] Bhaskar K., and Flower J., with Sellers R., *Disruption in the Audit Market: The Future of the Big Four*. Routledge, 2019. See also fin-rep.org and fin-reo.com for updates.

[12] Kinder, T., UK's Big Four accounting firms told to outline plans for audit split by October, *Financial Times*, 6 July 2020.
Available at:
https://www.ft.com/content/4464e0a3-9ba2-47d2-9f85-3f2912a22f25
Accessed July 2020

Whilst PwC, KPMG and E may be willing to so voluntarily in some shape or form. Deloitte's is not[13]. BDO and GT are also interested in a voluntary separation.

Tabby Kinder of the FT[14] that there is indeed a conflict of interest brought about by the requirement to rotate auditors. When a company switches auditor, the outgoing one is freed up to take on non-audit work more or less immediately. This cycle could potentially weaken the incentives of the existing auditor to challenge a company if it knows it will be in a position to sell consulting work in the future. By way of evidence, Tabby Kinder quotes this senior auditors:

> However, the head of audit at one large UK accounting firm, who wished to remain anonymous, disagrees: "Mandatory audit firm rotation has meant that in the last three years of an audit mandate you start to think how to translate the audit relationship into a consulting one." He adds: "You start introducing people and you make sure you don't piss off the client."
> Scott Knight, head of audit at mid-tier BDO, says: "The auditors work for the shareholders and not the management. [Consulting] services are procured by management so it really isn't difficult to see how conflicts arise. The FRC has told the audit firms...that they are falling short in terms of challenging management. Clearly robust challenge is often inconsistent with a procurement relationship."[15]

Despite the protestations of strict rules, the above confirms our own evidence taken from private interviews with many senior audit partners.

Implementation of the audit reform (Brydon, Kingman, CMA *et al*)[16]

Now how much of the various reports and reviews will be implemented is a moot point. There is no doubt that the UK's largest accounting/audit firms have come under pressure after high-profile auditing failures and scandals leading to an environment under Theresa May that would have led to major change and tighter regulation. Under Boris Johnson there appears to be less motivation for so much major change and indeed the government shows signs of waning appetite for thorough reform.

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13 Ashton, J., (Senior partner and chief executive, Deloitte North and South Europe), Divide audit and consulting at Deloitte? Not on my watch (at least, not voluntarily), *The Times*, 1 February 2020.
Available at:
https://www.thetimes.co.uk/article/divide-audit-and-consulting-at-deloitte-not-on-my-watch-at-least-not-voluntarily-q60jjqbc0
Accessed February 2020.

14 Kinder, T., Decision looms over Big Four consultancy and audit 'conflict', *Financial Times*, 29 January 2020/
Available at
https://www.ft.com/content/dfd5703a-2363-11ea-b8a1-584213ee7b2b
Accessed January 2020.

15 Ibid.

16 The Kingman Review and associated material is available at:
https://www.gov.uk/government/news/independent-review-of-the-financial-reporting-council-frc-launches-report
The CMA Report and its associated material is available at:
https://www.gov.uk/government/news/cma-recommends-shake-up-of-uk-audit-market

Nevertheless it looks likely that the new ARGA/FRC will take action along the lines already specified and there may be an operational split between Audit and Consultancy – either voluntary or legislated.

The FRC, in preparation for the new ARGA watchdog, has made a number of changes to beef up its resources. The FRC announced (February 2020) an increase its voluntary levy on companies, through which it is funded, by £5.5m to £47.2m in its budget for 2020/2021. This will entail recruiting more than 100 employees (particularly lawyers and forensic accountants) to improve its decision-making process and to 'strengthening its case examination function to fast-track decisions on whether to open an' investigation[17]. The FT commented[18]:

> The move, which follows an overhaul of its leadership, comes ahead of the watchdog's transformation into a new regulatory body. It is a response to concerns the FRC has been too slow to investigate misconduct, its sanctions too lenient and its board too close to the industry it supervises.
>
> A string of corporate collapses and accounting scandals at BHS, Carillion and Patisserie Valerie intensified concerns about the FRC's effectiveness.

What is not in vogue?

1) **Joint audits** an original idea of the CMA for a Big Four and a challenger firm to perform joint audits. This is now a non-starter.
2) New much **enhanced governance codes**. However, there may be tinkering and minor adjustments. There may be some tightening of regulations.
3) A full **separation of the accounting and audit professions** as per Brydon. This is just a step to far of all concerned including the government.
4) A **cap on the number of FTSE firms** that the Big Four can audit. Just a non=-starter and would lead to many distortions of the audit markets.

[17] FRC News, FRC plan for greater regulatory oversight, 5 February 2020.
Available at:
https://www.frc.org.uk/news/february-2020-(1)/frc-plan-for-greater-regulatory-oversight
Accessed February 2020.

[18] Provan, S., and Kinder, T., Corporate scandals prompt shake-up at UK accounting watchdog, *Financial Times*, 5 February 2020.
https://www.ft.com/content/0abe6718-47ed-11ea-aee2-9ddbdc86190d
Available at:
https://www.ft.com/content/0abe6718-47ed-11ea-aee2-9ddbdc86190d
Accessed February 2020.