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New UK Watchdog Poised To Take On Embattled Audit Sector

By **Richard Crump**

Law360, London (March 15, 2019, 5:17 PM GMT) -- Britain's plan to transform its audit regime has set the stage for a radical shakeup of the accounting sector by a new regulator empowered to crack down on the industry in the wake of a series of scandals and corporate collapses.

The government confirmed Monday that the Financial Reporting Council will be abolished and replaced with an enhanced regulator called the Audit, Reporting and Governance Authority. The move comes after a damning review into the audit watchdog, prompted by the high-profile collapses of companies including contracting giant Carillion and retail mainstay BHS.

But the demise of the beleaguered FRC, which has frequently been accused of being too cozy with the companies it regulates, is just the first of a wave of reforms that will usher in wide-reaching changes to how the biggest auditors, and the businesses whose accounts they vet, are regulated.

"There is clearly an appetite for changes to the regulation of the profession, driven by questions asked about recent corporate collapses," said Andrew Howell, head of the disputes and investigations group at Taylor Wessing LLP. "Those corporate failures led to questions about how well-equipped the audit process is, looking at both preparers of financial statements and auditors."

"The creation of a regulator with statutory powers was somewhat inevitable," Howell added.

The Big Four accounting firms — PricewaterhouseCoopers, EY, Deloitte and KPMG — have been buffeted by many of the recent corporate scandals.

That includes the collapse of Carillion, which was given a clean bill of health by KPMG shortly before it went bust in January 2018 with debts of more than £5 billion ($6.6 billion). PwC meanwhile came under the spotlight over its audit work at the retail chain BHS.

Those scandals, along with audit failures dating as far back as the banking crisis, prompted a series of reviews by government and regulators last year that recommended that the FRC be disbanded. Lawmakers meanwhile have called for the Big Four to be broken up.

“It has been a steady drumbeat of criticism of auditors and the FRC, but it may be the government will reform its regulation of the audit sector without breaking up the Big Four,” Howard Morris, head of the London insolvency group at Morrison & Foerster LLP, said.

The first of those reviews, a government-commissioned investigation led by John Kingman, chairman of Legal and General Group PLC, highlighted a series of weaknesses in what it termed the "ramshackle house" of the regulator. Kingman found the council to be a “hangover from a different era” of light-touch regulation as he published his scathing 96-page review, which made 83 recommendations, including disbanding the agency.

The audit body, formed in 1995, was never a regulator in the truest sense of the word, and lacked the weight of the City watchdog, the Financial Services Authority — now the Financial Conduct Authority. The FRC's outgoing chief executive, Stephen Haddrill, has complained that the body lacks the tools to intervene, both in the audit market and in response to warning signs that companies might be beginning to fail.

This hampered the FRC in its ability to effectively investigate companies and their auditors, according to White & Case LLP partner Stuart Willey.

The new agency, which will be known as ARGA, will be able to directly regulate the biggest auditing companies. It will be empowered to impose greater sanctions in cases of corporate failure, require rapid explanations from companies and to publish reports about a firm’s conduct and management.

"Those are powers the FRC never had,” Willey said. “It is not the fault of the FRC that it was never given a very clear mandate or given powers that are proposed to be bestowed on the new regulator.”

Crucially, the new authority will be able to make direct demands to companies and auditors about their accounts rather than having to seek court permission. It will regulate the biggest firms directly rather than being delegated to do so by the main professional accounting institutes. By agreement with the six chartered accountancy bodies, the FRC has a non-statutory role for oversight of the regulation of their members beyond those that are statutory auditors.

These new powers are expected to make ARGA more willing to intervene and aggressive than its predecessor, which Kingman said had taken an “excessively consensual” approach to its regulatory work.

The FRC is also partially reliant on a voluntary levy from audit companies for its budget, which Kingman warned could reduce its willingness to “bite the hand that feeds.” Under the new regime, ARGA will have the ability to breath directly down the neck of auditors and call for documents and clarifications to accounts, Morris said.

“The proof is going to be in the eating. There is a question of whether this regulator is going to be able to lean heavily on auditors in a particular appointment,” Morris continued. "It is a major step to a much more interventionist approach — it will be up-close and personal. The regulator and firms will be able to smell each other’s breath."

But having a statutory body that is too forceful raises concerns that it could discourage some large corporations from choosing to incorporate or list in the UK, particularly given the proposal to extend the international reach of the new body, Richard Ufland, a corporate finance partner at Hogan Lovells LLP, suggested.

“I am expecting there to be some fightback against something that overly heavy-handed, particularly that the chief executive and chief financial officer of a public-interest entity can be held directly to account. This is likely to create quite a swell of disquiet,” Ufland said.

Of course, just how different the new agency proves to be will depend in large part on the people who end up leading it.

The FRC's board frequently came in for criticism for drawing too heavily from the Big Four auditors it was regulating. But the new body will get a new board.

Although Kingman suggested that many members of the FRC would transfer to ARGA under his proposals, he recommended that there should be a “limited” overlap in senior management and that the new board should be much smaller. Current chief executive Haddrill and chairman Win Bischoff will both be replaced.

“If you look at the board of the FCA, there are some ex-industry people on it,” Willey said. "It’s a mixture of public-interest representatives and practitioners with an independent chairman. I don’t think the fact there may be ex-members of the audit profession on board will necessarily tell us it will be captured by industry.”

The Kingman review also proposed that the new regulator should get the power to look into concerns that arise from corporate reporting and governance, which might result from whistleblowing by staff or an auditor.

Kingman said it would be impractical for the watchdog to have a general responsibility to prevent corporate failure, but he said the government should introduce a duty for auditors to report serious concerns.

Erika Kelton, a senior partner at Phillips & Cohen LLP who represents corporate whistleblowers in the U.K. and the U.S., described the FRC’s approach to whistleblowing as “quite backward.” It is essential that the new regulator includes a robust process that motivates employees to come forward with reports and protects them, she said.

“I find it astounding the FRC policy requires whistleblowers to submit information in writing, but that the whistleblower won’t be interviewed by the regulator’s staff,” Kelton said. “The new organization needs to take a very close look at their existing policies and not just import them.”

Whistleblowers are particularly useful in exposing sophisticated accounting frauds that regulators otherwise would not uncover, Kelton said, adding that financial regulators in the U.S. have described their programs — which offer protection, confidentiality and rewards — as “game changers” in enforcement. "A whistleblower reward program with the new regulator would have a similar impact," she said.

The creation of a new regulator also comes as Britain's accounting profession is wrestling with a review by the Competition and Markets Authority. The antitrust regulator has recommended splitting companies' auditing units from their advisory businesses, and having a joint audit system with a Big Four firm and one smaller company working together on the audit. It also wants more accountability for those who appoint auditors.

The sector is also being scrutinized in a separate review by London Stock Exchange Chairman Sir Donald Brydon. But, with the U.K. government focused on managing Britain's exit from the European Union, attorneys expect lawmakers to give the new regulator time to settle in before overhauling the wider market.

"It may be the establishment of new body will mean less emphasis is placed on structural changes in the market," Willey said. "It may deflect from the breaking up of the Big Four. The new body will be given an opportunity to demonstrate its effectiveness."

However, Willey also warned that ARGA "will want to show its colors early" and that companies and auditors should expect clear action quickly.

"I expect the first company failure to be accompanied by a deep look by the watchdog into standard of the audit processes," he said.

--Additional reporting by Joanne Faulkner. Editing by Ed Harris and Melissa Lipman.