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UK Audit Reform Plan May Be Poisoned Chalice For Upstarts

By **Martin Croucher**

Law360, London (March 18, 2021, 7:47 PM GMT) -- The U.K. government outlined the biggest overhaul to the country's accounting sector in a generation Thursday, but experts questioned whether efforts to limit the Big Four's dominance would entice many challengers amid growing scrutiny of big corporate collapses.

The long-awaited reforms will mean that the largest British companies will need to use smaller "challenger" companies to audit a portion of their accounts, rather than just relying on the four giants that have long dominated the accounting market.

The government hopes the measures will lead to a "watering down" of the market share of PricewaterhouseCoopers, Ernst & Young, Deloitte and KPMG, collectively known as the Big Four. The companies were collectively responsible for all of the FTSE-100 company audits in 2019.

But with the creation of a new regulator with greater powers to punish professional failure, as well as more responsibilities on auditors to detect corporate fraud, some experts questioned whether smaller players would want the additional market share.

"We have already seen mid-tier firms moving away from the large [public interest entity] audit arena, given the intensive regulatory scrutiny the work brings," said Julie Matheson, accounting advisory partner at Kingsley Napley. "My concern is that the fear of significant sanction and costs if anything goes wrong could dampen the enthusiasm of those mid-tier firms."

Audit Reform

Demands for reform to the audit sector date back at least three years, following the high-profile collapses of department store BHS Ltd. in 2016 and construction company Carillion PLC in 2018.

PwC was fined £6.5 million ($9 million) in 2018 over shortcomings in its audit of BHS, which went under in 2016 with a £571 million pension deficit.

Similarly, KPMG is expected to face an official report soon after issuing a clean bill of health to Carillion shortly before the construction company imploded in 2018 with £1.5 billion of debt and an £800 million pensions deficit.

The government launched two consecutive official reviews into the audit sector in 2018. The first, published in December that year, was chaired by Legal & General Chairman John Kingman and called for the audit regulator, the Financial Reporting Council, to be replaced with a new body with tougher powers.

After the report, the regulator started work in transitioning to its new form as the Audit, Reporting and Governance Authority, or ARGA. It said last year it has taken on additional staff to bolster its enforcement work, as well as broadening the number of companies it supervises.

Kingman said in a statement Thursday that "much had been done" already to bolster the regulator.

"The critical missing piece is to fix the regulator's legal status and powers," he added.

The second government-commissioned review, published in December 2019 by former London Stock Exchange chairman Donald Brydon, called for an overhaul of the audit sector itself, including the recommendation that the role of auditors be broadened, so that they are also responsible for detecting fraud.

Auditors have long maintained that it was not their job to detect fraud. David Dunckley, chief executive of Grant Thornton, told lawmakers in January 2019 that criticism of the sector was due to an "expectation gap" over the scope of responsibilities that auditors were asked to fulfill.

The reforms the government announced Thursday included recommendations from both reviews, as well as suggestions from the Competition and Markets Authority, the U.K.'s antitrust watchdog.

The CMA called in April 2019 for new laws that would require the Big Four to separate their accounting and auditing divisions. The FRC called for the companies to submit their proposals on how they would achieve that and last month said it had approved the plans.

Nevertheless, the government said Thursday that ARGA will have the ability to "impose an operational split" on the companies it regulates, enshrining the CMA recommendations in legislation.

ARGA Powers

But the proposals go beyond the auditing sector. The government's plans would also give the new regulator powers over corporate executives.

Under the government's plans, larger businesses will need to be more transparent over the state of their finances, publishing annual "resilience statements" that set out how they are managing short and long-term risks.

Companies will also no longer be able to pay out shareholder dividends or bonuses to executives if they are close to insolvency. They will also be required to write into contracts that directors will have to repay bonuses if a company fails two years after they receive the additional pay.

Gareth Sykes, corporate governance specialist at Herbert Smith Freehills LLP, said corporate directors should be "particularly interested" in new accountability requirements.

"If implemented, the proposals would lead to considerable changes to the way that companies approach their financial statements and financial reporting," he said.

At the moment, however, it is still unclear if the additional requirements are just for the U.K.'s largest companies, according to Paul Winrow, partner at accountancy company MHA MacIntyre Hudson. He said there was a risk that they would be "unnecessarily bureaucratic" for smaller businesses.

"At a time when many businesses are still reeling from the effects of COVID-19 and coming to terms with the changes brought about by Brexit, there is an important balance to be struck between ever-increasing regulations and the need for British businesses to remain competitive," Winrow said.

The government's reform package is open for consultation until July, and therefore still subject to change. But lawyers have already compared it to the U.S. Sarbanes–Oxley Act, which was introduced in 2002 following the accounting scandal at Enron.

Ariel White-Tsimikalis, partner at Bryan Cave Leighton Paisner LLP, said the proposals represented "one of the most significant shake-ups in the U.K.'s corporate governance framework."

"Whilst the proposals have not gone as far as mirroring Sarbanes-Oxley standards in the U.S., they do seek to make a number of significant changes to improve the audit, corporate reporting and corporate governance framework in the U.K.," she added.

Still, Gareth Rees, a partner at Morrison & Foerster LLP, warned the legislation could still be watered down by the time it is introduced into Parliament as a bill.

"There will be a lot of push back in the consultation, with companies saying they do not need this amount of regulation, and that it would serve to make directors risk averse," he added. "Already it's not as robust as Sarbanes-Oxley, and it certainly won't end up being anything like that."

Rees, the former executive director of enforcement at the FRC, said although the reforms would be unlikely to hit the statute books before 2023, the industry's regulator will still be going through a steady transformation in the meantime.

"In the last five years there's been a huge amount of change at the FRC," he added. "It's a much stronger organization now than when I joined it in 2012. The change of name will be part of an ongoing transformation into what I'm sure will be a much more effective regulator."

--Additional reporting by Najiyya Budaly. Editing by Alyssa Miller.