The Future Regulation of Financial Reporting

Ben Hubble QC and Miles Harris of 4 New Square look at the potential impact of reforms suggested by the Kingman Review and the Competition & Market Authority's Update Paper on the audit sector.

Introduction

The days before Christmas 2018 saw the publication of two very important documents for the future of financial reporting. First, Sir John Kingman submitted his review of the Financial Reporting Council ("FRC"). Second, the Competition & Market Authority ("CMA") published its Update Paper on its review of the audit sector.

Taken individually, the reforms proposed in each of the reports are far reaching in themselves. However, their combined impact would reshape the face of financial reporting and its regulation. If implemented, the reforms would see a new, more interventionist, longer armed and more powerful regulator not only supervising professionals participating in a materially changed and more varied audit market, but also holding to account non-professional directors involved in financial reporting.

In this article, we look at the Review and the Update Paper, highlight notable aspects of their proposals and give some thoughts on what they might mean for the future of financial reporting and its regulation.

The Kingman Review: Time to build a new house

Sir John's Review acknowledged some strengths and general respect for the UK among the international regulatory and standard-setting community. It also accepted that some of the FRC's critics overstated their case. However, ultimately it sympathised with the view that the FRC has tended, overall, to take an excessively consensual approach to its work and that even its own approach to its own governance had not been consistent with either its public importance, or its role in championing governance in the corporate world. In memorable language, the Review concluded that the FRC was an institution that had been:

> *"constructed in a different era – a rather ramshackle house, cobbled together with all sorts of extensions over time. The house is – just – serviceable, up to a point, but it leaks and creaks, sometimes badly. The inhabitants of the house have sought to patch and mend. But in the end, the house is built on weak foundations. It is time to build a new house."*

As to that new house, the Review recommends the replacement of the FRC with a new body with a clear and precise sense of purpose and mission, firmly focused on the interests of consumers of financial information, not producers, respected by those who depend on its work, and where necessary feared by those whom it regulates, equipped with the right powers and resources and able to attract the highest-quality people.

The problems with the FRC

In reaching these conclusions, the Review identified many flaws and limitations in the FRC's current character, status, powers and resources, including that:

- It had only recently come to be seen as a regulator at all, something reflected both in its title of 'Council' (rather than authority or regulator) and the fact that for most of its time it had been a private institution and not a public body;

- Uniquely among regulators, it has no meaningful statutory base;

- It is funded through a voluntary levy making it dependent on the willingness of companies and others to contribute. The Review felt this was "seriously inappropriate", creating a clear danger of blunting the FCR's incentive to bite the hand that feeds it;

- It operates under a clear Direction from government to rely on delegation to industry bodies "to the maximum extent possible", meaning it has no direct regulatory purchase on the major audit firms and that "*some of the biggest and most important economic actors in the UK are still regulated not by an independent body but, in effect, by their trade association*"; and

- It is hampered by public sector pay guidance structures on appointments, something that was not just anomalous for a non-public body and inconsistent with other market-facing regulators, but also affected its ability to recruit effectively.

The Review also criticised the way in which the FRC, in its present guise, had functioned in the past, concluding that:

- Even allowing for its limited powers, it had failed to make the case for change to regulation in this area, or failed to make its case persuasively;

- It had not been as effective as it might have been in shaping debate on major issues, such as the audit 'expectations gap', competition in audit, auditor rotation and the relationship between audit and non-audit work (many of which were examined by the CMA- see below);

- Its work on audit work was not as credible as, for example the PCAOB in the USA;

- Its Corporate Reporting Review work was too limited in its scale and scope, excluding key areas of reporting including companies reporting against the principles and provisions set out in the UK Corporate Governances Code and their remuneration reports;

- The FRC has not been a particularly effective champion of the need for annual reports and accounts to be comprehensible and of genuine value for their readers, rather than simply to provide ever greater volumes of information; and

- Its staffing and culture was not open and attractive to the best talent. It needed to be seen, in the words of a distinguished international stakeholder, as *"a place where you go to enhance your career, not a place where you end your career".*

Recommendations: A new regulator with new responsibilities and new powers

A total of 83 recommendations were made covering a range of matters. Some, will require primary legislation and will take time. However, the Review recommended that many of the proposals could be implemented in whole or in part without legislation and should be taken forward without delay.

The headline recommendation by the Review is the replacement of the FRC as soon as possible with a new independent regulator underpinned by primary legislation, funded by a statutory levy and with significantly expanded powers and objectives. It is suggested that this new regulator should be named the Audit, Reporting and Governance Authority ("ARGA"), be accountable to Parliament and have a new, smaller transparently recruited board that exercises significantly stronger ownership and oversight of its investigation and enforcement functions.

As to the aims and approach of this new regulator, the Review recommends that the ARGA should:

- Have an overarching duty to promote the interests of consumers of financial information, not producers, and also a duty to promote competition and innovation in financial reporting and audit work;

- Bring an end to the self-regulatory model for the largest audit firms, introducing a new regime for the approval and registration of audit firms conducting PIE audits. This should be supported by a range of sanctions, some less severe than the nuclear option of de-registration (e.g. requiring the implementation of actions, temporary bans on tendering for new clients, requiring enhanced quality control reviews);

- Have statutory power to carry out compulsory monitoring of audit work to give it more insight into possible structural problems within audit firms which in turn may be leading to poor quality statutory audits;

- Work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of Audit Quality Reviews (AQRs). For the present, as a first and interim step, the Review recommends publication of AQR reports on an anonymised basis;

- Increase, on a risk-based basis, the volume of Corporate Reporting Review (CRR) work currently carried out by the FRC and extend the reach of such work to cover the entire annual report. This enhanced corporate review role should be supported by new, stronger powers both to require documents and other relevant information in order to conduct that review work and, having conducted its review, to require changes to accounts promptly without having to go to Court; and

- Working with the Government, develop detailed proposals for an effective enforcement regime in relation to Public Interest Entities ("PIEs") that holds all relevant directors, not just members of professional bodies, to account for their duties to prepare and approve true and fair corporate reports and to deal openly and honestly with auditors.

The Review stated that, to meet these aims, the new regulator must be able to recruit staff of the calibre, expertise and seniority necessary to hold those regulated to account. To that end it should recruit more partner-equivalent staff, adding weight and commanding more substantial respect in conversations with firms and also develop a pool of 'grey panthers' whose expertise could be drawn on when needed.

For those involved in disciplinary and regulatory disputes, particularly notable are the Review's recommendations regarding the approach ARGA should take to enforcement and to helping to reduce the risk of avoidable corporate failure.

Enforcement

With regard to enforcement, the Review recommended that ARGA:

- Should have its performance monitored closely by its board and the Government to ensure that it provides an adequate deterrent to wrongdoing. The Review said it was heartened by evidence of a change of approach in this regard, but emphasised that the regulator should be neither too reluctant to act, nor too slow when it does;

- Should revisit its publication policy in relation to concluded cases resulting in undertakings;

- Where appropriate, should extend its statutory enforcement action to overseas auditors on a risk-based basis, if necessary barring such auditors from UK public company audit work;

- Should take the lead where there has been wrongdoing in relation to financial reporting or corporate governance of PIEs, holding to account both auditors and accountants on an equal footing under a procedure similar to the Audit Enforcement Procedure ("AEP"). The Review criticized the operation of parallel enforcement procedures against auditors (the AEP) and accountants (the Accountancy Scheme), observing that the AEP had a lower threshold for action and power to compel information and documents from PIE audited entities. It highlighted the oddity that, for example, investigations into the audit of Patisserie Holdings Plc will be conducted under the AEP while the CFO's behavior was to be investigated under the Accountancy Scheme; and

- Should also hold to account PIE directors personally for their duties to prepare and approve true and fair accounts and compliant corporate reports and to deal openly and honestly with auditors. The review recommended that this should apply to a company's CEO, CFO, chair and audit committee chair, regardless of whether they are members of a profession. It is suggested that the regime for non-member directors should follow the same principles as the AEP and have a graduated range of sanctions, judging them against requirements or statements of responsibilities to be formulated and published by the new regulator. These powers would be in addition to actions for director disqualification that rest with the Insolvency Service.

Corporate Failure

Unsurprisingly, given the current political climate in the wake of well-publicised corporate failures, the Review concluded that there is more that could and should be done by the regulator, where feasible, to act on intelligence and to identify problems earlier. The FRC's current practice was inherently backward-looking on corporate reporting and audit quality but could and should be supplemented by new forward-looking powers.

To this end, the Review recommended a number measures relating to both the proposed new regulator and the work and duties of auditors themselves:

- Development of a robust market intelligence function for the ARGA aimed at identifying emerging risks by drawing together market and internal intelligence, and conducting economic and risk analysis;
- Giving the ARGA a new power to look into concerns relevant to the regulator's strategic objective using 'skilled person' reviews and publishing their findings where appropriate to help inform investors' decisions. Concerns justifying such investigations might stem from the regulator's own work on corporate reporting and governance, whistleblowing from members of staff or an auditor, or from evidence of investor disquiet;
- Giving ARGA the ability to take a range of pre-emptive actions appropriate to the circumstances, from:
    - Relatively modest steps such as: notifying the company of its views of the risks and requiring the company to make a rapid formal response, requiring additional assurance on the viability statement or any other aspect of the company's reports or accounts, requiring an independent board evaluation, or examination of the audit committee, repeating AQR or CRR inspections more quickly than usual, or ensuring that problematic issues are raised with other regulators or standard setters;
    - To stronger measures where serious concerns about governance or financial viability come to light, such as the removal of the auditor or an immediate retendering, requiring the production of a recovery plan or the prompt restatement of accounts or other disclosure to the market;
    - To, in the most serious cases, the ability to recommend to shareholders that they consider a change of CEO, CFO, chair or audit committee chair, or that they reconsider the payment of dividends.
- Introducing a duty to alert obliging auditors to report viability or other concerns relating to audit;
- Reviewing and reforming viability statements with a view to making them more effective, failing which consideration should be given to abolishing them;
- Considering introducing in the UK something more closely similar to, though not the same as, the Sarbanes-Oxley (SOX) regime in the US specifically relating to internal corporate controls, and assurance by directors around internal controls.

The Competition & Market Authority's Update Paper

The changes proposed in the CMA's Update Paper are smaller in number. However, they are arguably more significant for the audit market and the future of financial reporting. The proposals would lead to a dramatic intervention and reshaping of the present audit market coupled with ongoing involvement by the new ARGA (or whatever it may ultimately be called) to assist in the promotion of competition and quality of work, by utilising new and significant interventionist powers. It seems that the two publications have had a heavy influence on one another and a number of the CMA's proposals depend upon a newer and more powerful regulator with far wider reach than the FRC.

Again, the Update paper is lengthy and makes many recommendations. However, in summary, the CMA proposes:

Firstly, that audit committees should be subject to specific regulatory requirements and obligations that would require them to report directly to the ARGA before, during and after a tender selection process and to report directly to the regulator throughout the audit engagement. The aim of such requirements would be to allow the regulator to utilise a new ability to include an observer on all or at least a sample of audit committees and to issue public reprimands or direct statements to shareholders where it thought appropriate.

Secondly, that there should be mandatory joint audits, at least as regards the FTSE 350 (perhaps with some limited exceptions), with one of the pair to be a 'challenger firm'. The CMA suggest that this would reduce the barriers to the challenger firms and reduce risks of excessive concentration of audit expertise in the Big Four. The proposal is that each auditor on a joint audit should be entrusted with a significant proportion of the audit with a minimum amount to be set over time to allow challenger firms to build their capacity. This was preferred by the CMA to a market share cap as a means of breaking down barriers to non-Big Four firms competing successfully because, although it would deliver a less substantial increase in competition in the short-term, it would pose less risk to audit quality than immediate and blunt imposition of a cap.

Thirdly, that there should be a prohibition or limitation on the ability of audit firms to impose restrictive covenants. The aim of this is to assist partners in switching firms so, again, helping challenger firms in building capacity for their new role in the market.

Fourthly, that a way be devised in which the ARGA might help build market resilience by ensuring continuity of supply and maintaining the integrity of the market to prevent an acute shortage of suppliers that might arise if one of the Big Four failed and was effectively absorbed by one of the others. The CMA acknowledges in its Update Paper that it was very much looking for ideas and suggestions in this respect, recognising that one of the challenges of protecting against such a situation is that partners and clients generally move before such a collapse and the difficulties there would be in incentivising or mandating the move of audit clients to challenger firms. A suggestion is that the ARGA could have a role in ringfencing equity for audit partners and other steps to ensure partners and clients stay with a failing firm. Another is that firms should have living wills of the kind implemented by financial institutions in the USA.

Fifthly that there should be either a structural or (more likely if practicable) an operational split of audit and non-audit functions applied to the Big Four. It is to consult on whether this should be applied just to the Big Four or also to challenger firms. The aim of this proposal is to address concern about the culture of firms (being too integrated into the aims and wishes of clients) and also to allow greater choice for the market by removing concerns about conflict arising from provision of non-audit services. The CMA noted concerns that there would be about the cost for audit firms if there was a structural split as losing non-audit expertise (which is regularly called on by audit teams) might see international networks break away from the UK audit arm and so retain the non-audit services business. It also recognised that a structural split would pose a risk for smaller firms in accessing the expertise required to compete. For this reason, the CMA's preference is for an operational split, which it recognises would be complex but suggested would be manageable.

Finally, that there should be peer reviews of overall financials (for example, the consolidated accounts) coupled with shadow audits of risky areas with a view to keeping the statutory auditors 'on their toes'. In common with Kingman, as part of this the CMA suggested that it should be part of a Regulator's powers, to target companies considered high risk or deserving more scrutiny.

Notably, the CMA did not favour:

- Breaking the Big Four into smaller audit firms;
- Introducing an insurance-based system;
- Creating an NAO-style auditor for private sector audits;
- Further changes to the frequency of auditor tendering or rotation; or
- Changes to restrictions on ownership of audit firms.

Will it ever happen?

It seems reasonable to assume that, once Parliament has time, the vast majority of the recommendations in the Kingman Review will likely be implemented. Although some of the most significant recommendations require primary legislation, the main obstacle to their enactment would seem to be time rather than appetite. The Government has already welcomed the Kingman Review, there is the fall-out from recent corporate collapses and the recommendations are aimed at satisfying an existing demand for change.

As to the CMA's Update Paper, the shape of any actual changes is more difficult to predict. Views on the Update Paper were invited by a deadline of 21 January 2019 and the detail and full extent of any changes may undergo significant alteration. Nevertheless, again, the political climate is firmly in favour of change and, if anything, the proposals of the CMA fall short of the demands by various stakeholders by, for example, not demanding the break-up of the Big Four.

In the circumstances, the likelihood is that the future landscape of financial reporting and its regulation will resemble that painted by the recommendations of these two documents.

The Future

What is the future for regulatory disputes if the proposals in Kingman and the CMA are largely implemented?

Although the Review was critical of the FRC, one suspects that many with experience of the FRC's investigations in recent times would feel that the FRC was already being (more) zealous. However, one must expect the ARGA to be even more vigorous. This is inevitable given Kingman's criticism of the FRC for being excessively consensual and the clear message that a regulator needs not just to be respected but, when necessary, feared. The ARGA will also be better able to fulfil that aim if it is staffed by what are seen as higher calibre, more ambitious staff able to call on greater resources. A bulked-up regulator will inevitably find more work for itself and may feel the need to be more aggressive in order to justify its existence (and show mettle to its own stakeholders). In addition, the volume and variety of regulatory action and disputes will also increase for other reasons.

The proposed reforms to the audit market by the CMA will see firms grappling with new challenges in this more heavily regulated environment. To take on the increasing role the CMA hopes they will have, challenger firms would need to increase their capacity significantly over time and such expansion frequently results in the kind of organisational growing pains that can strain internal systems for ensuring quality of work. Similarly, although the imposition of joint audits would be a major opportunity for challenger firms, one can foresee these posing risks for the auditors involved. Where tasks are split, there is a greater risk of the overall picture being missed or warning signs falling into the gap between the two spheres of responsibility. In the same vein, as the CMA recognises, although an operational split within accountancy firms between audit and non-audit work may be preferable to a structural split, creating an organisational split within firms will not be straightforward, especially as one of the reasons for adopting that approach is to ensure that firms have access to non-audit expertise where necessary. The new regulator would presumably have to take action periodically to police operational splits and if those splits are required not just of the Big Four but challenger firms, then such action will be more frequent.

All that said, even if the market were to remain structurally unchanged, the proposed enlargement of the scope of the ARGA's involvement in financial reporting is dramatic. This is particularly the case with the intended shift such that both the regulator and the regulated are to become more forward-looking, which is at odds with the previous essentially backward-looking approach of the audit profession (going concern issues aside).

If the ARGA is to fulfil the aim of being more forward-looking and pre-emptive then new disputes are likely to arise between it, auditors, companies and company officers:

- If the ARGA has the ability to impose a range of sanctions on firms tendering for audit work short of de-registration, then one would expect it to be more likely to be prepared generally to impose a sanction, with any concern about a sanction being disproportionate reduced;

- If the results of AQRs are to be published, either as a matter of routine or where the ARGA is concerned, then, especially if they are no longer anonymous, one can envisage intense arguments over the conclusions of the reviews with the aim of protecting reputations and guarding against the threat of consequent sanctions; the fact of publication may be a hook to enable judicial review proceedings to be launched;

- One can also foresee clashes resulting from the Review's recommendation that there be increased CRR and the CMA's proposal that there be peer reviews and 'shadow audits'. The expectation is that the ARGA will take action to ensure these steps are effective and to act on any findings. If that is to take place, one would expect arguments over whether information demanded of companies or auditors can be required or is necessary to facilitate reviews, the accuracy of any conclusions reached, and the legitimacy and appropriateness of any actions required or taken as a result of those conclusions. Auditors will wish to defend their work and reputation, while the officers of companies are unlikely to be passive where, for example, there is a risk of the ARGA recommending the removal of their key officers to shareholders; in short, there is plenty of scope for relationships between regulator, primary auditor, shadow or second auditor and the audit client to become confrontational.

Perhaps the most striking part of the new proposals is the recommendation in the Review that the ARGA should be able to set standards for and take enforcement action against non-accountants who are CEOs, CFOs, chairs or audit committee chairs. In our view, this is a logical extension of the regulation of financial reporting. It is hard to see a basis for treating non-accountant officers differently to accountants in business when they each could have a fundamental role in financial reporting by a company, and the diligent and honest performance of their role is central to the interests of investors and by extension the wider economy. Bringing such individuals within this limb of regulation regardless of their particular professional status should end the perverse incentive for such officers to give up professional membership, a practice that cannot be in the public interest and creates unfairness. It also means, for instance, that CEOs ought to be as keenly aware of their responsibilities (and the regulatory risks they face) whether they are an accountant in business or not. It will be fascinating to see the shape of the standards imposed by the ARGA to achieve the stated aim of encouraging non-accountant company officers to prepare and approve true and fair accounts and to deal openly with auditors. Presumably, although this is not clear from the proposals, the ARGA will be expected to enforce those standards not just in the wake of corporate collapse, but also on the basis of information derived from pre-emptive activities such as CRR and 'shadow audits'.

This is a move likely to be welcomed by the audit profession. Expanding the jurisdiction of the regulator to involve more company officers should add a new dimension to the traditional investigation of or disciplinary proceedings against the auditor and the finance director (and possibly the CEO if they happened to be an accountant). We expect to see cases where the ARGA pursues enforcement action against auditors and all the relevant directors in parallel. In the past auditors have often felt that directors' responsibilities for deficiencies in financial reporting have been underplayed or overlooked. However, if both the auditor(s) and all the key individuals on the board at the audit client are subject to investigation simultaneously, then there ought to be more focus on the conduct of the directors who, after all, have the primary responsibility for the truth and fairness of the company's financial statements.

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