Audit market reform and revised auditing standards and guidance

Audit Committee update

January 2020

Building a better working world

Next steps regarding the key regulatory and independent reviews – January 2020

Brydon Review

Effectiveness review of audit

- Responses to a Call for Views were due in June 2019
- EY was represented on the Auditor Advisory Board
- A final report was published in December 2019, comprising 64 main recommendations
- Proposed changes include corporate reporting, the audit process and product

CMA Market Study/BEIS Consultation

Increasing competition in the audit market

- The CMA published its final report in April 2019, setting out four recommendations and citing a need for legislation
- The Government consulted on the recommendations in July 2019; the consultation closed in September 2019
- A policy paper is expected in early 2020 with a further consultation to follow; Autumn 2020 is the earliest date for legislation

Kingman Review/BEIS Consultation

Strengthening the audit regulator

- The Kingman Review's final report was issued in December 2018, yielding 83 recommendations
- The Government consulted on the recommendations in March 2019; the consultation closed in June 2019
- A consultation on a Sarbanes-Oxley (SOX) regime for the UK, the PIE definition and corporate failure is expected in early 2020

2016 Ethical Standard Review

Enhancing auditor independence

- In July 2019 the FRC issued an exposure draft for consultation on the Revised Ethical and Auditing Standards; the consultation closed in September 2019
- The Revised Ethical Standard was published in December 2019, changes include an extension of prohibitions on non-audit services

FRC Future of Corporate Reporting

Evolving corporate reporting

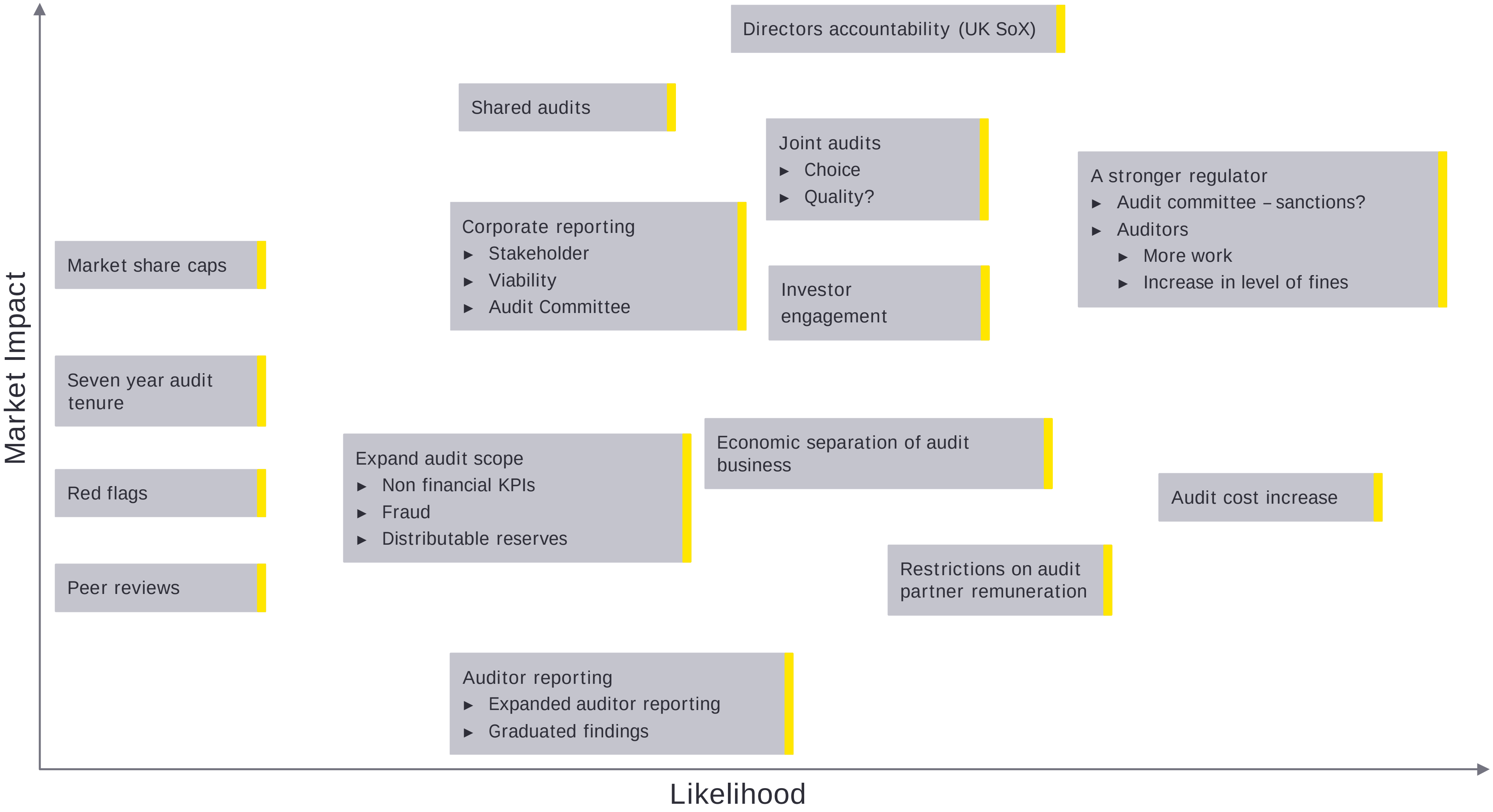
- In October 2018 the FRC launched a review of the future of corporate reporting, led by Paul Druckman
- In October 2019 the FRC opened a survey on stakeholder views of corporate reporting
- The review is set to conclude in 2020 with the FRC's publication of thought leadership
- EY is the only Big Four firm represented on the Review's Advisory Board

BEIS Select Committee Review

Overseeing audit reform

- Following evidence hearings, a final report setting out bold recommendations was issued in April 2019; the Government responded by indicating that many of the issues raised are the subject of consultations or under consideration by ongoing reviews
- In November 2019 the Select Committee issued a letter urging the Government to act on its recommendations, stating that reform of the sector is "urgently needed"

Potential outcomes of regulatory reviews – January 2020



CMA four key recommendations: potential implications

Impact	Greater scrutiny of audit committees	Mandatory joint audit or peer review for FTSE 350	Operational split between Big Four audit and non-audit	A five-year implementation review, inc changes to tendering period and independent appointment of auditors
Business process	► Introduction of mandatory minimum standards for auditor appointment and oversight ► Audit committee time required to produce reports to regulator during tendering and throughout the audit ► Potential observer from Regulator at audit committee meetings	► More board, audit committee and management time required to appoint, oversee and coordinate two auditors ► New audit committee reporting requirements doubled ► Greater pressure for audit committees and finance functions in meeting already challenging reporting cycles	► Greater pressure on audit committees and finance functions due to restricted or delayed access to specialists	► Continued uncertainty created by more reviews and changes ► Further audit committee and management time
Quality and choice	► Greater accountability and transparency potentially leading to enhancements in auditor selection and oversight ► Opportunity for increased engagement with shareholders	► Audit quality reduction due to capability/ capacity gap and joint audit programme complexities ► Management's ability to “opinion shop” between firms ► Reduces choice, esp. when coupled with mandatory rotation and non-audit services ban ► Resource scarcity	► Access to specialists may be restricted or delayed ► Profession’s attractiveness to recruit and retain high calibre talent and people with required skills/experience will likely diminish ► Reduced financial resilience may impact on acceptance and continuation	► Reduced choice due to some audit firms declining to participate in frequent, costly tenders and/or loss of control of which auditors to appoint ► Benefit of ‘fresh eyes’ outweighed by loss of deep auditor understanding derived from longer term tenure
Cost	► Increased internal costs, including senior management time, to meet regulatory requirements	► Increase in audit fees has been estimated at between 10-70% without a clear benefit	► Transfer pricing for internal specialists at market rates will increase cost of audit ► Costs of separation will increase the cost of audit ► Wage inflation	► Increased internal costs, including senior management time ► Increased audit cost if rotation period shortened

Brydon recommendations

The main recommendations are directed towards different, and in some cases multiple stakeholders including boards, audit committees, auditors, the regulator and investors. EY suggests that for now boards focus on the recommendations most relevant to companies – in particular the readiness of the organisation for a potential internal control attestation regime.

Potential impact on directors

- If implemented directors, for example, would be required to publish statements on public interest and resilience, with a mid-year risk report issued for shareholder comment to allow input to the subsequent year's external audit plan.
- In particular, the CEO and CFO would be required to provide an annual attestation to the board on the effectiveness of the company's internal controls over financial reporting. The disclosure of a material failure would trigger an external audit of these controls for three subsequent years.

Potential impact on auditors

- Auditors would also be required, amongst other things, to extend the scope of their audit beyond the financial statements and would be more explicitly required to find material fraud. They would also exercise suspicion as well as scepticism and apply a new descriptor for financial reporting statements (to be enshrined in UK company law), replacing 'true and fair' with the term 'present fairly, in all material respects', to reflect the use of estimates and judgements more effectively.
- A statement would also be included in the audit report as to whether the directors' s172 stakeholder engagement disclosure is 'based on observed reality, on the basis of the auditor's knowledge of the company and its processes'. The report also recommends the establishment of a corporate auditing profession, to follow a set of principles within a new regulatory framework that includes but is not limited to the statutory audit of financial statements.

The challenge for the Government

- The Government now has the task of reviewing the recommendations alongside reports from other reviews into the audit market and regulatory regime. It committed to do this before making any decisions on which changes should be taken forward, and to what extent legislation may be required.
- The combination of all this with a full parliamentary timetable and impending challenge of Brexit, makes it difficult to predict an implementation timetable. What is certain is that they will require a combination of regulatory and voluntary measures, with a pragmatic approach towards implementation by all concerned.

Board considerations

Board accountability

- The new regulator will focus on increased accountability for all directors
- The implementation of a strengthened framework around internal controls – benefit vs cost
- Expanded Audit Committee reporting and regulatory oversight
- Increased investor engagement, possibly similar to that with the Remuneration Committee
- ‘Red flag’ reporting by the auditor to the regulator

Cost

- Expanded finance functions to meet regulatory expectations
- The introduction of additional regulation, joint audits, and operational separation, for the Big Four, will materially increase the cost of audit. Access to specialists may be restricted
- Management time is increased by coordinating two auditors on mandatory joint audits, management of peer reviews and increased requirements on regulatory compliance

Quality

- Consideration of whether challenger firms have the capacity and capability, in terms of resource, technology and global coverage and willingness to invest to undertake joint audits
- Management ability to play one firm off against the other in joint audit

Corporate Reporting

- The Brydon and Druckman Reviews, as well as the Review of the 2016 Ethical and Auditing Standards, may change both corporate reporting and the scope of audit
- There may be an extension from shareholder to stakeholder responsibility

Choice

- Joint audit will require a challenger firm to be selected – scaling issues
- If market becomes more attractive new entrants should appear
- The Revised Ethical Standard result in further restrictions on the provision of non-audit services

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