Understanding the BEIS consultation

‘Restoring trust in audit and corporate governance’

A series of frequently asked questions on the key proposals

Managed shared audit

Introduction

On 18 March 2021, the Government (BEIS) published its long-awaited consultation on reforms aimed at ‘Restoring trust in audit and corporate governance’ (the Consultation). It’s a significant consultation with 98 questions covering almost all 155 recommendations from the Kingman, CMA and Brydon reviews, and sets out a broad programme of reform for auditors, companies, directors, audit committees, investors, other stakeholders and the regulator. The deadline for responses to the Consultation was 8 July 2021. See our summary briefing document for more details of the key proposals.

These ‘frequently asked questions’ are part of a series intended to help you understand the implication of these proposals in more detail.

This is not an exhaustive list, and we’re sure there will be plenty of questions we’ve not yet thought about. Our answers are based on our interpretation of the Government’s proposals. There’s also still a lot of uncertainty about what will be implemented, and the details of any new regime; the thoughts we’ve set out below are designed to help you think through the implications for your organisation, but please do remember that the final rules could well result in a different outcome.

One of the proposals in the consultation is to introduce a ‘managed shared audit’ regime for FTSE 350 companies. This proposal could have a significant impact on companies and their auditors. Here we’ve explained what such a regime might look like, as well as some of the potential challenges around how it might be implemented and operated.

If you would like to discuss any of these points further, please ask your usual PwC contact, or alternatively you can contact:

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Background

1 Why is the Government proposing a managed shared audit regime?

The Government outlines in the Consultation their concern that the audit market for companies in the FTSE 350 is highly concentrated* with limited choice. In their view, this limits incentives for audit firms to compete on quality. They also note in the Consultation that 'challenger firms' (see question 2) often struggle to win FTSE 350 tenders and to gain the experience of auditing FTSE 350 companies that they can apply to their wider client base. These issues combined, they believe, are detrimental to audit quality and audit market resilience. The Government considers that a managed shared audit requirement for FTSE 350 companies will increase choice and support new entrants to the FTSE 350 audit market in an effective, efficient and proportionate way.

In addition to managed shared audits, there have been other remedies proposed to increase choice in the FTSE 350 audit market – namely joint audits and a market share cap. For reference, in the Appendix we have compared the potential implications of each of these remedies.

*As of the end of March 2021, our analysis shows that 328 of FTSE 350 companies had one of the four largest audit firms as their statutory auditor. Of the remaining 22, 17 were audited by BDO and 4 were audited by Grant Thornton.

2 Who is considered to be a 'challenger firm'?

The Government's working definition of a challenger firm in this context is an audit firm that provides statutory audits to Public Interest Entities (PIEs) and whose audit revenues did not represent more than 15% of the FTSE 350 statutory audit market by fees in either of the prior two years.

However, the Government has said it would be grateful for views on the appropriate threshold. Using the Government's current definition, any audit firm auditing PIE entities, outside of the so-called 'Big 4' firms (Deloitte, EY, KPMG, PwC), would be deemed to be a challenger firm.

3 Does the Government believe the challenger firms will have the capacity and appetite to participate in this regime?

Per the Consultation, the Government's expectation is that a managed shared audit regime would motivate smaller audit firms to invest in their capacity and capabilities in order to grow and compete across the FTSE 350 audit market. In the near term, the Government believes the regime would enable the challenger firms to gain experience and credibility, but without facing unlimited liability for the entire group audit. The regime would be overseen by the regulator, who would have powers to request information from audit firms, including their growth and investment plans.

We believe that establishing the capacity and appetite of the challenger firms would be a critical success factor for the entire regime and, ideally, would be undertaken before the regime is implemented.

4 What are 'shared' audits and are they different from 'joint' audits?

A shared audit is where one audit firm (the lead auditor) takes overall control, responsibility and liability for the audit. However, another audit firm supports the lead auditor on certain aspects of the audit (potentially auditing a number of subsidiaries in a group situation). The lead auditor is the only one who signs the audit opinion.

This means that the lead auditor has to take responsibility for the direction, supervision and review of the whole audit and is responsible for all material audit judgements – but the lead auditor might rely on detailed work done by the other audit firm in reaching those judgements.

Shared audits are different from joint audits. In a joint audit, two audit firms take joint responsibility for the entire audit, and both firms sign the audit opinion. Both audit firms have to take responsibility for all material audit judgements and both could be held accountable if something goes wrong.

5 Don't we have shared audits today?

Yes. The concept of a shared audit is not new. Today, there are plenty of examples of group audits where one firm signs the group accounts, but another audit firm performs the audit work over one or more subsidiaries (or components) of the group. Circumstances where a different audit firm may be the subsidiary/component auditor include:

- Where the group auditor does not have a presence in a particular territory.
- Where the component is an associate or joint venture and so has a degree of independence from the parent entity, meaning that the component has chosen to appoint a different audit firm.
- Where there is a different cycle of audit firm rotation in the subsidiary's territory, meaning that the subsidiary has been required to change audit firm.
- In a post merger/acquisition situation where two legacy groups have had different auditors.

Often a subsidiary/component auditor will audit all or parts of the financial information of a specific subsidiary/component. They may also be requested to perform 'specified procedures' on financial information; this would not be considered a full audit of the information, but would contribute to the group auditor's consolidated work over that information. UK auditing standards set out requirements for the oversight that a group auditor must exercise over a subsidiary/component auditor.

UK auditing standards don't specify a maximum amount of an overall group audit that can be performed by another audit firm. At PwC it would be extremely unusual for us to accept a group audit appointment where a significant proportion of the group was to be audited by a non-PwC network firm.

6 So what is the 'managed' shared audit regime that the Government is proposing and how would that be different?

The Government is proposing a managed shared audit regime whereby, at their next audit retender date (after the proposal became effective), all UK-registered FTSE 350 companies would be required to either:

- Select a challenger firm as their lead auditor; or
- Outsource a 'meaningful proportion' of the group's statutory audits to a challenger firm.

This is different from today's shared audits as:

- The regime would be mandatory with few, if any exemptions;
- The audit would need to be shared with a challenger firm; and
- The part of the audit that is 'outsourced' would need to be a meaningful proportion of the work that would give the challenger firm access to, and engagement with, a company's main audit committee.

It is proposed by the Government that this 'meaningful proportion' would be calculated with reference to one or more of total group audit fees, revenues, profits and assets or would be somewhere between 10-30% of these measures.

The regime would be overseen by the Audit, Reporting and Governance Authority (ARGA) and would not remain in place indefinitely (see question 8 below). ARGA is the new regulator that the Consultation proposes to replace the Financial Reporting Council (FRC), the current regulator.

7 How would I split the audit work between the two firms?

As noted in question 6, the Consultation proposes that under a managed shared audit regime, the challenger firm would be given a meaningful proportion of the group's statutory audits with the meaningful proportion measured by reference to 10-30% of group audit fees, revenues, profits or assets. The reference to 'statutory audits' suggests that the Government contemplates audit work being split by legal entity; there may be some practical challenges in splitting the audit work this way (see questions 14 and 17 below).

It is also proposed in the Consultation that there would be merit in the subsidiaries that the challenger firm audits being varied during the term of the audit contract, to provide the challenger firm with greater exposure throughout the group.

8 Is this expected to be a permanent requirement? Are any other measures being considered?

This is not expected to be a permanent requirement. The regulator (the FRC, who will become ARGA) will be responsible for monitoring the success of the proposal. If, after a period of time (likely to be 5-9 years), it is decided that the regime has been effective in increasing choice in the FTSE 350 audit market it may continue for a further period.

However, if ARGA determines that the market has not changed sufficiently, the Government reserves the right to try an alternative option, which could be the imposition of a market share cap meaning that a limited portion of the FTSE 350 audit market would be reserved for the challenger firms. The Government proposes that the principal features of a market share cap would be that:

- It would apply to all UK-registered FTSE 350 companies (although in reality it may only impact a proportion until the cap was reached); and
- The cap would not be set at a specific percentage applied to an audit firm or group of audit firms, rather it would be at the discretion of the regulator as they examined the pipeline of upcoming tenders taking into account the capacity and capabilities of a cohort of challenger firms.

In reality, we think this would mean that ARGA could identify a number of upcoming FTSE 350 audit tenders and require that the audit mandates be awarded to the companies' choices of challenger firm.

Scope of a managed shared audit regime

9 You say this would apply to all FTSE 350 companies. Would there be any exemptions?

The Consultation is clear that the managed shared audit regime would be applied to all UK-registered FTSE 350 companies with only very limited exceptions. There would be no blanket exemptions for the largest and most complex FTSE 350 companies (this differs from previous consultations where there have been suggestions that the 'choice' remedy might not be applied to very large and complex groups). Also, there would be no exemptions for Investment Trusts and individual entities that don't prepare group accounts (see question 12 below for more details).

The Government intends to provide exemptions for companies only in 'exceptional circumstances', and proposes to give the regulator the power to determine when such circumstances have arisen. The Consultation notes that exceptional circumstances could include a situation where a company does not receive a bid from a challenger firm or where those bids are of insufficient quality. The Consultation also suggests that allowances would be made for companies who have not been in the FTSE 350 for a certain length of time (see question 13 below)

However, in the Impact Assessment accompanying the Consultation, the Government acknowledges there is a risk that companies may not have suitable subsidiaries for sharing and that they believe the proposal would work most successfully on FTSE 350 groups where there are 'material UK subsidiaries that a challenger firm could comfortably audit'. They consider these groups to be those that have UK-incorporated subsidiaries that individually account for 20-60% of group turnover or group total assets. The Impact Assessment estimates this could be just 149 of the FTSE 350 companies.

So it appears that, although there are no blanket exemptions, the Government does not expect a managed shared audit to be workable for all FTSE 350 companies and that, perhaps, as noted above, the regulator would have the power to determine which companies might be exempted.

It also appears that the Government may be seeking to design a managed shared audit remedy that relies on the audit of UK-incorporated subsidiaries being outsourced to a challenger firm. It's likely that this would be easier to implement, rather than creating extra-territorial impacts, and of course, this could encourage the challenger firms to build capacity in the UK. However, such an approach would not address the potential need for challenger firms to reinforce their overseas networks.

10 Would this only apply to companies listed in the UK or could it also apply to UK subsidiaries of overseas listed companies?

The Consultation suggests that the managed shared audit regime would only apply to UK-registered companies that are in the FTSE 350. So if a company is listed overseas and not in the UK it would be unlikely to be captured as part of the regime, and neither would any of its non-listed UK-registered subsidiaries. The managed shared audit regime is one of the few proposals in the Consultation where the Government doesn't suggest that application could ultimately extend to all PIEs.

11 I already use a challenger firm to audit a number of my overseas subsidiaries, will this count as a managed shared audit?

As discussed in question 9 above, the Government's focus appears to be on the audits of UK-incorporated subsidiaries being shared as part of the regime. It's not clear whether a situation where a meaningful proportion of the group was audited by a challenger firm, but where that proportion only included overseas businesses, would qualify as a managed shared audit under the proposed regime. However, since ARGA will have oversight of the regime, we expect that groups could engage with ARGA to discuss individual situations. The Consultation does also specify that the challenger firm would need access to, and engagement with, the group's main audit committee.

12 How would this work for investment trusts and companies that do not prepare group accounts? It seems like it wouldn't be possible to share these audits by dividing up subsidiary statutory audits.

The Government acknowledges that it may not be possible for the managed shared audit regime to be implemented on these types of entities. However, in these situations, the Consultation suggests that there should be no reason why a challenger firm shouldn't be appointed as sole auditor and that audit committees of these types of entities would be expected to carry out an audit tender that encouraged the appointment of a challenger firm.

13 Are there any allowances for companies moving in and out of the FTSE 350?

The Consultation proposes that the managed shared audit regime would not apply to a company which has not been a FTSE 350 company for at least half of the annual accounting period prior to the auditor appointment and which is not a FTSE 350 company when the audit tender process begins.

The Consultation also suggests that if a company that has already implemented a managed shared audit subsequently leaves the FTSE 350 index, it would be expected that the shared audit arrangements would remain in place until the audit engagement is next retendered. The only exceptions to this would be if the company were to cease trading in its current form, were to be delisted from the London Stock Exchange Main Market or were to be acquired by an overseas entity that was not subject to the managed shared audit requirements.

Possible scenarios and practical challenges of a managed share audit regime

Significantly large UK-incorporated subsidiary/subsidiaries

14 I have one UK subsidiary that generates 90% of my group revenue, does this mean that a managed shared audit regime won't work for me?

As we explain in question 7 above, the Consultation suggests that under a managed shared audit regime, audit work would be shared by allocating the audit of particular legal entities (likely UK subsidiaries) to a challenger firm. However, this approach could be problematic for a group where a UK subsidiary represents a very large proportion of the whole; if the UK subsidiary audit were to be awarded to a challenger firm, then there could be insufficient audit work remaining for another audit firm to feel able to sign off on the group accounts. As we note in question 5 above, it would be extremely unusual for PwC to accept a group audit appointment where a significant amount of the group was to be audited by a non-PwC network firm. In this case, a managed shared audit might not be achievable through allocating whole subsidiary audits to a challenger firm.

An alternative might be to split the audit work in a different way, perhaps with a challenger audit firm taking responsibility for auditing a particular process or cycle (for example, the purchases and payables cycle). However, our experience suggests that the complex interplay between financial statement balances and transactions, and financial systems and processes, could mean that such an approach would be complex to implement and could result in significant duplication of audit effort.

Small UK-incorporated subsidiary/subsidiaries

15 What if I don't have a UK subsidiary that contributes more than 20% of my group revenue or assets?

As noted in question 9 above, the Consultation proposes that the managed shared audit regime would apply to all UK-registered FTSE 350 companies (unless they choose to appoint a challenger firm as their lead auditor); the regime would involve a meaningful proportion of their statutory audits being 'outsourced' to a challenger firm. In the Government's Impact Assessment, it's suggested that this would work best on companies that have UK-incorporated subsidiaries that represent 20-60% of group turnover or group assets. The Government hasn't provided their rationale for the 20-60% range – but clearly if audits of UK subsidiaries of this magnitude were to be outsourced to a challenger firm then the Government's desire for the challenger firm to audit a 'meaningful proportion' of the group would be achieved.

This could suggest therefore that UK-incorporated subsidiaries representing less than 20% of group revenue or assets would not be considered material enough to achieve the objectives of the managed shared audit regime. However, the Consultation doesn't specify that there would be an exemption in this situation. It's possible, as noted in question 11 above, that ARGA could accept the allocation of audits of overseas subsidiaries to a challenger firm as an alternative – although this is not specifically contemplated in the Consultation.

Subsidiaries that are heavily integrated with the group operations

16 At my company, we have a material UK subsidiary but the financial processes at this subsidiary are fully integrated with the rest of the group. We have one finance team, one system and one set of processes. How will this regime work for me?

It's clear that there could be challenges in efficiently outsourcing a meaningful proportion of the audit work in companies where the subsidiaries are highly integrated with the parent company or other parts of the group. In particular, it could be difficult to avoid substantial duplication of audit work.

Shared service centres and shared audit evidence

17 How would a managed shared audit regime work where my company has significant shared service centres or where my auditors test certain controls centrally and share the audit evidence with others in their network (an approach often used in respect of IT general controls)?

As noted in question 7 above, the proposals contemplate that the audits of whole legal entities would be allocated to a challenger firm. As this question demonstrates, the operations of a large group do not always follow a legal entity structure – often systems and processes are shared between entities. Where a single audit firm is responsible for the audit of such a group, audit work can be planned so that it is performed once, with the results shared throughout the team to facilitate the completion of audits of statutory entities.

In theory, the same approach could be used if more than one audit firm is involved. For example, the group auditor could take responsibility for the audit of a shared service centre and then share the results of that work with a challenger firm responsible for the audit of a subsidiary. However, we anticipate that this process of sharing audit evidence could be significantly more complex if operating between different audit firms.

Additional costs

18 It seems inevitable that there will be some duplication of efforts, perhaps a lot. What are the additional audit costs to the company estimated to be?

The Impact Assessment that accompanies the Consultation assumes that, where a managed shared audit is undertaken, the additional effort would be in the planning, cross-review and completion phases of the audit. There is an assumption that no additional effort would be required during the execution phase of the audit (questions 14 and 17 highlight situations where we believe this may not be the case).

Overall, the Impact Assessment estimates that the additional audit effort would result in an increase in audit fees of between 5% and 15%. However, we believe that the complexities of this regime mean that the uplift in audit fees could be higher than the Government has estimated. It's also important to note that it's likely there would be considerable additional time and effort for management teams in dealing with two audit firms.

The auditor appointment process

19 Would there be one or two separate audit tenders?

Changes to UK Company Law (including the Competition and Markets Authority (CMA) Order) introduced mandatory audit tendering every ten years for FTSE 350 companies incorporated in the UK. The regime requires a competitive tender process whereby a company invites and evaluates bids for the provision of audit services from two or more auditors. The Consultation suggests a managed shared audit regime would apply at the next tender and that there would be separate tender processes for the lead auditor and the challenger firm. Although it is likely that both tenders would be held at the same time, the tender outcomes would be independent of each other (i.e. the lead auditor and challenger firm would be selected separately, not as a 'package').

20 Would both the lead auditor and the challenger auditor be subject to non-audit services restrictions?

The FTSE 350 companies that this regime would apply to are PIEs. As such, their auditors would already be subject to restrictions over the non-audit services they can provide to the company. As the challenger firm would be performing a meaningful proportion of the audit work, it is our expectation that many of the restrictions for PIE entities would apply to the challenger firm and some may apply to other firms in its network, but the situation is complex and not covered in detail in the Consultation.

21 Would the challenger auditor also be subject to the same rotation requirements as the lead auditor?

Strictly speaking the mandatory audit firm rotation regime applies only to PIEs, and the Consultation doesn't suggest that it would be extended beyond PIEs. This means that in a group headed by a PIE, and where a challenger firm audits a number of non-PIE subsidiaries (as part of a managed shared audit arrangement), those subsidiaries would not, technically, be subject to the mandatory audit firm rotation regime. This could mean that the challenger firm could stay in place at the subsidiary level, even if the group auditor (the Big 4 firm in a managed shared audit arrangement) were to be required to rotate.

We think this could be an area that ARGA examines more closely as part of the implementation of any managed shared audit regime. It's possible that ARGA could conclude that if the challenger firm is taking responsibility for a meaningful proportion of the audit work for the group, then it would be appropriate for the group rotation regime to apply to the challenger firm.

Appendix

The debate about audit reform has progressed over a number of years, and during that time, several different remedies have been proposed to meet the policy objective of increasing the amount of choice in the FTSE 350 audit market. Remedies considered include managed shared audit (currently favoured by Government), but also joint audits and market share caps.

In the table below we've considered some of the implications of each of these remedies to assist in comparing the advantages and disadvantages of each. Please note that this table reflects our opinions, and other stakeholders could hold different views.

	Managed shared audit	Joint audit	Market share cap
Access to large company audit committees for challenger firms	To some extent	Yes	Yes
Managed shared audit	To some extent	To a larger extent	Yes (albeit not across the whole market – it is unclear whether any cap would target less complex organisations or simply those whose rotations are imminent)
Managed shared audit	Yes	Yes	No
Reduces choice of audit firm at next tender	Probably (challenger firm could be considered 'timed out' and unable to take on the group audit)	Yes (both joint audit firms would become time barred)	Yes (substantial reduction in choice as Big 4 firm could not be appointed)
Reduces choice of non-audit service providers	Yes	Yes	No
Increases number of tenders required	Yes	Yes	No
Requires a particular structure to make it work well	Yes – if the proposal is based on outsourcing audit of UK subsidiaries	No – but there could be challenges in agreeing division of audit work	No

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