

# ANTICIPATING MUCH-NEEDED REFORM IN THE UK AUDIT INDUSTRY

*Counsel should be aware of reforms due to be made in wake of recent high-profile company collapses in the UK and wider implications for businesses*

**A**lmost two decades after the Enron scandal and Arthur Andersen collapse brought sweeping regulatory reform to the US audit profession, the UK is now taking major strides in a similar direction. What will this mean for counsel to both UK audit firms and businesses?

Recent scandals in the UK – Thomas Cook Group, Carillion and BHS to name a few – have put auditor independence and audit quality firmly back at the top of the agenda, particularly in the Big Four firms. Auditors’ ability to maintain independence in the face of pressure from large corporation management is being questioned. When the wave of post-Enron scandals stirred similar questions in the US, the result was the establishment of the Public Company Accounting Oversight Board (PCAOB), additional regulation of auditors and tightened rules around selling non-audit services to audit clients. Structural reforms such as these could create new legal obligations for audit firms and businesses in the UK.

Recent developments have signalled a path to reform similar to the US in the years post-Enron. They address concerns over weak audit independence and professional scepticism, resulting from lengthy auditor tenure or simultaneous provision of audit and non-audit services.

- In 2016, changes to the EU Audit Reform Legislation required mandatory audit firm rotation for Public Interest Entities (PIEs) in the EU.
- In April 2019, the UK Competition and Markets Authority (CMA) recommended splitting the audit and non-audit practices of the Big Four firms.
- Meanwhile, the UK Financial Reporting Council’s (FRC) revised ethical standard of 2019 only permits PIE auditors to provide non-audit services which are closely linked to the audit itself or required by law or regulation. This will impact auditors’ ability to provide various services including recruitment, remuneration, due diligence, tax advice, advocacy and acting in management roles for public companies they audit.
- The newly formed Audit, Reporting and Governance Authority (ARGA) will replace the UK FRC, though it remains to be seen if this new authority’s remit will indeed tackle fundamental issues plaguing the UK audit industry. It has announced its intention to add lawyers and forensic accountants to strengthen oversight, including within its case examination function.

Another lesson learnt from the US is that UK audit reform is likely to impact companies as much as accountancy firms. There are no companies ‘too big to fail’ when the economy is in decline and regulators are equipping themselves to catch any illicit behaviour by companies under pressure to produce results that appease stakeholders. An imminent rise in interest rates and heightened risk of recession threaten to put more UK businesses in this difficult position of meeting investor expectation.

Counsel should be aware of the implications of key complex accounting issues that may arise in situations such as fair value disputes, inappropriate revenue recognition or insolvency proceedings. Whether you are advising a company or the audit firm in such scenarios, you may at some point need to engage robust and independent accounting expertise in areas for which a UK court or regulator may eventually hold your client liable. Pivotal areas for counsel to bear in mind include:

- Where a company has engaged both advisory and audit services from the same firm, be very alert to potential conflicts of interest further down the line.
- Seek appropriate accounting advice to ensure that complex issues are handled in line with industry best practice.
- Encourage auditors to reasonably challenge management’s estimates in areas of judgement (e.g. fair value, goodwill impairment, provisions and contingent liabilities) without bias or fear of retaliation.
- Support auditors in exercising professional scepticism, ensuring the application of specific skillsets and assessing the reliability of information when auditing complex matters or areas of professional judgement in which information is often not available.

It is important for lawyers to consider the consequences for client corporations of underperformance by professional accounting firms or internal audit teams. With accounting and audit scandals on the rise, UK audit reform will bring about some much needed legislative change that will impact both professional accounting firms and corporations. Legal counsel must be ready to act.



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