

<p>Title: Post-Implementation Review of the Statutory Auditors and Third Country Auditors Regulations 2016, the Statutory Auditors and Third Country Auditors Regulations 2017, and the Statutory Auditors Regulations 2017</p> <p>PIR No: BEIS032(PIR)-21-BF</p> <p>Original IA/RPC No: BIS016 (F)-16-BE</p> <p>Lead department or agency: Department for Business, Energy and Industrial Strategy</p> <p>Other departments or agencies: Financial Reporting Council</p> <p>Contact for enquiries: Orkid Russell - 0300 068 8037</p>	Post Implementation Review
	Date: 07/09/2021
	Type of regulation: EU
	Type of review: Statutory
	Date measure came into force: 17/06/2016 (<i>the 2016 Regulations</i>)
	Recommendation: Keep
RPC Opinion: Green	

1. What were the policy objectives of the measure? (Maximum 5 lines)

The specific objectives of the reforms enacted by the Regulations were to: a) improve confidence in the value of audit, b) reinforce the independence of, and professional scepticism applied by, the statutory auditor, c) increase accountability of independent audit committees of Public Interest Entities; d) improve and better co-ordinate auditor supervision by competent authorities, thereby enhancing audit oversight and quality, e) reduce the risk of misstatement or error in audited accounts, thereby making accounts and audit more credible for shareholders and audit committees; and f) increase competition and choice in the PIE audit market, thereby making the market for large company audits more dynamic.

2. What evidence has informed the PIR? (Maximum 5 lines)

This Post Implementation Review (PIR) takes a medium-evidence approach to evaluation, which is proportionate for this medium-high-impact measure. The evidence marshalled in this review is collated from several sources including **primary research; this includes a stakeholder survey and data analysis using FAME, Audit Analytics and econometric modelling** to examine the economic burden from compliance with the Regulations. **An evidence review** was also conducted where independent reports and academic literature was assessed.

3. To what extent have the policy objectives been achieved? (Maximum 5 lines)

There has been progress towards achieving the Regulations' objectives. The Regulations were a step towards the goal of higher audit quality. The effectiveness of the Regulations will depend on improvements currently being made to the regulator, through the Government's proposals on audit reform. Less progress has been achieved at increasing auditor choice as challenger firms are not considered to provide the same breadth of audit services as Big Four firms. For this reason, the Government is consulting on reforms to try to increase capacity and experience of non-Big Four audit firms.

Sign-off for Post Implementation Review: Chief economist/Head of Analysis and Minister

I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

Signed:

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Date: 07/09/2021

Further information sheet

4. What were the original assumptions?

In estimating the impact of the measures, the original impact assessment (IA) made several assumptions. The assumptions related to coverage of measures and the unit costs of compliance. These resulted in total costs of £220m (Present value over 10 years).

5. Were there any unintended consequences?

The evidence shows there have been unintended consequences, in those measures to increase audit quality have come at the expense of auditor choice either because of mandatory rotation or because the added burden of auditing some PIEs has reduced the number of auditors available. As more companies have come into scope of the definition of a PIE, this has reduced the number of auditors available in the PIE audit market. For this reason, the Government is consulting on reforms to try to increase supply side capacity to carry out the largest audits. We would then expect the effectiveness of the Regulations in promoting choice to increase.

6. Has the evidence identified any opportunities for reducing the burden on business?

Respondents to the stakeholder survey, particularly those that represent smaller companies, are concerned about compliance costs. Just under half of the respondents recognised that the benefits of the Regulations either outweighed or justified the costs. Findings from our econometric analysis shows that firms brought into the PIE definition by the regulation have faced higher audit fees. The rationale for the expansion of the PIE regime was that the previous regime did not include all companies that potentially represented a systemic risk, particularly to the financial system. It is therefore likely that companies do not recognise all the benefits of the Regulations, many of which will not accrue to them but will accrue to wider society.

7. For EU measures, how does the UK's implementation compare with that in other EU member states in terms of costs to business? (Maximum 5 lines)

In terms of *scope*, the Regulations went further than the minimum implementation requirements in EU law. They applied the relevant provisions of the Audit Directive to auditors of non-PIE Limited Liability Partnerships (LLPs), to ensure consistency in treatment for similar legal entities under the audit regulatory framework (the Regulations were also applied to PIE LLPs in line with the Directive). However, in terms of *content* the UK implemented the minimum EU requirements. The UK implemented the minimum EU baseline for: the PIE definition (along with 9 of 27 other Member States); the measures on mandatory rotation; and the measures on non-audit services (up to 2020, when the non-audit 'white-list' came into effect).

Post Implementation Review of the Statutory Auditors and Third Country Auditors Regulations 2016, the Statutory Auditors and Third Country Auditors Regulations 2017 and the Statutory Auditors Regulations 2017

Introduction

1. The Statutory Auditors and Third Country Auditors Regulations 2016 (“the Regulations”)¹ came into force on 17th June 2016. The Regulations implemented: i) Directive 2014/56/EU (“the Audit Directive”) on the audit of limited companies and other undertakings required to be audited under EU law; and ii) Regulation (EU) 537/2014 (“the Audit Regulation”) on the audit of undertakings classified as public interest entities (PIEs), that is, entities whose securities are traded on a regulated market, credit institutions and insurance undertakings.
2. In terms of *scope*, the Regulations went further than the minimum implementation requirements in EU law in one respect. They applied the relevant provisions of the Audit Directive to auditors of non-PIE Limited Liability Partnerships (LLPs), to ensure consistency in treatment for similar legal entities under the audit regulatory framework. This was consistent with the approach taken for implementing accounting reforms made the same year, where a separate 2016² regulation implemented the same amendments for LLPs that had already been implemented for companies in 2015³. These parallel reforms for companies and LLPs, though LLPs were not subject to the obligation to comply with EU law in the same way, helped businesses, and their investors, clients and contractors by making sure that the accounts prepared were comparable and had been subject to the same preparation and audit arrangements. This also reduced familiarisation costs for preparers and auditors with two different frameworks.
3. However, in terms of *content* the UK implemented the minimum EU requirements. Annex A sets out a comparison of the UK’s implementation of the audit reform programme with that of other EU Member States. The UK implemented the minimum EU baseline for: the PIE definition (along with 9 of 27 other Member States); the measures on mandatory rotation; and the measures on non-audit services (up to 2020, when the non-audit ‘white-list’ came into effect⁴).
4. In October 2015, the Government launched a consultation on proposals relating to the implementation of the Audit Regulation and Audit Directive. The consultation informed a final Impact Assessment⁵ for the Regulations in 2016, which estimated that the net cost to business per year would be £24.7 million, and that the Regulations would impose a total present value cost over 10 years of £220.1 million.
5. The Regulations contain an obligation in regulation 24 to review them within five years of coming into force. This PIR fulfils that obligation. The Statutory Auditors and Third

¹ <https://www.legislation.gov.uk/ukdsi/2016/9780111147047/contents>

² The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (SI 2016/575)

³ The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980).

⁴ <https://www.frc.org.uk/getattachment/601c8b09-2c0a-4a6c-8080-30f63e50b4a2/Revised-Ethical-Standard-2019-With-Covers.pdf>, the new regulations are set out in section 5.

⁵ https://www.legislation.gov.uk/ukia/2016/149/pdfs/ukia_20160149_en.pdf

Country Auditors Regulations 2017 and the Statutory Auditors Regulations 2017 also came into force on 1st May 2017 and 1st January 2018 respectively, and are covered by this Post Implementation Review, although these contain no statutory review obligations. The two sets of 2017 Regulations continued the implementation of the Audit Regulation and Audit Directive in respect of other entities such as friendly societies and miscellaneous insurance undertakings, to better ensure consistency across the audit and accounting framework and improve the clarity of some of the original Regulations' provisions. Relatively few entities were affected by the 2017 regulations. This review largely focuses on entities that were impacted by the 2016 reforms but the findings are also relevant to those covered by the 2017 regulations.

6. This PIR considers the costs and benefits of the reforms, and establishes whether, and to what extent:
 - the objectives of the Regulations remain appropriate;
 - the Regulations have achieved their original objectives;
 - the objectives could be achieved through a less onerous regulatory provision to reduce the burden on businesses and/or increase societal value;
 - the measures within the Regulations are still required and remain the best option for achieving those original objectives.
7. This review also assesses the extent to which the effects anticipated in the original Regulatory Impact Assessment (IA) occurred, and whether there were any unintended effects of the measure, and the reason for those.
8. This review utilises evidence gathered from a wide range of sources, including new data collection, and secondary research.
9. The Government is currently consulting⁶ on further reforms to audit and corporate reporting in response to the Independent Review of the Financial Reporting Council (the FRC Review)⁷, the Competition and Markets Authority (CMA) Statutory Audit Services Market Study (the CMA Study)⁸, and the Independent Review into the Quality and Effectiveness of Audit (the Brydon Review)⁹. This consultation closed on 8th July 2021. This PIR is therefore relevant to the wider audit reform package that the Government is undertaking but does not include the findings of the latest consultation.

⁶ <https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms>

⁷ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

⁸ https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf

⁹ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf

Policy background

10. In the early 2000s, audit scandals occurring in the US (Enron), Netherlands (Ahold), and Italy (Parmalat) had created a justification for audit regulatory reform. European legislators revised the existing Eighth Council Directive (84/253/EEC) to strengthen the regulation of statutory auditors, and, in April 2006, the European Council went further by adopting, in its place, the original Audit Directive (2006/43/EC) on the audit of accounts of companies and other undertakings required to be audited under EU Law.
11. Following the financial crisis of 2008, however, there was a widespread perception that the accounts of many financial institutions had been given unjustifiably clean bills of health, which had misled investors and regulators, undermined business confidence in, and the operation of, the wider financial system, and contributed to the eventual recession.
12. This led to measures to re-establish investor confidence in the audit process and in the quality of financial information reported by companies. The European Commission introduced Regulation (EU) 537/2014 on specific requirements regarding the statutory audit of PIEs and the Directive 2014/56/EU amending Directive 2006/43/EC on statutory auditors of annual and consolidated accounts. The Audit Regulation and Audit Directive entered into force on 17 June 2014, with the Audit Regulation taking effect on, and the Audit Directive having to be implemented by, 17 June 2016. The Regulation and the implementation of the Directive applied to accounting years beginning on or after 17 June 2016.
13. The UK implementation in the form of the 2016 Regulations and the two sets of 2017 Regulations, covered measures set out in both the Audit Regulation and the Audit Directive. They were part of a package to improve audit quality and build confidence in the audit process. Hence this PIR treats the UK Regulations as one set of regulatory measures and refers to them as “the Regulations”.
14. This PIR therefore assesses the following legislative reforms:
 - **Extending the scope of the Regulations to unlisted banks, building societies, and insurers (unlisted PIEs) and non-PIE LLPs**

Article 2 of the Audit Regulation extended the scope of the requirements on audits of PIEs by removing a Member State option to exempt banks, building societies and insurers that do not issue securities on a regulated market. The scope of the UK’s implementation of the Audit Directive was also extended to non-PIE LLPs to ensure consistency in treatment for similar legal entities under the audit regulatory framework.

Article 13 of the Audit Regulation extended the scope of transparency reporting to also include unlisted PIEs. As part of the report, the auditor was required to report to the regulator on audit and non-audit revenues received from each PIE.
 - **Mandatory retendering and rotation for PIE audit engagements**

Article 17 of the Audit Regulation set a maximum period for all PIE audit engagements at 20 years, with mandatory retendering after 10 years. Mandatory retendering for FTSE350 companies was announced by the CMA

in 2014¹⁰, i.e., 2 years before the Regulations took effect, but it was decided that commencement of CMA requirements would coincide with implementation of the Audit Regulation.

- **Restrictions on provisions of non-audit services for PIEs**

Article 4 of the Audit Regulation mandated that all PIEs would be subject to a 70% cap on the amount of fees for non-audit services that could be paid to their auditor.

Article 5 of the Audit Regulation prohibited auditors from providing certain non-audit services¹¹. However, effective 15th March 2020, the FRC moved to a “white-list” approach to non-audit services¹², going above the EU baseline for minimum implementation to enforce more stringent rules.

- **Development of independent audit committees**

Article 1(32) of the Audit Directive extended audit committee requirements to cover unlisted PIEs. It also placed additional independence requirements on the constitution of audit committees by PIEs so that a majority of members should fulfil non-executive roles and that the chair must be independent.

Article 11 of the Audit Regulation required all auditors of PIEs to prepare an additional report for the audit committee setting out the results of the audit.

- **Changes to the framework of the statutory regulator**

Article 24 of the Audit Regulation required the FRC, as the competent authority, to inspect all auditors of PIEs. This increased the number of auditors subject to FRC inspection and meant that inspections of smaller auditors of PIEs could no longer be delegated to the professional bodies. Under Article 26 of the Regulation, the minimum frequency of inspections for auditors of small and medium sized PIEs was decreased from every three to every six years, while the minimum frequency of inspections for auditors of unlisted large PIEs was increased from every six to every three years. Under Article 1(24) of the Directive, for auditors of small non-PIEs, the minimum frequency of FRC inspections was removed, though the frequency of inspections was to be determined on a risk basis.

Articles 20 to 25 of the Regulation and 1(26) of the Directive required the introduction of a new framework for FRC powers as the competent authority with ultimate responsibility for the regulation of auditors. The FRC had the option to delegate the following activities to professional bodies: the approval and registration of statutory auditors and audit firms; the adoption of relevant

¹⁰ https://assets.publishing.service.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf

¹¹ The prohibited non-audit services were: certain tax services; any services playing a part in management or decision-making; bookkeeping; preparing accounting records/financial statements; payroll services; designing/implementing internal control or risk management procedures related to financial information; designing/implementing financial information technology systems; valuation services; certain legal services; any services related to internal audit; services linked to financing, investment strategy, or capital structure and allocation; promoting/dealing in/underwriting shares; and certain human resources services.

¹² <https://www.frc.org.uk/getattachment/601c8b09-2c0a-4a6c-8080-30f63e50b4a2/Revised-Ethical-Standard-2019-With-Covers.pdf>, the new regulations are set out in section 5.

standards; oversight of continuing education; quality assurance systems (but only for non-PIE audits); and the investigations (for non-PIE audits) and the disciplinary system of sanctions and measures to remedy poor performance. However, for PIE audits, tasks related to sanctions and other measures could only be delegated to a body independent from the profession, so these have not been delegated. Furthermore, an administrative direction by the Secretary of State required the FRC to delegate tasks to the Recognised Supervisory Bodies to the maximum extent possible and retain only those tasks that the competent authority is required to carry out under the Regulation, i.e. audit quality monitoring for PIE audits, and investigations and enforcement for PIE audits and other cases of significant public interest.

Article 23 of the Regulation and Article 1(25) of the Directive set a new framework on the imposition of sanctions by competent authorities, including new powers for the FRC to obtain information from third parties.

- **Prohibition of “Big Four only” clauses**

Article 1(30) of the Directive prohibited restrictive clauses in financial loan agreements which restricted the borrower’s choice of auditors (often to the Big Four audit firms – KPMG, PwC, Deloitte and EY) for the duration of the loan agreement. Similar provision is also included in Article 16 of the Regulation specifically for audits of PIEs.

- **Auditor dismissal framework**

Article 1(31) of the Audit Directive created a framework which allowed the regulator, or 5% of the members of the company, to remove an auditor in specific circumstances.

Rationale for intervention

15. The IA identified information asymmetry and the under-supply of robust, independent audit – arising from misaligned incentives, conflicts of interest and a lack of competition – as the key market failures affecting audit. These market failures were expected to lead to poor corporate reporting quality for business decision-making, reduced investment, higher costs of capital for companies, and ultimately, to undermine the value of audit and investor and stakeholder confidence in the market.
16. Misaligned incentives were recognised to be at the heart of the problem with audit. These arise from two fundamental issues: the ‘principal-agent problem’, wherein the interest of the company, managers may diverge from the best interests of shareholders when appointing auditors or when providing corporate reporting, which could lead to poor quality reporting and audit for shareholders. There is also the issue of the ‘expectation gap’ that is perceived to exist between the assurance that statutory auditors are required to provide and the assurance that commentators and the public believe they should provide.
17. Conflicts of interest were also recognised as a threat to auditors’ independence, integrity, and professional scepticism. These could result from provision of non-audit services to audited entities; the fact that an audit client selects and pays the auditor,

and from the familiarity resulting from a client retaining the same auditor for long periods.

18. The audit market was also shown to be affected by limited choice, with a small group of large auditors dominating the market for large audits. Prior to these Regulations, evidence presented to the European Commission¹³ showed that the effective choice in the market for audits of large, listed companies and large financial institutions had gradually become limited to the Big Four audit firms. Less choice can lead to more imperfect matches between auditors and their audited entities, leading to welfare losses for auditees as they cannot get the auditor they prefer. The following were highlighted as barriers to market mobility:
 - Asymmetric information about the quality of audit firms, resulting in reputation becoming an important factor in auditor choice.
 - Well-developed international networks of the Big Four covering most countries in which multi-national companies had a presence.
 - Restrictive clauses in loan agreements which restricted borrowers' choice of auditor, often to the Big Four audit firms.
 - Lack of audit contract retendering and rotation which gave little opportunity for new entrants to compete for audit contracts – this issue arose because of the potentially significant time spent in the selection and education of a new auditor, and the existence of strong, long-standing relationships between auditors and auditees.
 - Restrictive ownership rules which created a competitive advantage for larger audit firms.

Policy Objectives

19. The objectives of the reforms were to:
 - Improve confidence in the value of audit;
 - Reinforce the independence and professional scepticism of the statutory auditor;
 - Increase accountability of independent audit committees of PIEs;
 - Improve and better co-ordinate auditor supervision by competent authorities, thereby enhancing audit oversight and quality;
 - Reduce the risk of misstatement or error in audited accounts, thereby making accounts and audit more credible for shareholders and audit committees; and
 - Increase competition and choice in the PIE audit market, thereby making the market for large company audits more dynamic.
20. This PIR evaluates whether the reforms have achieved their objectives, the extent to which the reforms have addressed the identified problems in the audit market and

¹³ http://ec.europa.eu/internal_market/auditing/docs/reform/impact_assesment_en.pdf

the extent to which the expected benefits, as set out in the logic model in Figure 1 below, have been achieved.

Review approach

21. This PIR takes a medium-evidence approach to evaluation, which is proportionate for a medium-high-impact measure.
22. The evidence marshalled in this review is collated from several sources and is summarised below, but further detail can be found in Annex B.
 - **Evidence review** – the existing evidence was first collated to understand the current landscape and existing evidence gaps. This involved a review of academic papers and independent reports which include the three major independent reviews of audit regulation, audit practice and the audit market: the FRC Review, the Brydon Review, and the CMA Study. This also included the EU’s own review of the 2016 audit reform package¹⁴, which assessed the impact of the Audit Regulation and Audit Directive throughout all Member States.
 - **Stakeholder survey** – this online survey gathered views from a range of stakeholders, e.g., companies, investors, audit firms and representative groups, on how effective the Regulations have been in meeting their objectives. BEIS contacted and distributed the survey to 102 email contacts. Some respondents canvassed views from colleagues in the organisation or collected views from their members and submitted a collective response. Others distributed the link to colleagues and submitted their responses individually. Responses were uneven with most responses received from ‘businesses/companies that are subject to statutory audit and is a PIE’ (32 responses), 11 responses from audit firms, 10 from representative organisations, 5 from businesses/companies that are subject to statutory audit and is not a PIE, and lastly, 4 individual investors. This has been considered in the interpretation of results. Further information can be found in Annex B and C.
 - **Primary research** – we carried out in-house primary research and analysis into the impact of the regulation, using available data taken from FAME and Audit Analytics. Econometric modelling was then utilised to review the change in audit fees, to examine the economic burden from compliance with the Regulations. Further information can be found in Annex C.
23. As the regulatory change applied to all companies in scope and applied across the EU, it is difficult to identify a non-regulated comparison group to use as an appropriate counterfactual. Therefore, we use the assessment of the market made

¹⁴[https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU\(2019\)631057_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU(2019)631057_EN.pdf)

in the final stage IA as our counterfactual and adopt a theory-based approach¹⁵ to understand the impact of the Regulations.

24. We do not consider the impact on small-medium enterprises (SME's) in this review as they are not required to comply with SATCAR under the Companies Act 2006. However, we do consider impacts on smaller and larger PIE's.
25. This PIR, whilst assessing the various elements of the Regulations, focuses on the 6 key elements which were predicted as having the highest cost to business. These were:
 - the extension of the Regulations to unlisted PIEs and non-PIE LLPs;
 - the cap on non-audit services and prohibition of certain non-audit services by the auditor;
 - mandatory rotation and retendering;
 - the prohibition of Big Four-only clauses;
 - provisions on the appointment and scope of independent audit committees; and
 - changes in the audit regulatory framework.

These measures accounted for 98% of the non-familiarisation costs identified in the IA.

26. The measures on the appointment and scope of audit committees were assessed in the IA but implemented by the Prudential Regulation Authority (PRA)¹⁶; and the Financial Conduct Authority (FCA), which made amendments in 2016 to its original 2008 rules¹⁷. Neither body has yet to review implementation; thus, this PIR will cover these measures.
27. This PIR does not cover the following measures, which were either never pursued or required few or no legislative changes:
 - The increase in scope of the 2006 Directive to cover the following entities: issuers of transferable securities trading on a regulated market; 'markets in financial instrument Directive' investment firms (MiFIDs); undertakings for collective investment in transferable securities (UCITS); alternative investment funds (AIFs); and payment institutions. This measure was not pursued following the result of the EU referendum.
 - The measures in Article 12 of the Audit Regulation on listed companies having to report to supervisory authorities of PIEs on certain matters. Sufficient measures were already in place on reporting to the PRA on the entities it

¹⁵ A theory of change approach to evaluation helps to understand the impact of an intervention by drawing conclusions about whether and how the measures and activities introduced deliver the changes that lead ultimately to the intended outcome. A key use of the theory of change is in synthesising the evidence about the intervention. It considers the context and mechanisms driving the change rather than observing the counterfactual. The logic model presented in Figure 1 maps the theory of change for this evaluation.

¹⁶ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2016/ps1616>

¹⁷ https://www.handbook.fca.org.uk/instrument/2016/FCA_2016_40.pdf

supervises. Legal interpretation of the Audit Regulation in respect of the role of the FCA was that no further changes would have to be made.

- The changes to provisions on handover files and on the transfer to group auditors and competent authorities in third countries of audit information, as few substantive changes were made.
 - The convergence of Member State qualifications, as there was no implementation needed for this, and the European Commission, Member States and national competent authorities are yet to progress it.
 - Requirements for the FRC to set the audit regulations under Schedule 10 to the Companies Act 2006, rather than Recognised Supervisory Bodies (RSBs), as this was rejected at the consultation stage.
 - The development of the framework on cooperation between EEA and third country competent authorities, as these required few legislative changes and led to no practical changes.
 - The individual auditor adaptation periods, which were introduced as an alternative to aptitude tests. While RSBs were given the option to offer adaptation periods through amendments to the Companies Act, they chose not to take advantage of this facility. Following the UK's exit from the EU this framework has been amended further but it continues to be possible for the FRC to require that an individual complete an adaptation period as a condition of a declaration approving a third country qualification.
 - Article 22 of the Audit Regulation, on professional secrecy in relation to the FRC. This was already part of the UK framework prior to the EU audit reform programme, having been implemented by previous measures in the Companies Act 2006.
 - Parts of the Audit Directive also required no implementation as they were consistent with the prior and existing UK approach. A breakdown of these can be found in the latest Transposition Note¹⁸ to the 2014 Directive, which was published alongside the Statutory Auditors Regulations 2017.
 - The impact of the auditor dismissal framework is not covered in this review as we are not aware of any circumstances where an auditor has been dismissed by auditors or shareholders. Therefore, we have decided to focus on the most significant measures with the highest compliance costs.
28. The Audit Regulation and Audit Directive also included several Member State options, a small number of which only affected Ethical and Auditing Standards and were separately assessed by the FRC in their own 2016 'Enhancing Confidence in Audit' Impact Assessment¹⁹. As these provisions only necessitated changes to the FRC's Ethical and Auditing Standards covered there, the Government's original IA did not include these provisions. Since then, they have also been covered separately

¹⁸ https://www.legislation.gov.uk/ukxi/2017/1164/pdfs/ukxsi_20171164_en.pdf

¹⁹ <https://www.frc.org.uk/consultation-list/2015/consultation-enhancing-confidence-in-audit>

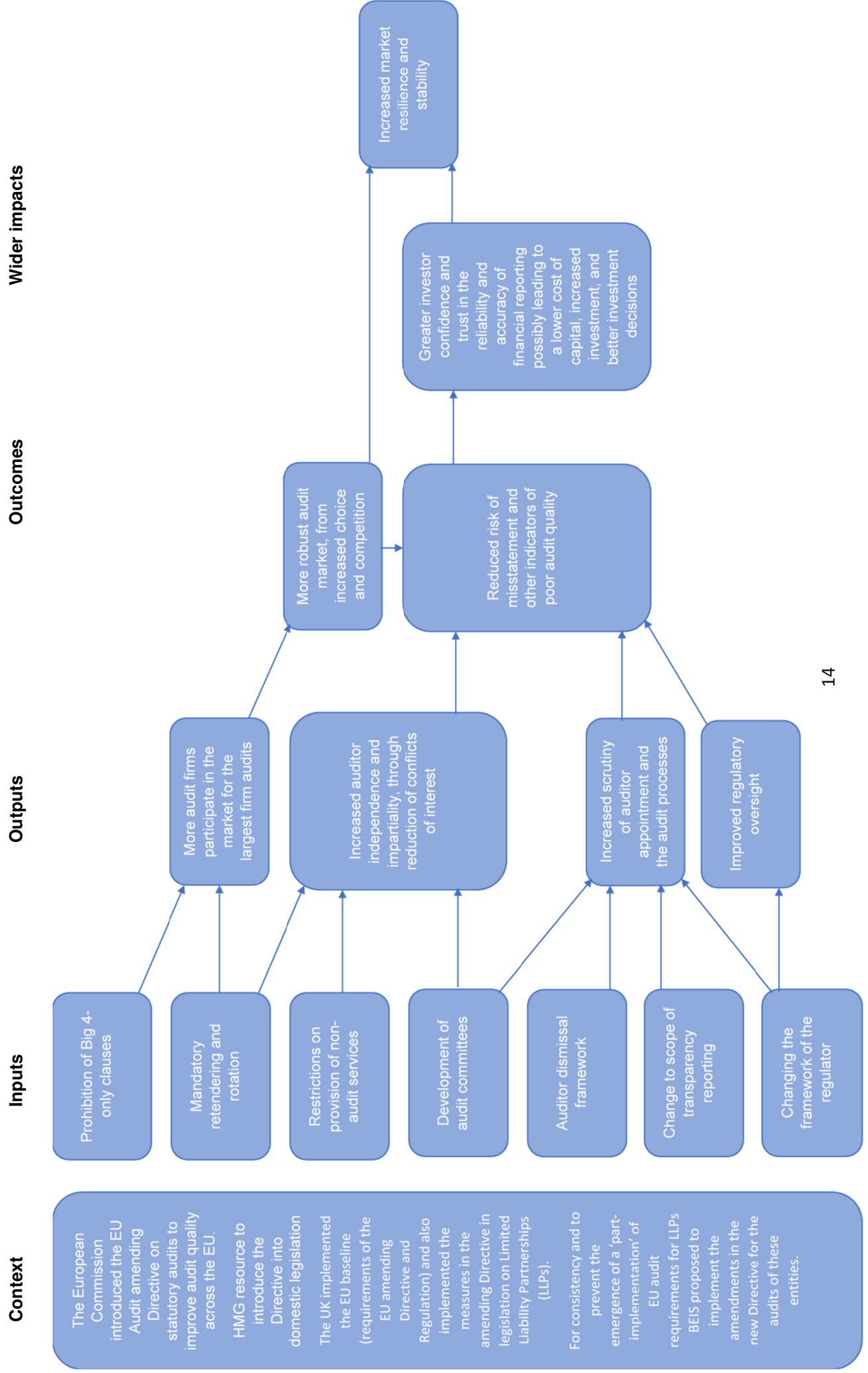
in a post-implementation review by the FRC²⁰. As such, these measures will not be reviewed in this PIR.

Logic model

29. As this PIR follows a theory-based approach to evaluation, we have developed a logic model to show the causal chain of events expected to bring about this change. This provides a framework for understanding the evidence presented in this review. The various components of the logic model are outlined in Figure 1.

²⁰ [https://www.frc.org.uk/getattachment/7335d389-dbd0-4c4d-b265-1278ce9af5bb/Position-Paper-post-implementation-review-audit-ethical-standards-next-steps-\(March-2019\).pdf](https://www.frc.org.uk/getattachment/7335d389-dbd0-4c4d-b265-1278ce9af5bb/Position-Paper-post-implementation-review-audit-ethical-standards-next-steps-(March-2019).pdf)

Figure 1: Logic model displaying relationships between measures in the Regulations and their impact.



Are the objectives of the Regulations still relevant?

30. Audit regulation continues to be of significant international and domestic policy interest, especially with recent large corporate failures such as the collapses of BHS, Carillion and Patisserie Valerie, all of which have brought the quality of audit and corporate information under additional scrutiny. Auditors do not have a duty to predict when a company may fail, but their work does involve identifying and reporting problems sometimes associated with a potential corporate failure – and in the recent cases mentioned above it was felt that auditors did not do enough in this regard.
31. It is more important than ever to restore **confidence in the value of audit** – the Chief Executive of the ICAEW²¹ argued that this “*continual cycle of high-profile corporate failures [produced a] palpable crisis in public trust*” towards the audit profession, which “*required fundamental change if trust was to be regained*”. The CMA Study found that even after the EU reforms, the audit market was still not consistently delivering high-quality audits and exhibited deep-seated problems, which further reinforces the current relevance of these Regulations.
32. Furthermore, questions remain surrounding auditors’ ability to maintain **independence and professional scepticism** in the face of pressure from management, and around the **accountability of independent audit committees**. For example, evidence provided to the 2019 BEIS Committee’s Future of Audit report²² showed ‘culture fit’ and ‘personal relationships’ were still important factors for certain audit committees when appointing audit firms, and that some committees “remained under management power”. Enhanced independence and the removal of conflicts of interest are paramount to ensuring the increased professional scepticism with which auditors approach their work, which in turn increases audit quality and can make **audit reports more informative and transparent**.
33. The **co-ordination of auditor supervision from competent authorities** has also been heavily criticised. The FRC Review identified several weaknesses in the operation of the FRC and wider constraints on its effectiveness as the audit regulator, and ultimately recommended its replacement with a new independent regulator. The Brydon Review supported these findings, suggesting that the FRC needed to be tougher, especially in its use of sanctions. Recommendations to replace the FRC with a new regulator with clear statutory powers and objectives suggest that there is still much work to be done in this area. The FRC has recently re-vamped its approach to audit supervision²³ through the creation of three teams – Audit Firm Supervision, Audit Market Supervision and Audit Quality Review (within the Supervision Division) – to regularly engage with firms as a key part of ensuring good practice is disseminated, and any concerns and issues can be raised as early as possible and rectification plans agreed.
34. Moreover, fears over a heavily concentrated audit market remain just as strong. According to the FRC’s *Key Facts and Trends in the Accountancy Profession*²⁴

²¹ <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf>, para 5.

²² <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf>, para 154.

²³ <https://www.frc.org.uk/getattachment/db4ef2e0-72f6-4449-bda0-c8679137d1b1/FRC-Approach-to-Audit-Supervision-FINAL.pdf>

²⁴ <https://www.frc.org.uk/auditors/professional-oversight/key-facts-and-trends-in-the-accountancy-profession>

reports, the Big Four audited 97% of the FTSE 350 in 2016 – this has barely changed, at 96% in 2019.

35. The commissioning and reporting of three large reviews (the CMA Study, the Brydon Review, the FRC Review) into audit following the implementation of the Regulations demonstrates the significance and relevance of the issues facing the audit framework in the UK. These reviews generally urged swift reform.
36. The Government has also maintained its close interest in this area, with a planned wide-ranging audit reform programme which will action many of the reviews' recommendations and tackle audit issues. The consultation for this package of reforms has now closed, and the Government is preparing a response²⁵.
37. Therefore, our judgement is that the objectives and rationale for the measures included within the Regulations are still relevant, as there is still significant investor and public demand for robust, independent audit, and for transparent, informative financial reporting.

Did the reforms achieve their original objectives?

38. To assess whether the objectives have been achieved, we review the evidence we have gathered against each section of the logic model set out earlier.
39. At the end of this section, we judge whether the objectives of the Regulations have been met.

Context - *what was happening before the Regulations?*

40. The 2008 financial crisis highlighted weaknesses in the statutory audits, especially of PIES (particularly banks). Many investors and the wider public raised questions around how auditors could have given clean audit reports to their auditees prior to the crisis, with many banks revealing huge losses from 2007 to 2009 on the positions they had held both on and off the balance sheet.
41. These issues led to a failure of prudential regulation, which led the EU Commission to recommend a level playing field for audit regulation across Member States, especially as financial crises can cross borders. The aim of the reforms was to re-establish investor trust and market confidence. The Regulations were introduced in this context, to solve some of the major issues around audit, rather than totally reform the entire audit landscape.
42. Further, following the financial crisis, the UK created in 2012 a new prudential regulator, the Prudential Regulation Authority, to supervise around 1,500 banks, building societies, credit unions, insurers, and major investment firms.²⁶

²⁵ <https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms>

²⁶ <https://www.bankofengland.co.uk/prudential-regulation>

Audit quality

43. Audit contributes to investor protection by providing easily accessible, cost-effective, and trustworthy information about the financial statements of companies, and potentially reduces the cost of capital for audited companies by ensuring more transparency and veracity of financial statements – therefore, audit fulfils a societal role in offering an opinion on the truth and fairness of the financial statements of companies. The 2008 financial crisis highlighted shortcomings in quality of the statutory audit, leading to calls for reform.

Auditor independence

44. Prior to the Regulations, auditor independence was neither assured nor demonstrable. The lack of assurance was considered to negatively impact audit quality and professional scepticism. Conflicts of interest were perceived to affect independence and robust scrutiny of the performance of company management. These included: payment and selection of auditors by management; managerial influence on audit committees; the lack of regular auditor tendering and switching; and audit firms' provision of non-audit services to their audited entities. For example, as early as 2009, the Treasury Select Committee²⁷ had called for the appropriateness of non-audit service provision to be investigated. This resulted in a revision to audit regulation through the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011²⁸, as well as the FRC revising their ethical standards²⁹ on disclosure of non-audit services.

Competition

45. The Regulations also aimed to increase competition and reduce the market's reliance on Big Four firms, reflecting the view that limited competition was a key underlying factor in many of the audit market's issues. The market was highly polarised, with the Big Four dominating audits of the largest companies according to the Competition Commission's 2013 investigation into the audit market³⁰. It showed that the Big Four firms consistently held over 95% of FTSE 350 audit contracts between 2001 and 2010, and over 99% of fees. Many of these contracts were also rarely tendered – between 2002 and 2010, the average annual switching rate for the FTSE250 was 4%, and over 20% of the FTSE 350 also had held their auditor for over 20 years. This was exacerbated by the frequent use of Big Four-only clauses in loan agreements. The Regulations' reforms were predicated on the argument that the high degree of concentration adversely affected the audit market, as the benefits of price and quality competition often were not realised.

²⁷ <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

²⁸ <https://www.legislation.gov.uk/ukxi/2011/2198/contents/made>

²⁹ [https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/2010-ethical-standards-for-auditors-\(1\)](https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/2010-ethical-standards-for-auditors-(1))

³⁰ https://assets.publishing.service.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf

Scrutiny and oversight of the audit process

46. The Regulations were also intended to address insufficient scrutiny and oversight of the audit process. For example, the level of oversight that the regulator provided was not seen as adequate due to limitations on its powers; while the FRC was seen to have its strengths, it received tough and persistent criticism – for example, the Treasury Select Committee³¹ criticised the FRC for inaction following the collapse of HBOS in 2013.

Inputs and activities – were there any issues with the implementation of the Regulations and the measures they contained?

Compliance

47. Enforcement of audit regulation has historically been a concern. For example, the FRC Review³² stated that the FRC was “*widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing*”. As we show later it is possible that these weaknesses in enforcement have reduced the effectiveness of some of the regulatory provisions introduced.
48. Several measures within the Regulations were mandatory, and therefore businesses are subject to sanctions and penalties in cases of non-compliance. Enforcement of the Regulations is the responsibility of the FRC³³. The FRC introduced the Audit Enforcement Procedure³⁴ in 2016 to detect, correct and prevent inadequate execution of the statutory audit. Sanctions have increased since the Regulations’ implementation. For example, the FRC³⁵ reported nearly £18 million taken in 2017/8 from sanctions, compared to £14.5 million in 2016/7.
49. However, other measures allowed for greater variation and flexibility within the rules; for example, there were instances found where some audit committees were not working an appropriate level of hours. The CMA Study³⁶ found some committees spent more than 400 person hours on their duties a year, and others less than 20. More evidence (see Outputs section below) suggested large variations in the quality of some Audit Committee Reports (ACRs), the appropriateness of their selection criteria, and their levels of investor engagement. Respondents were asked in the BEIS stakeholder survey how much they spent on their duties – most said this was difficult to answer, with those that did answer still showing wide variations, ranging from 7 hours to 400 hours.
50. While Big Four-only clauses in loan agreements were successfully prohibited, there is some evidence that suggests that businesses can, in practice, still require audits

³¹ <https://committees.parliament.uk/committee/158/treasury-committee/news/98866/financial-reporting-councils-enquiries-into-the-auditing-of-hbos/>

³² FRC Review, para 2.55.

³³ Fines for audit failures against audit firms can range from £700,000 to £6.5 million; against individuals this can range from £45,000 to £325,000. A more detailed breakdown can be found in the FRC Review, on pg.40.

³⁴ <https://www.frc.org.uk/auditors/enforcement-division/audit-enforcement-procedure>

³⁵ Future of Audit report, para 223.

³⁶ CMA Study, para 3.58.

to be conducted by Big Four audit firms. This is because there is a perception that Big Four auditors are the only auditors that have the capacity to audit large multinational businesses. The CMA Study³⁷ suggested that there are concerns about the capability of challenger firms to carry out the most complex audits, particularly those requiring large international teams. One survey respondent also stated,

“I don’t believe that lenders and companies have changed their behaviour – although not written, in many cases the companies can behave as though the restriction still applies”.

Company Director, PIE

Another argued,

“It’s more or less irrelevant. It’s a restriction of trade because it dictates the provision in contracts that gives the parties less choice about the level of protection and/or quality that they would prefer to require. However, in practice, most companies will intend that Big Four are used, and they therefore will be used. To do otherwise would often be reckless.”

Company Audit Committee Member, PIE

This suggests that even with the elimination of Big Four-only clauses firms may still, even reasonably, have a strong preference for a Big Four audit.

51. However, other evidence suggests that compliance with some measures is high. The introduction of mandatory rotation and retendering has forced companies to tender their audit contracts or even switch their auditors, and average periods of repeated reappointment have fallen dramatically. The CMA Study³⁸ found that from 2012 to 2017, the length of audit firm engagements for FTSE 350 companies greater than 20 years dropped from 23% to 14%, and those 5 years or less increased from 22% to 47%, showing the impact of rotation.
52. Overall, therefore, whilst there is evidence that suggests some variations in compliance for some measures, the Regulations are generally being complied with.

Outputs – are the Regulations relevant and useful, and how successful were they in achieving their objectives?

53. We assess the relevance and outputs of the Regulations in turn.

Extending the scope of the Regulations to unlisted PIEs and non-PIE LLPs

54. The removal from the Directive of an option to exempt audits of unlisted PIEs from certain requirements resulted in the Regulations affecting these audits in several additional ways. For example, the auditors of unlisted PIEs had to produce a transparency report under Article 13 of the Regulation. The Prudential Regulation Authority also had to require unlisted PIEs to have an audit committee. It was

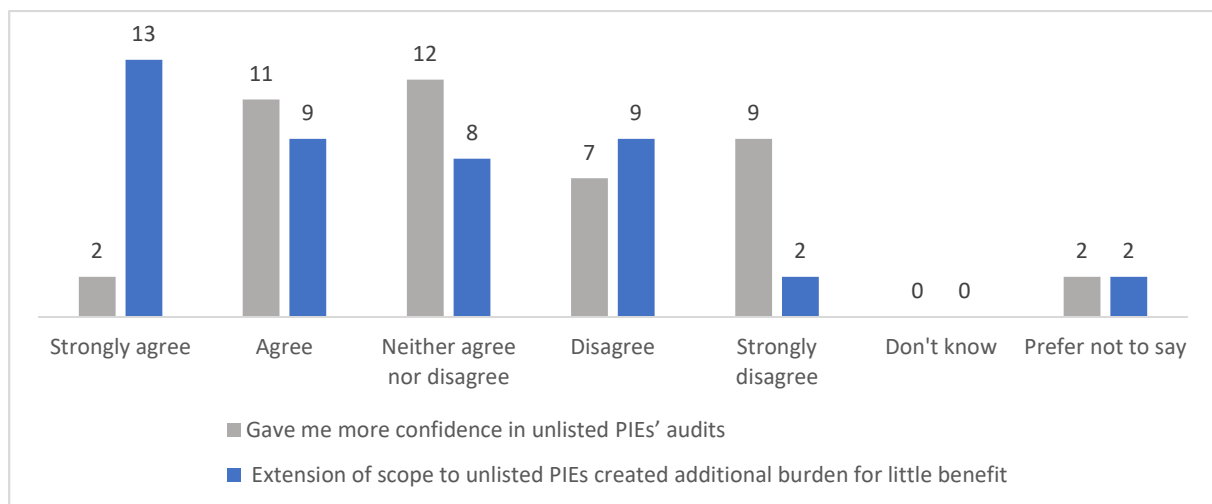
³⁷ CMA Study, para 3.134.

³⁸ CMA Study, fig. 2.8.

expected that this would have a beneficial effect on audit quality. This was not expected to create significant burden for businesses, for example as the PRA's advice was that many banks and building societies, which were expected to come into scope, already had audit committees in place prior to the reforms³⁹.

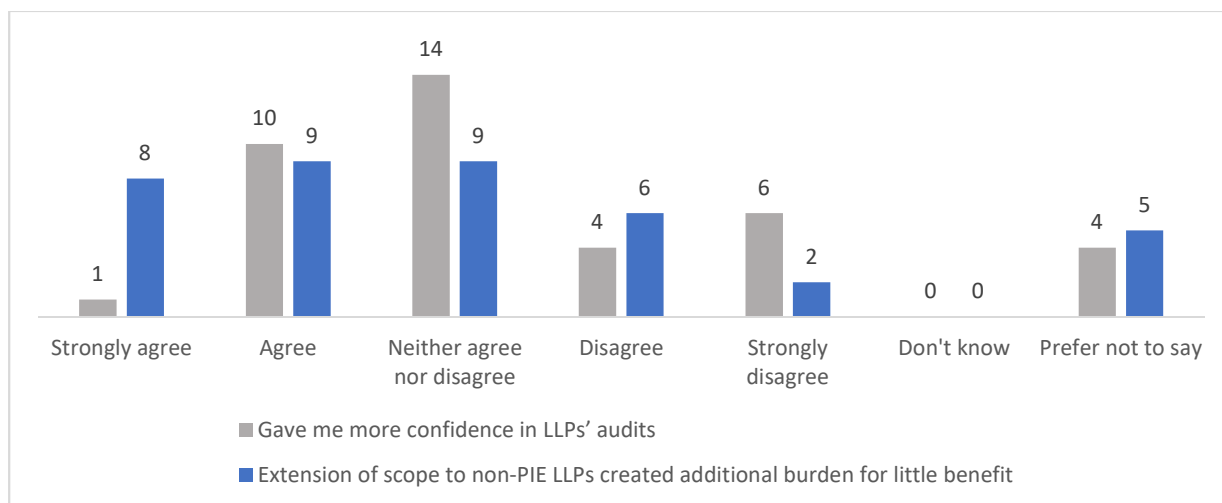
55. The decision to expand the application of the measures in the Regulations further to non-PIE LLPs was made to harmonise audit standards and avoid separate requirements for different entities.
56. The survey found that there were mixed views about whether the extension of the relevant requirements in the Regulations in each case to unlisted PIEs or to non-PIE LLPs increased the confidence in their audits and whether these measures created additional burden for little benefit.
 - Views on whether there was increased confidence in unlisted PIE audits were evenly split: 13 respondents agreed that confidence was higher compared to 12 who thought confidence was unchanged and 16 who disagreed that this gave them more confidence in unlisted PIE audits (Figure 2).
 - Just over half of respondents agreed that that extending the scope to unlisted PIEs created additional burden for little benefit (Figure 2).
 - Responses to a question asking whether there was increased confidence in non-PIE LLP audits were also evenly split (Figure 3).
 - Just under half of respondents agreed that extending the Regulations to non-PIE LLPs created additional burden for little benefit (Figure 3).

Figure 2: Chart showing whether the measure to extend the Regulations to unlisted PIE's has increased respondents' confidence in unlisted PIE audits and whether it has created additional burden for little benefit, (N=43)



³⁹ https://www.legislation.gov.uk/ukia/2016/149/pdfs/ukia_20160149_en.pdf, para 73.

Figure 3: Chart showing whether the measure to extend the Regulations to non-PIE LLPs has increased respondents' confidence in non-PIE LLP audits and whether it has created additional burden for little benefit, (N=39)

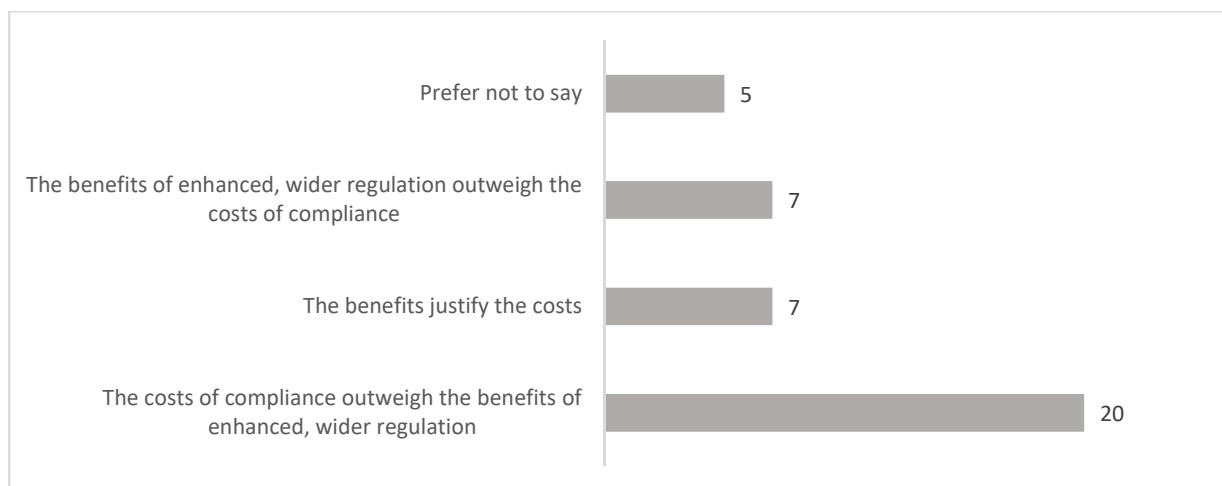


57. Similarly, most respondents felt the costs of compliance outweigh the benefits of enhanced wider regulation (Figure 4). One survey respondent stated:

“By making all small insurers PIEs, there has been a significant reduction in the available audit firms ... there has also been a hugely disproportionate increase in our audit cost due to us being a PIE”

Company Director, PIE

Figure 4: Chart describing respondent views towards the costs and benefits of the measure of extending the Regulations to unlisted PIE's and non-PIE LLPs (N=39)



Mandatory rotation and retendering

58. The introduction of mandatory rotation and retendering has reduced average audit tender lengths dramatically – the CMA Study⁴⁰ found that from 2012 to 2017, the percentage of audit firm tenures for FTSE 350 companies which were greater than 20 years dropped from 23% to 14%, and those 5 years or less increased from 22% to 47%. The number of audit contracts put out for tender has also increased dramatically. From 2002-10, the average annual switching rate for the FTSE250 was 4%, whilst from 2013-7, over half of FTSE 350⁴¹ companies tendered their external audit, with around 75% resulting in a switch. It is important to note, however, that the effects of mandatory rotation and retendering have yet to be fully realised. The retendering and rotation periods are 10 and 20 years respectively and the Regulations have only been in force for 5 years so there are tranches of companies that are only now being required to retender their audit contracts.

Mandatory rotation and retendering – on quality

59. Rotating audit firms was expected to create more opportunities for new audit firms to challenge poor audit practices and reduce the incidence of conflicts of interest. Higher audit quality from greater scepticism was expected to be the greatest benefit from mandatory rotation and retendering. However, by encouraging turnover in auditors it could also be viewed as promoting greater competition.

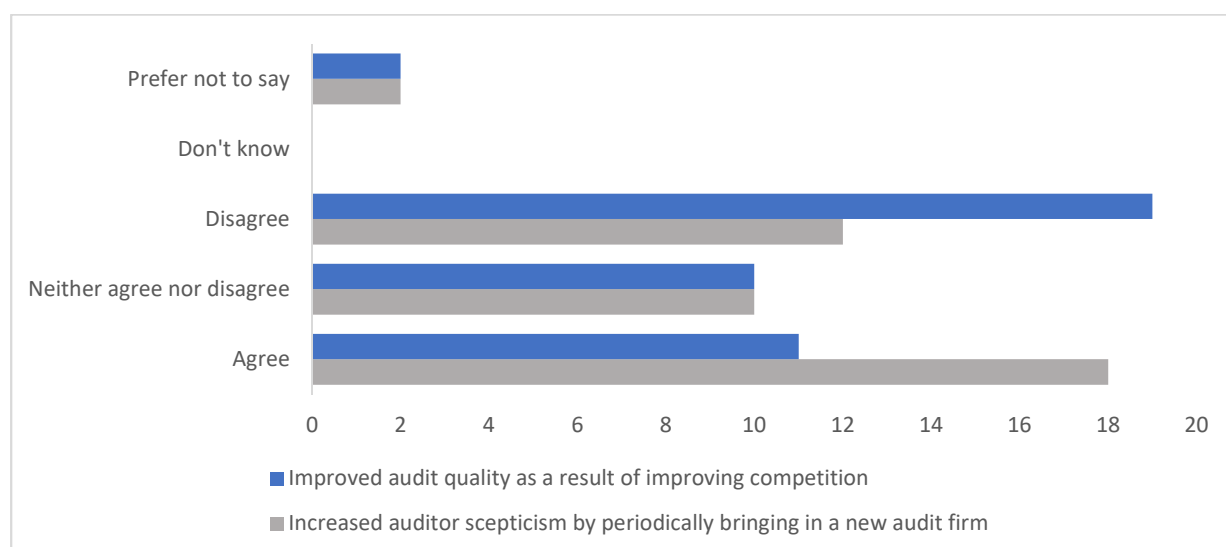
60. Our survey explored these issues and found (Figure 5):

- 18 out of 42 respondents agreed with the proposition that auditor scepticism had increased after mandatory rotation and retendering was introduced, with 10 not expressing an opinion and 12 disagreeing that scepticism had increased.
- 11 out of 42 agreed with the proposition that audit quality had improved because of mandatory rotation and retendering improving competition, with 10 neutral and 19 disagreeing.

⁴⁰ CMA Study, fig . 2.8.

⁴¹ CMA Study, paras 2.22-2.23.

Figure 5: Chart showing how far respondents agree or disagree that mandatory rotation and retendering has led to higher audit quality (N=42)



61. One survey respondent said this measure has applied:

“Additional pressure on audit firms to provide quality services and ensure thorough investigation, and provided more comfort that [financial] reports are an accurate representation of businesses.”

Senior Finance Manager, A business/company that is not a PIE

62. Another respondent said that:

“The Big 4 quickly developed good processes for handover and rapid learning, and the changeovers have brought valuable new perspective.”

Company Audit Committee Member, PIE

63. However, in theory mandatory rotation and retendering can have a negative impact on audit quality. For example, breaking up longstanding audit relationships can have a direct negative impact on quality because of a loss of client-specific knowledge. One respondent argued that audit quality in the time leading to rotation could decrease, since an incumbent firm would be:

“Very worried about the scrutiny of their process by new incoming auditors, [they would] sacrifice judgement and common sense to accommodate a cautious litigation and regulation-fearing culture”

Company Audit Committee Member, PIE

64. This wide range of views is also reflected in the academic research on mandatory audit firm rotation, and its effects on quality and independence. Some research studies have found longer auditor tenure lengths to be associated with greater real earnings management (Chi et al., 2011)⁴², less timely discovery and correction of

⁴² Chi, W., Liscic, L. and Pevzner, M. (2011) *Is Enhanced Audit Quality Associated with Greater Real Earnings Management?*. Accounting Horizons, 25(2), pp. 315-225. doi: 10.2308/acch-10025.

misstatements (Singer and Zhang, 2018)⁴³, and lower accounting conservatism for larger audited entities (Rickett et al., 2016)⁴⁴. Conversely, others have found longer engagement periods to increase investor confidence in earnings quality (Ghosh and Moon, 2005)⁴⁵ and decrease the cost of debt financing (Mansi et al., 2004)⁴⁶, with some even finding contradictory evidence of a positive relationship between audit tenure and quality (Johnson et al., 2002⁴⁷; Myers et al., 2003⁴⁸). Geiger and Raghunandan (2002)⁴⁹ and Carcello and Nagy (2004)⁵⁰ also find increased audit reporting failures and incidence of fraudulent financial reporting in the earlier years of the audit-client relationship.

65. Looking at mandatory firm rotation itself, some studies find that investors perceive mandatory rotation as being beneficial; Kim et al. (2019)⁵¹ found mandatorily switched firms in South Korea have a significantly negative association with the cost of capital. Harris and Whisenant (2016)⁵² find that rotation can lead to decreased earnings management, decreased managing to earnings targets and more timely loss recognition, although notes that audit quality does decrease in the years immediately before and after an auditor switch. This latter finding is backed by Bae et al. (2013)⁵³ and Kwon et al. (2014)⁵⁴. Bae et al. also find increases in Big Four market share following the introduction of rotation, and Kwon et al. found increased audit fees. Increased audit fees and other imposed non-trivial costs are a common discovery for many studies, with many suggesting that, as a result, the costs of

⁴³ Singer, Z. and Zhang, J. (2018) *Auditor Tenure and the Timeliness of Misstatement Discovery*. The Accounting Review, 93(2), pp. 315-338. doi: 10.2308/accr-51871.

⁴⁴ Rickett, L., Maggina, A. and Alam, P. (2016) *Auditor Tenure and Accounting Conservatism: Evidence from Greece*. Managerial Auditing Journal, 31(6/7), pp. 538-565. doi: 10.1108/MAJ-10-2014-1103.

⁴⁵ Ghosh, A. and Moon, D. (2005) *Auditor Tenure and Perceptions of Audit Quality*. The Accounting Review, 80(2), pp. 585-612. doi: 10.2139/ssrn.385880.

⁴⁶ Mansi, S., Maxwell, W. and Miller, D. (2004) *Does Auditor Quality and Tenure Matter to Investors? Evidence from the Bond Market*. Journal of Accounting Research, 42(4), pp. 755-793. doi: 10.2139/ssrn.384594.

⁴⁷ Johnson, V., Khurana, I., and Reynolds, J. (2002), *Audit Firm Tenure and the Quality of Financial Reports*. Contemporary Accounting Research, 19(4), pp. 637-660. doi: 10.1506/LLTH-JXQV-8CEW-8MXD.

⁴⁸ Myers, J., Myers, L. and Omer, T. (2003) *Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?*. The Accounting Review, 78(3), pp. 779-799. doi: 10.2308/accr.2003.78.3.779.

⁴⁹ Geiger, M. and Raghunandan, K. (2002) *Auditor Tenure and Audit Reporting Failures*. Auditing, 21(1), pp. 67-78. doi: 10.2308/aud.2002.21.1.67.

⁵⁰ Carcello, J. and Nagy, A. (2004) *Audit Firm Tenure and Fraudulent Financial Reporting*. Auditing, 23(2), pp. 55-69. doi: 10.2308/aud.2004.23.2.55.

⁵¹ Kim, S., Kim, S., Lee, D. and Yoo, S. (2019) *How Investors Perceive Mandatory Audit Firm Rotation in Korea*. Sustainability 2019, 11(4), pp. 1089-1105. doi: 10.3390/su11041089

⁵² Harris, K., Whisenant, S. (2016) *Mandatory Audit Rotation: An International Investigation*. University of Houston, Available at:

<https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.470.1002&rep=rep1&type=pdf>.

⁵³ Bae, G., Kallapur, S. and Rho, J. (2013) *Departing and Incoming Auditor Incentives, and Auditor-Client Misalignment under Mandatory Auditor Rotation: Evidence from Korea*. Indian School of Business. doi: 10.2139/ssrn.2281127.

⁵⁴ Kwon, S., Lim, Y. and Simnett, R. (2014) *The Effect of Mandatory Audit Firm Rotation on Audit Quality and Audit Fees: Empirical Evidence from the Korean Audit Market*. Auditing, 33(4), pp. 167-195. doi: 10.2308/ajpt-50814.

mandatory rotation outweigh its benefits (e.g. Lantau and Ertman, 2012⁵⁵; Ottaway, 2016⁵⁶; Cameran et al., 2015⁵⁷). Augustsson and Osterlind (2017)⁵⁸ suggest that while the public may perceive auditor independence to have increased under rotation, in practice it does not, and finds the loss of client-specific knowledge to negatively impact audit quality. Their own review of available secondary research also found that more studies reviewed suggest longer tenures improve audit quality.

Mandatory rotation and retendering – on competition

66. Mandatory retendering and rotation were also intended to create a wider and more competitive market for audit services. The idea was that barring large, incumbent auditors from continuing in their role might open the door for a smaller audit firm to bid and win more tenders, creating an audit landscape in which smaller firms can compete and grow. Our survey found that (Figure 6):

- 17 respondents agreed that mandatory rotation and retendering had resulted in more opportunities for audit firms to compete, whereas 7 were neutral and 18 disagreed. Here respondents were broadly split as to the impact of the measure on opportunities to compete.
- 5 respondents agreed that mandatory rotation and retendering had led to more competitive audit pricing, whereas 12 were neutral and 25 disagreed. Respondents clearly disagreed that audit prices had become more competitive following the reform.

⁵⁵ Lantau, M. and Ertman, P. (2012) *Could Mandatory Audit Firm Rotation Improve Audit Quality?*. Lund University, Lund. Available at: <http://lup.lub.lu.se/student-papers/record/2968326>.

⁵⁶ Ottaway, J. (2016) *Improving Auditor Independence in Australia: Is Mandatory Audit Firm Rotation the Best Option?*. University of Melbourne. Available at: https://law.unimelb.edu.au/_data/assets/pdf_file/0004/1709509/27-OTTAWAYJoanne-MandatoryAuditFirmRotationPaper2.pdf.

⁵⁷ Cameran, M., Frances, J., Marra, A. and Pettinicchio, A. (2015) *Are There Adverse Consequences of Mandatory Auditor Rotation? Evidence from the Italian Experience*. *Auditing*, 34(1), pp. 1-24. doi: 10.2308/ajpt-50663.

⁵⁸ Augustsson, S. and Osterlind, A. (2017) *The Effects of Mandatory Audit Firm Rotation on Audit Quality*. Uppsala University. Available at: <http://uu.diva-portal.org/smash/get/diva2:1114921/FULLTEXT01.pdf>.

Figure 6: Chart showing how far survey respondents agree or disagree that this measure resulted in more competitive audit pricing (N=44)



67. When respondents were asked to describe the impact of this measure in their own words, one respondent said:

“It has increased the opportunities to tender and obtain PIE audits. It has also resulted in competitive pricing to mean quoting an adequate fee to provide a quality audit (rather than the lowest, which to most shareholders is not what is wanted).”

Individual Investor

68. However, most respondents highlighted the negative impact on competition:

“We have seen a dramatic reduction in the availability of audit from non-Big 4 audit firms. Many have withdrawn from the market, forcing our members to choose from Big 4 firms only. Our members report a real unwillingness to tender (one firm invited 10 auditors to tender for work, and the only one willing to was the incumbent). The lack of competition has also resulted in an unwelcome and unjustified increase in costs: one small....member, with only 5 employees and a very small book of insurance business, saw its existing auditor withdraw services in 2020, and the options available were three or more times higher- which in the insurer’s assessment increases dramatically the prospects that they will be unable to trade in the next three years.”

Representative Organisation, A body that has an interest in financial or non-financial reporting

69. Another respondent said, it:

“Has become very apparent that they are not prepared to even bid for FTSE 100 and 250 company audits so has probably led to them being perceived of not able to undertake large or complex global audits. In smaller PIEs, the opportunity for them to gain audits remains and mandatory rotation and

retendering has probably resulted in very little impact of the non-Big 4 audit firms in the audit market”

Company Audit Committee Member, PIE

70. Respondents generally attributed this negative impact to the lack of expertise and international presence of challenger firms. One respondent in the survey said:

*“The regulation has not particular (**sic**) worked in favour of the non-Big 4 audit firms, for smaller firms to ensure they have the relevant qualifications to audit a PIE company is onerous and expensive, therefore leaving little capacity to complete with the Big 4 audit firms”*

Company Director, PIE

71. Similarly, another respondent said:

“For larger companies e.g. FTSE 100, no effect. 'Next 3' firms do not have the global capacity, broad technical expertise or appetite to even bid, let alone win Also do not want the liabilities. They seem content to work in the next tier, and have declined to join a tender process when invited. Will only change if their capacity and capability increases, which does not seem to be their intent or desire.”

Company Audit Committee Member, PIE

72. These responses reflect the findings of the CMA Study⁵⁹, where the largest companies raised concerns about the capability of challenger firms to carry out their audits.
73. However, there is evidence to suggest that this measure has benefitted non-Big Four firms somewhat – the CMA Study⁶⁰ found that larger challenger audit firms have grown their overall UK audit revenues more strongly and at a faster rate than the Big Four from 2011-8. Total audit revenue in this period grew in nominal terms by 33% for Big Four firms, compared to 57% for challenger firms⁶¹; challenger firms also increased their operating margins in this period while Big Four saw decreases⁶².
74. Moreover, tenders now occur more frequently, and they usually involve detailed and comprehensive processes which allow companies to make well-informed decisions⁶³. The FRC Developments in Audit report suggests that mandatory rotation has marginally improved the functioning of the audit market⁶⁴. This judgement of a qualified success was reflected in our survey where one respondent said:

“I think it has increased the opportunity for non-Big 4 firms to tender for FTSE 350 audits. However I have concerns that non-Big 4 firms are potentially taking risks beyond their natural risk appetite which could lead to them collapsing if a major audit problem emerged under their watch which resulted in litigation or

⁵⁹ CMA Study, para 3.134.

⁶⁰ CMA Study, para 2.40.

⁶¹ CMA Study, Para 2.36.

⁶² CMA Study, Paras 2.39-2.40.

⁶³ CMA Study, para 3.83.

⁶⁴ <https://www.frc.org.uk/getattachment/cc181136-875b-41cc-9a90-b8b28c887949/Developments-in-Audit-2020-Summary.pdf>, p.4

regulatory punishment. They are more naturally set up to audit much smaller companies, which is their strength and which they do well.”

Company Audit Committee Member, Non-PIE

75. Challenger firms have made few inroads into the FTSE350. The CMA Study⁶⁵ showed that FTSE 350 switching takes place almost entirely between the Big Four, who accounted for over 97% of FTSE 350 contracts and 99% of their fees in 2017. This has remained largely unchanged since the reforms were introduced; in 2019, the Big Four accounted for 96% of FTSE 350 engagements and 99% of their fees⁶⁶. According to FRC data⁶⁷, the Big Four even increased their market share in the FTSE100 in 2019, now accounting for every audit contract in the index.
76. Analysis of all tenders since 2013 in the CMA Study⁶⁸ also found that switching generally occurs only between the Big Four, with 92% of FTSE 350 tenders switched between the Big Four firms, and only 3% of contracts moving from a Big Four firm to a challenger. Furthermore, every contract held by a challenger firm was switched to a Big Four firm.

Mandatory rotation and retendering – on choice

77. The introduction of mandatory rotation has had an unintended consequence in that it appears to have reduced market choice. This is a result of a) the incumbent firm being unable to bid for that contract again, which thus reduces the number of firms allowed to participate in the tender process; and b) the lack of challengers with a perceived capacity to compete with a Big Four auditor.
78. When survey respondents were asked about whether this measure increased choice, most respondents disagreed that more choice was created between the Big Four, and between the Big Four and non-Big Four (Figures 7 and 8).

⁶⁵ CMA Study, para 2.2.

⁶⁶ <https://www.frc.org.uk/getattachment/0f7be411-fb89-4afc-8e8c-281529cf76fc/Key-Facts-and-Trends-2020.pdf>

⁶⁷ <https://www.frc.org.uk/news/october-2019/big-four-increase-their-market-share-of-uk-audit>

⁶⁸ CMA Study, fig . 2.7.

Figure 7: Chart showing how far respondents agree or disagree that this measure has created more choice between the Big Four and the non-Big Four auditors (N=44)

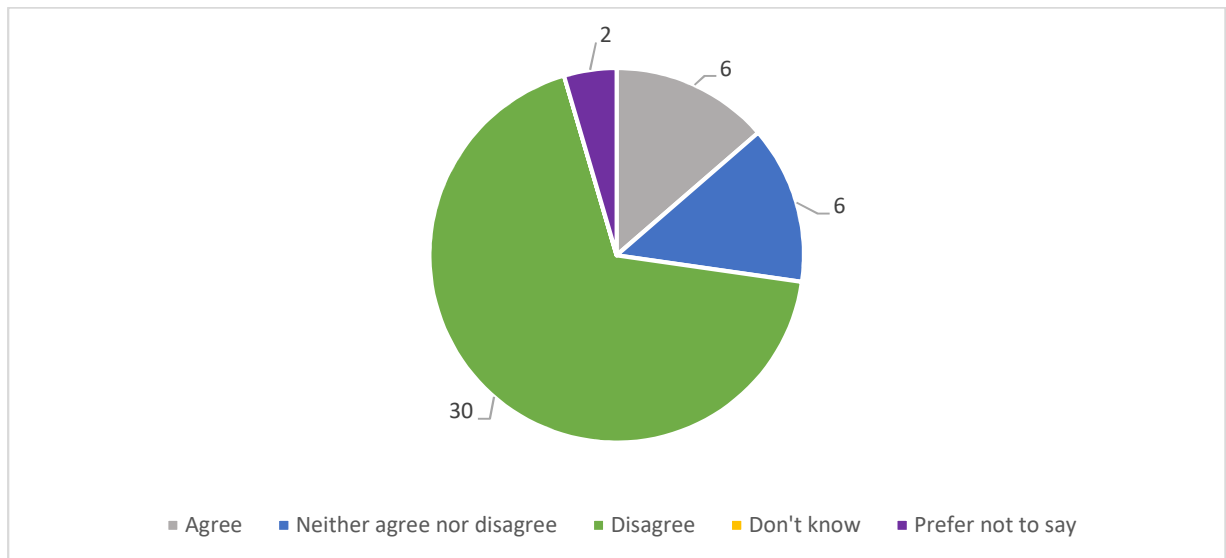
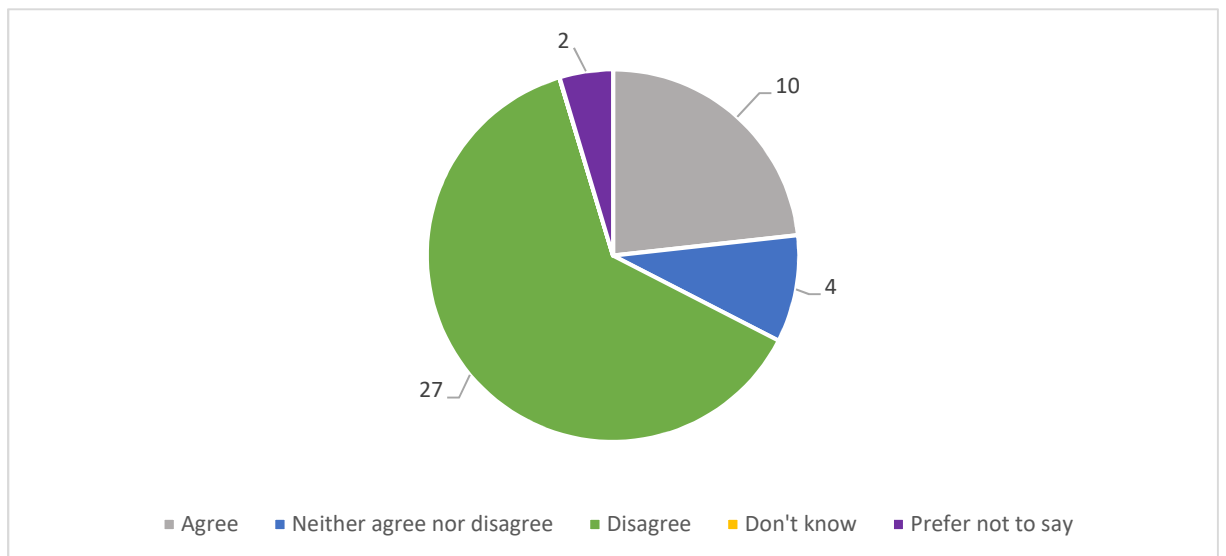


Figure 8: Chart showing how far respondents agree or disagree that this measure has created choice between the Big Four auditors (N=43)



79. One respondent said:

“Mandatory audit rotation and retendering has not had the desired or expected effect of eliminating unfair barriers to entry in, for example, the FTSE 350 market for challenger firms where there is a significant concentration of audit fees especially at the top end of the FTSE100 audit market. The Big 4 currently have 100% of appointments in the FTSE100 ... The above approach is severely reducing the choice of auditors amongst leading companies since if a current Big 4 auditor has to retire by rotation this leaves only three remaining Big 4 firms and at least one is often not able to tender for the appointment, often due to conflicts of interest arising from taxation, consulting or other work. This leaves at most two firms likely to be appointed as auditor.”

Audit Firm

80. When three of the Big Four were surveyed by the CMA⁶⁹, they claimed that 40% of cases where they did not bid for an audit contract were a result of mandatory rotation rules. Therefore, mandatory rotation can apply further constraints to already limited auditor choice. The Investment Association⁷⁰ agreed with the CMA that there was limited choice and that an entity may be faced with only two viable options – and with so few players in the market, they questioned whether auditors were really competing on quality.

81. This is amplified by the high costs of bidding for audit contracts – which often means that some audit firms (especially challenger firms) are unwilling to do so. For example, one survey respondent suggested:

“The investment required to pitch effectively is a high barrier and with a limited success rate it is not commercially viable for the smaller firms to engage.”

A body that has an interest in financial or non-financial reporting

82. This effect on choice is usually not an issue when there are many other interested audit firms – and evidence shows most audit committees were content with their levels of choice. FRC guidelines⁷¹ state that a typical tender should involve three or four audit firms; however, one survey respondent reported:

“Our members report a real unwillingness to tender ... one firm invited 10 auditors to tender for work, and the only one willing was the incumbent.”

A body that has an interest in financial or non-financial reporting

83. The CMA Study⁷² found that around 25% of FTSE 350 tenders reviewed had at most two bidders, a finding that was echoed by respondents in the survey. In this minority of cases, the CMA stated⁷³ that competition can be fragile; if one of the bidders fails to impress the audit committee, they are effectively left with no choice at all.

⁶⁹ CMA Study, para 3.111.

⁷⁰ CMA Study, Para 3.105.

⁷¹ https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf. The legal requirement is that at least two firms are presented to the full board by the Audit Committee, with a justified preference for one firm - see Article 16.2 of the Audit Regulation.

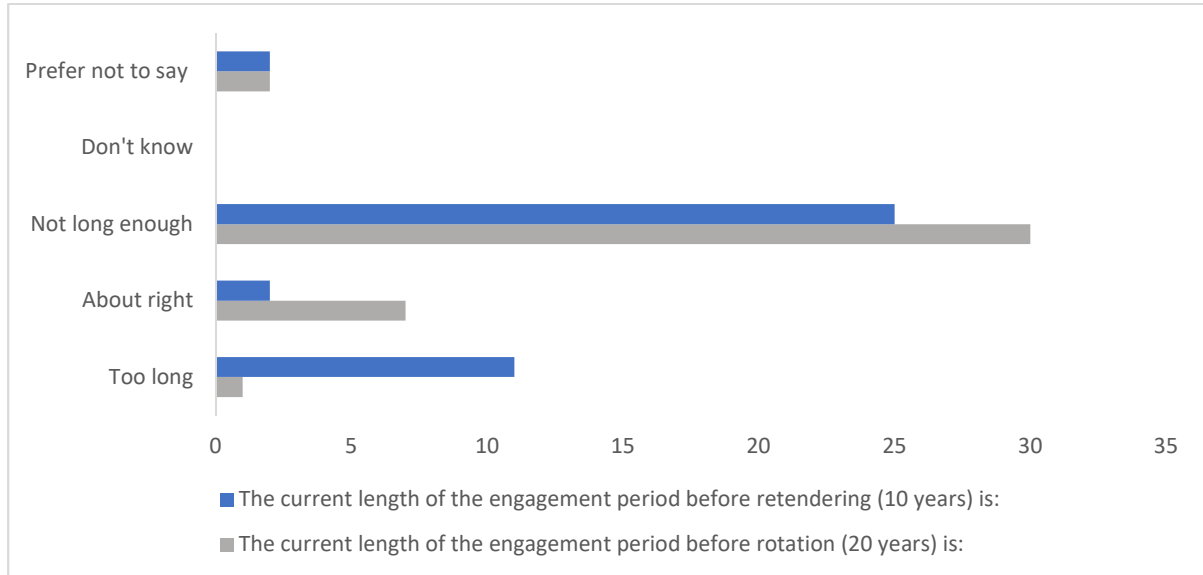
⁷² CMA Study, para 3.103.

⁷³ CMA Study, para 3.84.

Mandatory rotation and retendering - engagement periods

84. Survey respondents were asked what their opinions on the engagement lengths were (Figure 9). Most stated that the 10-year retendering and 20-year rotation periods were not long enough.

Figure 9: Chart showing respondent views on engagement lengths of audit contracts before retendering (N=40)



85. The BEIS Committee Future of Audit report⁷⁴ recommended that engagement periods should be reduced to 7-year, non-renewable contracts, to improve auditor independence and quality. Changing the tenure lengths would in effect see the same trade-offs, with shortening the time periods possibly creating greater levels of independence and audit quality, but further restricting choice in the audit market.

86. The BEIS Committee's Future of Audit report⁷⁵ found the CMA and the Big Four were not in support of changing the frequencies on the grounds of choice, competition, and cost, while their other stakeholder responses argued the lengths were still too long, arguing strong personal relationships and conflicts of interest could still arise in those periods.

EU Review

87. The UK was among 12 of 28 Member States to transpose all articles into national regulation by the June 2016 deadline when the Audit Regulation came into force and the Audit Directive. By July 2020, all EU Member States had fully transposed all articles. The Audit Regulation and Directive allowed a degree of flexibility in meeting specific requirements, referring to them as Member State options. Annex A provides

⁷⁴ Future of Audit report, para 128.

⁷⁵ Future of Audit report, para 177.

further detail on the implementation by different Member States and how these compare with the UK.

88. The EU Review⁷⁶ of the statutory audit reform programme looked at the impact of mandatory auditor rotation but noted that it is hard to separate the effect of these rules from effects triggered by other rules in the Audit Reform. Their review separated Member States which had strict implementation regimes (defined as having maximum engagement periods of less than 20 years, and less than 17.5 for the financial sector) with flexible implementation regimes which had longer engagement periods, which included the UK⁷⁷. Analysis showed that:

- The group of countries that adopted a stricter implementation regime had more concentrated audit markets prior to reforms, as measured by the Herfindahl-Hirschman Index (HHI) and by combined Big Four market share, than the group of countries that adopted a more flexible implementation regime⁷⁸.
- Following implementation, concentration in more flexible implementation countries, as measured by HHI, remained the same. In stricter regimes, HHI fell to levels which were broadly the same to that of flexible regimes⁷⁹.
- The EU review looked at how market share evolved in the strict and flexible regimes⁸⁰. They divided up the types of suppliers by the market leader, the runner-up, numbers 3 and 4, and the aggregate of smaller suppliers in the audit market. They found greater convergence of market share in stricter regimes. In particular:
 - The market share of the leader fell by 12.4% between 2013 and 2017 in strict regimes and only by 1.5% in flexible regimes.
 - The strongest drop in market share was experienced by the second market player in strict regimes. In flexible regimes, the second market player market share remained relatively unchanged. For the number three market player, we see an increase in market share in the strict regimes (about +6.7%) and a decrease in flexible MFR regimes (about -1.1%). The fourth market player gains almost 11 % in the strict regimes and almost 3.3% in the flexible regimes.
 - Finally, the market share of all other firms increased by about 6% over the period 2013-2017 in the strict regimes whereas it remained stable in flexible regimes.
 - Note in this analysis the top four is not always synonymous with the Big Four in EU countries as some countries, e.g. France, have a non-Big Four auditor in their top four.

⁷⁶ [https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU\(2019\)631057_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU(2019)631057_EN.pdf)

⁷⁷ EU Review, p51.

⁷⁸ EU Review, p52.

⁷⁹ Ibid.

⁸⁰ EU Review, p53.

- The combined market share for the top four audit suppliers in strict regimes was 96% in 2013; this fell to 90% in 2017. In flexible regimes, this combined market share stayed constant at 95% throughout 2013 to 2017⁸¹.
89. However, the separation of Member States by flexible and strict regimes does not consider differences in the PIE definition. Strict regimes have more expansive PIE definitions than flexible regimes⁸², meaning more entities would be in scope of the audit reforms. This is relevant as a larger PIE definition provides more opportunity for auditor switches away from incumbents including the Big Four, thus allowing for larger decreases in concentration.
90. Differences in switching rates between regimes is provided in Table 1 below⁸³:
- PIEs in stricter regimes had proportionately more switches than flexible regimes in 2016 and 2017.
 - In 2017, the first year of implementation, in strict regimes there were slightly more switches between Big 4 to non-Big 4 (8.5% of all switches), than non-Big 4 to Big 4 (5.2%). In other words, non-Big 4 auditors gained from the reforms.
 - This pattern is also seen in flexible regimes where in 2017 Big 4 to non-Big 4 switches were higher (around 15% of all switches) compared to non-Big 4 to Big 4 switches (9.4% of all switches). Indeed, the net gain to auditors outside the Big 4 appears to be slightly higher under flexible regimes.

Table 1: Percentages of PIE clients switching: strict versus flexible rotation regimes

	2016	2017
Strict regimes		
Percentage of PIE clients having different auditors in t and t-1	18.09%	16.67%
Big 4 to Non-Big 4 (as a % of total switches)	3.05%	8.45%
Non-Big 4 to Big 4 (as a % of total switches)	6.73%	5.16%
Flexible regimes		
Percentage of PIE clients having different auditors in t and t-1	9.96%	10.40%

⁸¹ Ibid.

⁸² Of those Member States with a stronger PIE definition than the EU baseline, 9 implemented strict regimes and 9 implemented flexible regimes with respect to mandatory rotation; while of the 10 Member States which adopted the EU baseline definition, only 2 implemented strict regimes and 8 adopted flexible regimes.

⁸³ EU Review, p.54.

Big 4 to Non-Big 4 (as a % of total switches)	10.43%	14.99%
Non-Big 4 to Big 4 (as a % of total switches)	14.32%	9.35%

Source: EU Review, p.54.

91. Overall, stricter regimes have led to more switching and appear to have been more effective at redistributing market share between the top 4 auditors. However, where switches occur, in terms of increasing opportunities for auditors outside the Big Four, stricter regimes appear to have been no more effective than flexible regimes.

Non-audit service fee cap and prohibition of non-audit services

92. The measures on non-audit services were intended to reduce real and perceived conflicts of interest that arise because of audit firms providing both audit and non-audit services to their auditees. The restrictions on non-audit services provision introduced by the Regulations were expected to result in greater alignment between auditors' financial incentives, professional scepticism, and audit quality.
93. Our survey respondents generally agreed that the provisions on non-audit services had helped to reduce conflicts of interest in audit and increase confidence in the reliability of audit (see Figure 10 and Figure 11 below).

Figure 10: Chart showing respondent views about how much conflicts of interests have been reduced in firms as a result of the non-audit service fee cap and prohibition of non-audit services measure (N=37).

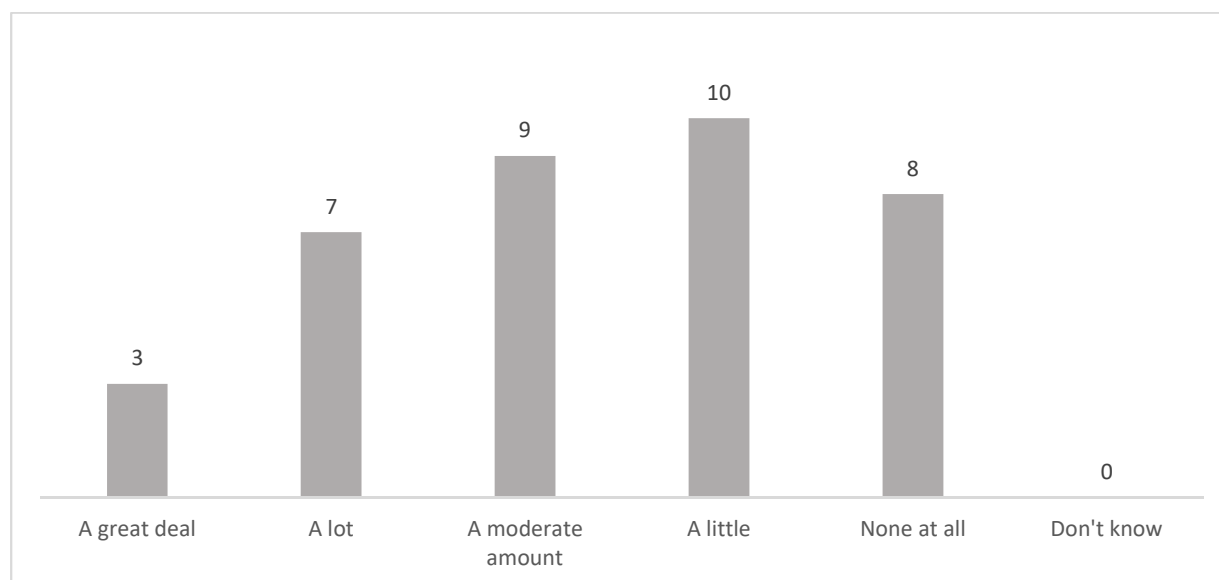
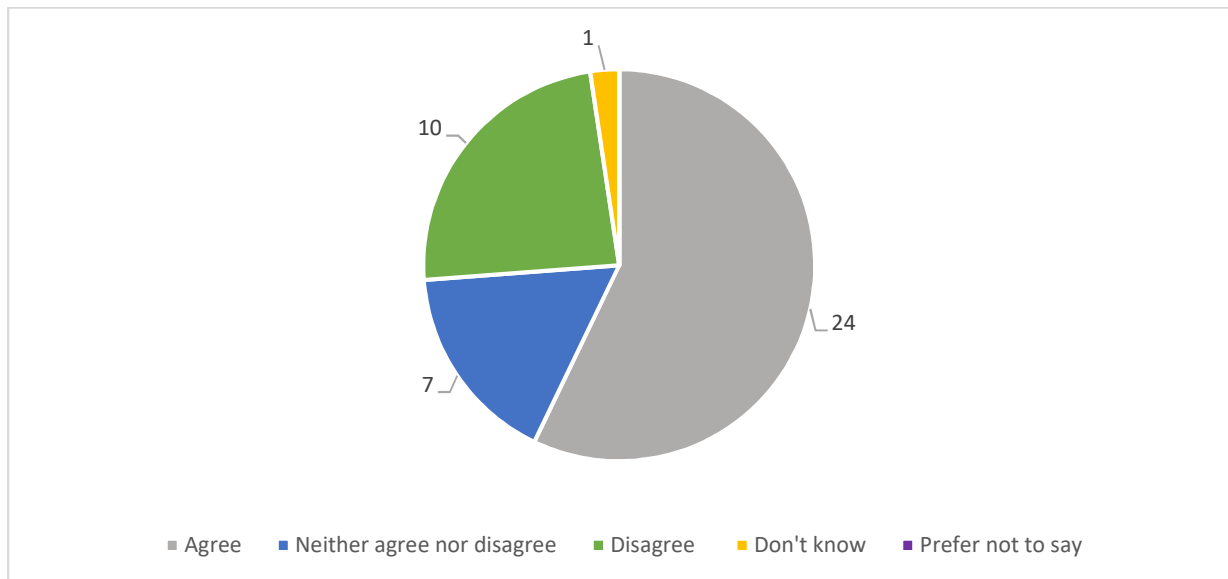
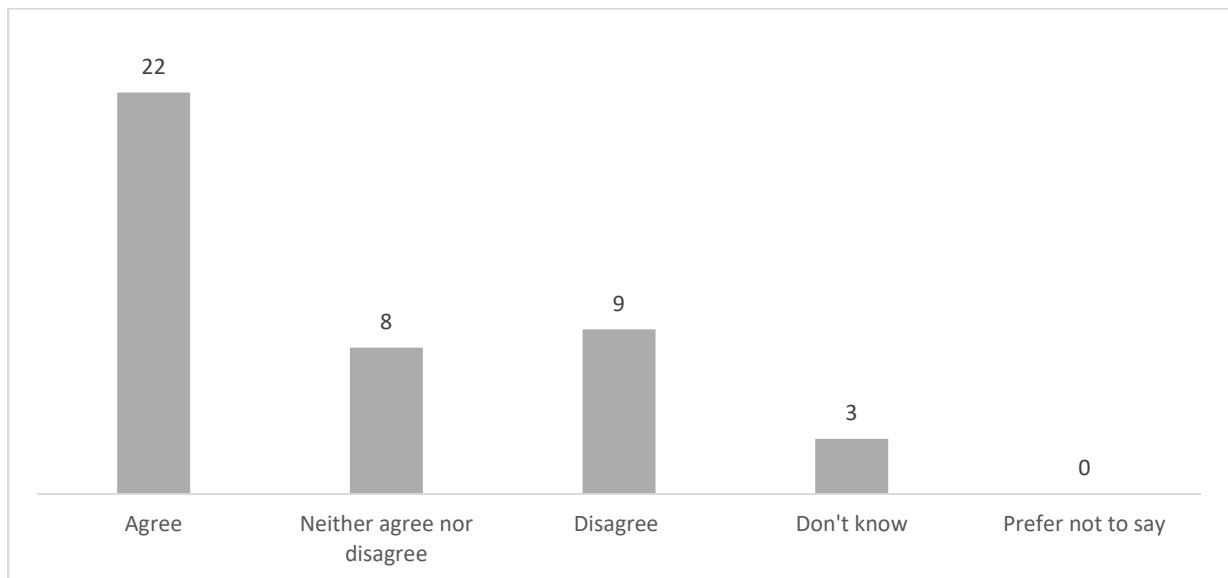


Figure 11: Chart showing respondent views about whether stakeholder confidence in audit has improved because conflicts of interests have been more clearly addressed (N=42).



94. However, most respondents agreed that the restrictions on non-audit services had also helped to drive up audit fees (Figure 12).

Figure 12: Chart showing whether respondents agree or disagree that this measure has driven up audit fees (N=42)



95. One respondent said:

“In terms of specific measures, the 70% fee cap had a long gestation period, only coming into effect in the course of the last year so that drawing firm conclusions on its success, in any respect, is too early to speculate on.”

Audit Firm

96. There is mixed academic evidence on the supply of non-audit services and its effect on audit quality. Kinney et al. (2004)⁸⁴, Ferguson et al. (2004)⁸⁵ and Krishnan et al. (2005)⁸⁶ all found negative relationships between the supply of non-audit services and audit quality, but others found no correlation at all (e.g. Ashbaugh et al., 2003⁸⁷; Knechel et al., 2012⁸⁸). Koh et al. (2013)⁸⁹ even found that the quality of reported earnings increased when auditors provided non-audit services, suggesting beneficial knowledge spill-over effects. The lack of a consensus extends to the relationship between non-audit service fees and the issuance of going-concern opinions – where Sharma and Sidhu (2001)⁹⁰ find a negative correlation between the two in Australia, while DeFond et al. (2002)⁹¹ find no significant association at all in the US following the Sarbanes-Oxley Act.
97. There is some empirical evidence that suggests the effect of non-audit service provision on audit quality and independence can be dependent on specialisation or circumstance (Lim and Tan, 2007)⁹². Bell et al. (2015)⁹³ also found that non-audit fees received from management advisory services and services related to new equity offerings were positively associated with audit quality, especially among publicly traded companies. Tax services and other non-audit services, however, were not significantly associated with audit quality, with none being negatively associated with quality.
98. The restrictions on non-audit services provided to PIEs do not seem to have substantially increased the non-audit revenues of non-Big Four firms; the CMA

⁸⁴ Kinney, W., Palmrose, Z and Scholz, S. (2004) *Auditor Independence, Non-Audit Services and Restatements: Was the US Government Right?* Journal of Accounting Research, 42(3), pp. 561-588. doi: 10.1111/j.1475-679X.2004.t01-1-00141.x.

⁸⁵ Ferguson, M., Seow, G., Young, D. (2004) *Non-Audit Services and Earnings Management: UK Evidence*. Contemporary Accounting Research, 21(4), pp. 813-841. doi: 10.1506/MFV5-9T3Q-H5RK-VC20.

⁸⁶ Krishnan, J., Sami, H. and Zhang, Y. (2014) *Is there a relation between audit fee cuts during the global financial crisis and banks' financial reporting quality?* Journal of Accounting and Public Policy, 33(3), pp. 279-300. doi: 10.1016/J.JACCPUBPOL.2014.02.004.

⁸⁷ Ashbaugh, H., LaFond, R. and Mayhew, B. (2003) Do non-audit services compromise auditor independence? The Accounting Review, 78(3), pp. 611-639. Available at: <https://www.jstor.org/stable/3203219>.

⁸⁸ Knechel, W., Sharma, D, and Sharma, V. (2012) *Non-audit services and knowledge spill overs: Evidence from New Zealand*. Journal of Business, Finance & Accounting, 39(1/2), pp. 60-81. doi: 10.1111/j.1468-5957.2011.02268.x.

⁸⁹ Koh, K., Rajgopal, S. and Srinivasan, S. (2013) *Non-audit services and financial reporting quality: evidence from 1978 to 1980*. Review of Accounting Studies, 18(1), pp. 1-33. doi: 10.1007/s11142-012-9187-6.

⁹⁰ Sharma, D. and Sidhu, J. (2001) *Professionalism vs Commercialism: The Association between Non-Audit Services and Audit Independence*. Journal of Business Finance, 28(5/6), pp. 563-594. doi: 10.1111/1468-5957.00386.

⁹¹ DeFond, M., Raghunandan, K. and Subramanyam, K. (2002) *Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern and Audit Opinion*. Journal of Accounting Research, 40(4), pp. 1247-1274. doi: 10.1111/1475-679X.00088.

⁹² Lim, C. and Tan, H. (2007) *Non-Audit Service Fees and Audit Quality: The Impact of Auditor Specialisation*. Journal of Accounting Research, 46(1), pp. 199-246. doi: 10.1111/j.1475-679X.2007.00266.x.

⁹³ Bell, T., Causholli, M., and Knechel, W. (2015) *Audit firm tenure, non-audit services and internal assessments of audit quality*. Journal of Accounting Research, 53(3), pp. 461-509. doi: 10.1111/1475-679X.12078.

Study⁹⁴ found that while between 2011 and 2016 total non-audit revenue increased by around 50% to around £1.05 billion, it further increased to around £1.1 billion in 2018. During this period Big Four firms total non-audit revenue increased from around £6.7 billion in 2016 to £7.3 billion in 2018⁹⁵.

99. Non-audit services also became relatively larger arms in the Big Four, accounting for 79% of total revenue in 2018 compared to 77% in 2011⁹⁶. For challenger firms, most revenues also came from non-audit services, however at a lower proportion, accounting for 71% of total revenue in 2018⁹⁷.
100. Furthermore, these provisions seem to have led to a largely unintended consequence, in that they also seem to have reduced choice in the audit market. The Big Four cited their conflicts around non-audit services as their most common reason for not participating in audit tenders, at roughly 57% of the time⁹⁸. These provisions can cause audit firms not to bid for audit work due to their non-audit engagements with the potential audit client.
101. The CMA Study⁹⁹ found that in most cases, the main constraint appeared to be from the restricted services, rather than the broader 70% fee cap. The recent FRC change to 'white-listed' services, which would restrict the ability of a firm to audit a client if they provided non-audit services that are not on a whitelist, could reduce choice further.

Audit committee requirements

102. The intention behind increasing the scope of audit committee requirements was to increase the independence of auditors. Newly created audit committees would allow for more independent selection processes, generally free from management biases and influence. This was expected to allow for greater audit quality and professional scepticism.
103. Most respondents agreed that this measure had provided greater transparency on the audit process, improved the quality of financial information in the accounts and reports, and improved audit quality and independence through greater scrutiny; results were slightly less positive on the accountability of audit firms (Table 2).

⁹⁴ CMA Study, fig. 2.14.

⁹⁵ CMA Study, fig. 2.12.

⁹⁶ CMA Study, para 2.34.

⁹⁷ CMA Study, para 2.37.

⁹⁸ CMA Study, para 3.126.

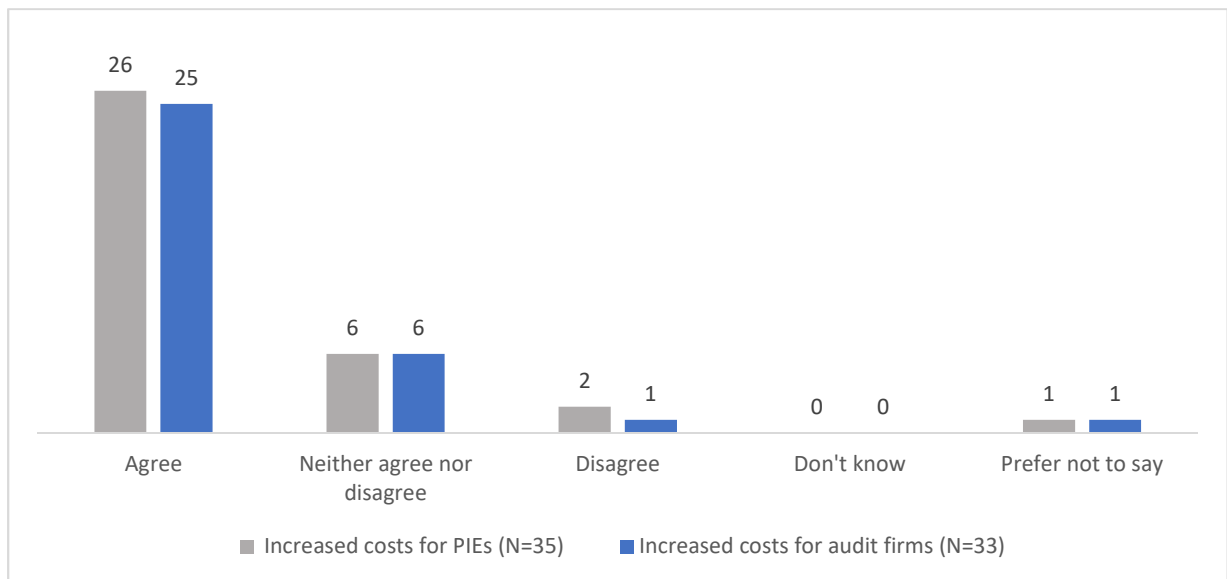
⁹⁹ CMA Study, para 3.122.

Table 2: Table showing respondent views on the development and additional requirements of audit committees.

	Improved audit quality and independence through greater scrutiny of the process by audit committees	Improved quality of financial information in the accounts and reports	Provided greater transparency on the audit process	Increased the accountability of audit firms, improving their scrutiny of accounting records and processes
Agree	21	19	20	16
Neither agree nor disagree	8	8	10	11
Disagree	4	6	6	8
Don't know	0	0	0	0
Prefer not to say	1	0	1	1
Total	34	33	37	36

104. When respondents were asked about whether this measure had increased cost, most respondents agreed that this measure increased costs for PIEs and audit firms (Figure 13).

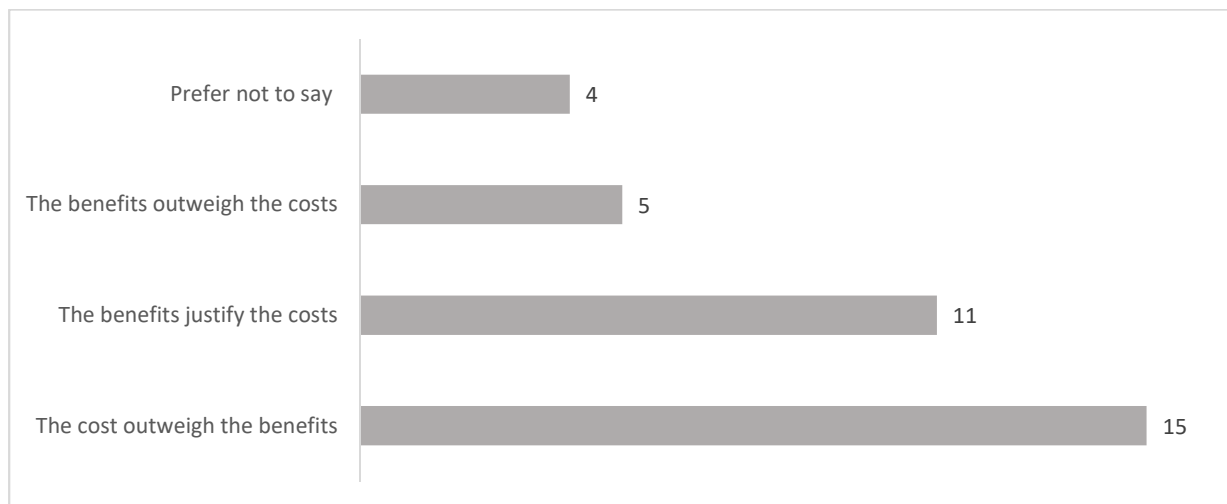
Figure 13: Chart showing how far respondents agree or disagree that this measure increased costs for PIE and audit firms.



105. On this measure, there were mixed views about the proportionality of costs. While the largest number of respondents suggested that the costs outweighed the benefits, more suggested that the benefits either outweighed or justified the costs (Figure 14

106. Figure).

Figure 14: Chart showing respondent views towards the costs and benefits of this measure (N=35)



107. The CMA Study¹⁰⁰ found that this provision had indeed strengthened the role of the audit committee, finding that all Audit Committee Chairs (ACCs) were clear in their duty to provide an independence function, represent shareholder interests, and value the professional scepticism and challenge of auditors.

108. The CMA Study¹⁰¹ reviewed 24 FTSE 350 tenders and found that those audit committees were actively involved in most, if not all, stages of the tender process. One respondent to our survey suggested that the measures on audit committees:

“Have likely increased professionalism and quality of execution of mandate, leading to an implicit better definition, understanding, and mitigation of risks”.

Company audit committee member, PIE

109. However, the CMA Study¹⁰² found wide variations in the amount of work done by committees, with some spending more than 400 person hours on their duties a year, and others less than 20. Survey responses on the matter of audit committee working hours were inconclusive, with many suggesting it was simply too difficult to quantify. The FRC also found that audit committees vary in the quality of their published ACRs, finding some provided “excessive description of process ... which was often boilerplate and uninformative”¹⁰³.

¹⁰⁰ CMA Study, para 3.10.

¹⁰¹ CMA Study, para 3.43.

¹⁰² CMA Study, para 3.58.

¹⁰³ CMA Study, para 3.64.

110. While some ACCs said their committees were independent, challenging, and supportive in their selection processes¹⁰⁴, the CMA Study¹⁰⁵ found evidence that factors such as ‘cultural fit’, ‘chemistry’, ‘management influence’ and ‘personal relationships’ could still be found driving audit appointments by some committees. Of 24 reviewed audit committees in the FTSE 350, the CMA Study¹⁰⁶ found all applied ‘technical capability’ in their selection criteria, while only 9 had ‘exercising scepticism and challenging management’, and 23 had ‘cultural fit and personal chemistry’ in their criteria. The CMA Study¹⁰⁷ also found instances when investors and shareholder representatives have a degree of influence on audit firm appointments, potentially even having encouraged an audit committee to appoint a Big Four firm.
111. Despite audit committees having the responsibility to represent investors’ interests, the CMA also found evidence that many provide low levels of investor engagement¹⁰⁸. Only one FTSE 350 company was able to provide the CMA with details of direct communications with shareholders about when the company last tendered their external audit¹⁰⁹. Several other ACCs confirmed their lack of active engagement on audit matters. As such, the CMA found that it was very rare for investors to have rejected appointments. This demonstrates that audit committees can occasionally be unclear on their responsibilities.
112. Some audit committees have said they have found it hard to directly observe the quality of audit undertaken¹¹⁰. In several cases, audit committees were also found to rely on executive feedback on the auditor as the main input into annual reviews of performance, thereby assessing auditors based on feedback of those being audited. This potentially introduces a conflict of interest.

Changes to the framework of the statutory regulator

113. The Regulations were intended to create more effective regulatory oversight of audit. The data from the survey shows that:
- 13 respondents agreed that changes in the regulatory framework increased audit quality, whilst 11 were neutral and 10 disagreed (Figure 15)

¹⁰⁴ Future of Audit report, para 156.

¹⁰⁵ CMA Study, para 3.11.

¹⁰⁶ CMA Study, fig. 3.1.

¹⁰⁷ CMA Study, para 3.69.

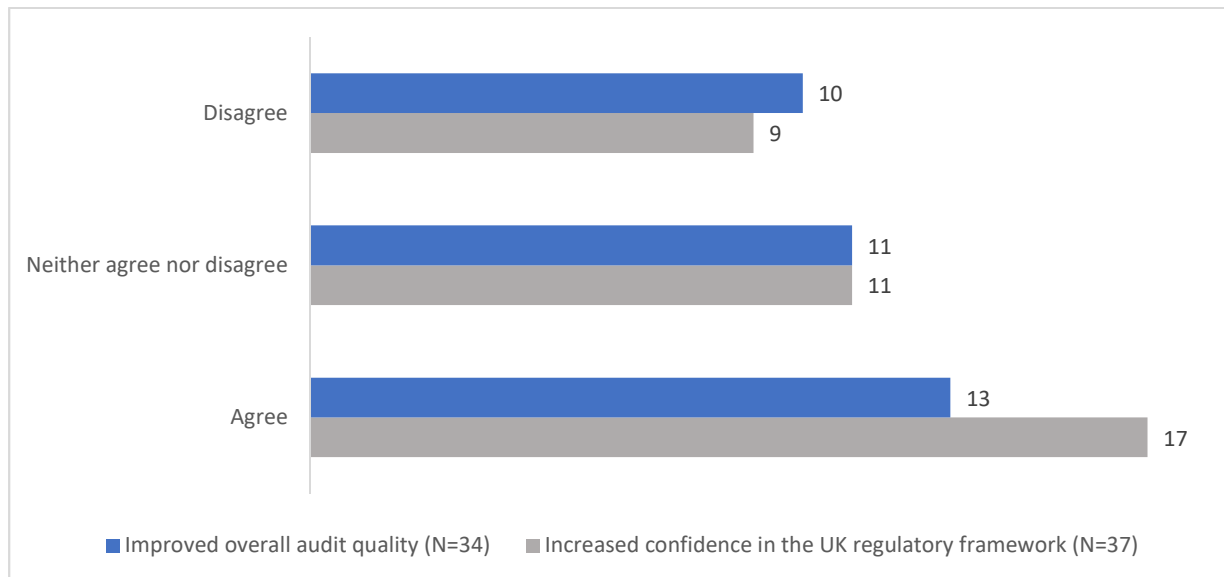
¹⁰⁸ CMA Study, paras 3.66-3.81.

¹⁰⁹ CMA Study, para 3.74.

¹¹⁰ CMA Study, paras 3.51-3.53.

- Figure).
- 17 respondents agreed that the changes had increased confidence in the UK’s regulatory framework, 11 were neutral and 9 disagreed.

Figure 15: Chart showing respondent views towards the change in the regulatory framework.



114. It is difficult to make a judgement about the effectiveness of this aspect of the Regulations, which predated Reviews that were critical of the regulator’s performance. For example:

- The Independent Review of the FRC¹¹¹ stated, “*the FRC has been widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing*”, and more generally found it to be weak, ineffective, and inadequate as a regulator.
- The Brydon Review recognised criticisms of the FRC’s Audit Quality Inspection process¹¹², and suggested that the FRC needed to be tougher, especially in its

¹¹¹ FRC Review, para 2.55.

¹¹² Brydon Review, section 26.2

use of sanctions¹¹³. The BEIS Committee’s Future of Audit report¹¹⁴ echoed these comments, arguing that the FRC seemed unwilling to explore major audit failures, and reluctant to use its available sanctions even when it found substandard audits.

- The FRC Review¹¹⁵ noted that there was no shortfall in the sanctions available to the FRC in relation to auditors. However, the Review also suggested that investigations and enforcement should still be made more appropriate and timelier.

115. However, at the time of the Reviews only a limited number of investigations had been commenced under the Regulations and few of these were yet completed. Cases under the preceding framework that were still under investigation were taking up the larger part of FRC resources¹¹⁶. The effectiveness of the Regulations is likely to be dependent on the changes made within the FRC following the FRC Review, and further proposed changes to the statutory framework of the Regulator which are included in the reform package currently being consulted on.

Prohibition of Big Four-only loan clauses

116. These clauses were successfully prohibited, which did allow for the possibility of challenger firms bidding for previously unobtainable audit contracts – and in theory this would have led to greater market mobility and competition.

117. However, the survey data shows that most respondents disagreed that this measure increased PIE audit market participation for non-Big Four firms, created more choice amongst the non-Big Four, and increased audit quality (Table 3) to have led to an increase in costs for audit firms.

Table 3: Table showing respondent views towards prohibition of Big Four-only clauses in loan agreements.

	Increased audit firm participation beyond Big-4 and competition	Created more choice between Big-4 and non-Big 4 auditors	Increased costs for firms	Decreased costs for firms	Increased quality through more choice in the market
Agree	5	8	16	0	4
Neither agree nor disagree	8	6	9	9	10
Disagree	18	21	6	22	22
Don't know	0	0	0	0	0

¹¹³ Brydon Review, 23.0.3.

¹¹⁴ Future of Audit report, para 226.

¹¹⁵ FRC Review, para 2.59.

¹¹⁶ <https://www.frc.org.uk/auditors/enforcement-division/past-cases-accountancy-scheme>

Prefer not to say	2	2	2	2	2
Base size	33	37	33	33	38

118. One respondent said:

“I don’t believe that lenders and companies have changed behaviour - although not written, in many cases the companies behave as though the restriction still applied.”

Company Director, PIE

119. Another respondent said:

“Given conflicts between clients and tendency to still favour Big 4 there is frequently little effective competition or price tension when appointing a new auditor.”

Individual Investor

120. As noted above the CMA Study¹¹⁷ also suggested that there can still be pressure from investors and other shareholder representatives to appoint a Big Four audit firm.

Outcomes – how did the Regulations affect the market for audits?

Audit quality

121. Since the reforms were passed, there have been several large corporate failures, such as the collapses of Carillion, Thomas Cook, and BHS, all of which have further damaged trust in audit, suggesting that audit quality is still not adequate. The FRC’s 2020 Developments in Audit report¹¹⁸ shows that audit quality remains “unacceptably inconsistent”, with 49 of 130 all inspected audits assessed as requiring improvement or significant improvement. Further, in 2019/20, only around 62% of all audits inspected by the FRC were rated ‘good’ or ‘limited improvements required’, which was the lowest across the last five annual inspection cycles; the number of audits assessed as ‘improvements required’, and ‘significant improvements required’ in the same period were 26% and 11%, respectively¹¹⁹.

122. These reports continue to raise concerns around lack of challenge by auditors and their inability to demonstrate sufficient professional scepticism, and the FRC also went as far as to say that KPMG’s audits had shown an “unacceptable deterioration”, while the other Big Four members needed to reverse a decline¹²⁰.

123. The evidence on how audit quality has changed since the Regulations came into effect indicates that some improvement is likely. Some survey responses suggest:

- Audit quality and confidence in the UK’s framework has improved because of changes to the regulatory regime,
- Audit quality increased because of new audit committee requirements, and

¹¹⁷ CMA Study, para 3.69.

¹¹⁸ <https://www.frc.org.uk/document-library/audit-quality-review/2020/developments-in-audit-2020>

¹¹⁹ <https://www.frc.org.uk/document-library/audit-quality-review/2020/developments-in-audit-2020>

¹²⁰ Future of Audit report, para 7.

- Auditor scepticism has increased because of the introduction of mandatory auditor rotation and retendering.
124. Key outstanding issues identified by the recent reviews of audit principally relate to: weaknesses and constraints affecting the regulator, which limit its ability to regulate effectively and with a firm focus on the interests of users of corporate reporting information (the FRC Review); a lack of focus on audit quality in the selection and oversight of auditors, and weakened incentives for firms providing both audit and non-audit services to prioritise audit quality (the CMA Study); and a lack of clarity for preparers and users of corporate reporting information around the purpose of audit, and the roles and responsibilities of auditors (the Brydon Review).
125. In particular, the CMA Study¹²¹ found that several investors and smaller shareholders agreed that the recent corporate failures and high-profile accounting scandals highlighted the problems in the audit market, undermining trust in the provision of audit to large companies. The study concluded that there is a persistent problem of variable and sometimes poor audit quality¹²². They have also said that there is still a systemic problem of insufficient challenge across a substantial portion of large company audits¹²³.
126. However, not all agree. Many stakeholders of large companies responding to the CMA Study¹²⁴ said they had no concerns about the quality of their audit process and did not think that the evidence indicated a systemic problem with UK audit quality. The CMA Study¹²⁵ found that while the responses from the Big Four did recognise a need to restore public confidence and regain trust of shareholders in audit, they did not agree with the CMA's analysis of audit quality. Several conflicts of interests and other issues, which plagued audit prior to the Regulations were addressed, leading to increases in independence, which should have brought about some beneficial effects on audit quality. However, on balance, there seems to be more evidence that the Regulations were a smaller step towards the goal of higher audit quality than hoped for. This seems to be the effect of more longstanding issues with audit, and the implementation of audit regulation, rather than a fault of the Regulations directly.
127. The Government has recognised the continuing issues with audit quality and, as part of its wider audit reform programme, is consulting on proposed measures for treating them. These proposals were informed by the FRC Review, CMA Study and Brydon Review, and approach audit quality concerns from three primary dimensions – the regulation of audit, the incentives of market players to deliver high-quality audits and the definition and purpose of audit itself.

Audit market competition and choice

128. **Competition and choice in the audit market have not improved.** The Big Four continue to dominate the market for large company audits. In 2017, the Big Four

¹²¹ CMA Study, para 2.84.

¹²² CMA Study, para 2.78.

¹²³ CMA Study, para 2.70.

¹²⁴ CMA Study, para 2.79.

¹²⁵ CMA Study, para 2.85.

carried out the audits of 97% of the FTSE 350, receiving more than 99% of its fees; audited 89% of companies in the FTSE Small index, corresponding to 92% of their audit fees; and received 86% of audit fees from the FTSE AIM 100¹²⁶. In 2019, the Big Four carried out the audits of 96% of the FTSE 350, and 100% of the FTSE100. Non-Big Four firms are small in comparison – even after the 2019 merger between the sixth and tenth biggest audit firms, BDO and Moore Stephens, which together became the fifth biggest firm in terms of total fee income¹²⁷. The new firm is still only around 30% of the size of KPMG, the smallest of the Big Four firms.

129. Despite the Regulations having made it an objective to improve competition in the audit market, challenger firms have not significantly increased their market share. This may not be a fault of the Regulations themselves as was echoed by one respondent in the survey; between 2013 and 2018, despite one or more challenger firms being approached to participate in around 30% of FTSE 350 tenders, a proposal was only submitted in fewer than 20% of FTSE 350 tenders¹²⁸. Challenger firms were reluctant to bid for certain audit contracts – their lack of sufficient scale, international presence and experience with large companies, and their lower perceived quality of work, were all highlighted in the survey as reasons why challenger firms were often eliminated in contract tenders.
130. Furthermore, the extension of the PIE definition has reduced the number of smaller audit firms participating in the PIE audit market (as now defined) because of higher regulatory costs. Survey respondents suggested:

“There are very few firms now who will tender for us. I think this is due to our PIE status. However, for a smaller firm with a PIE status, it is increasingly difficult to find audit firms willing to tender. While I don't think it is mandatory rotation that has caused this, I am very aware of how limited the options are to us in terms of audit firms willing to tender for our work. “

Company Director, PIE

131. The Regulations have in some ways also directly hindered competition and choice in the audit market. Measures such as mandatory rotation and the non-audit service provisions have been shown to have had unintended restrictive effects on choice, limiting the number of audit firms available to choose between for some companies. One survey respondent argued that:

“The above approach is severely reducing the choice of auditors amongst leading companies since if a current Big 4 auditor has to retire by rotation this leaves only three remaining Big 4 firms and at least one is often not able to tender for the appointment, often due to conflicts of interest arising from taxation, consulting or other work. This leaves at most two firms likely to be appointed as auditor.”

Audit Firm

¹²⁶ CMA Study, paras 2.2, 2.21.

¹²⁷ Future of Audit report, para 191.

¹²⁸ CMA Study, para 3.114.

132. The recent commitment by three of the Big Four firms to stop providing non-essential non-audit services to audited entities¹²⁹, and the FRC's new non-audit service whitelist, could further reduce choice in the market.
133. On the other hand, again, there is still some evidence that the Regulations have in some ways been beneficial in increasing market competition, as echoed by some of the respondents in the survey. Respondents were broadly split as to the impact of mandatory audit rotation and retendering on providing opportunities for audit firms to compete.
134. Furthermore, the FRC's *Key Facts and Trends in the Accounting Profession*¹³⁰ reports suggest that the combined Big Four market share of all main market firms has fallen since 2016. In 2016, the Big Four audited 81% of all main market firms; this fell to 79% in 2019.
135. The EU study also noted that financial audit concentration, as measured by the HHI, in the UK improved following the reforms. Mandatory audit rotation and retendering also led to higher fluidity in the market even if the dominant switches were from Big 4 to Big 4 or non-Big 4 to non-Big 4¹³¹. Larger challenger audit firms grew their overall UK revenues more strongly than the Big Four from 2011 to 2018¹³². Big Four-only clauses were successfully prohibited, banning a common anti-competitive practice.
136. Yet again, the overall assessment of the audit market seems to be that, while there is some evidence of improved opportunities to compete this has not translated into greater choice and therefore the original expectations were not met. There were also unintended consequences in that mandatory auditor rotation and retendering and restrictions on non-audit services have acted to reduce choice.
137. The Government is consulting on market opening measures aimed at addressing these remaining issues. These proposals are intended to: allow opportunities for challenger firms to grow in a sustainable way to become credible alternatives to the Big Four for the largest audits; and provide challengers exposure to, and experience with, large company audits, thereby addressing issues with perceived challenger firm quality and demand-side bias in the selection of auditors. The Government's proposals also include provisions that mitigate low challenger firm uptake of available opportunities to gain market share. In doing so, it will build up the supply of credible auditors for the largest audits and therefore allow the current Regulations to operate more effectively.

Auditor independence

138. While mandatory rotation and the measures on non-audit service provision may have had some negative effects on competition, the evidence suggests that they, as well as the measures on audit committees, have increased independence. Tenure lengths are now shorter, and the prohibition of certain non-audit services has

¹²⁹ CMA Study, para 3.118.

¹³⁰ <https://www.frc.org.uk/auditors/professional-oversight/key-facts-and-trends-in-the-accountancy-profession>

¹³¹ [https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU\(2019\)631057_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU(2019)631057_EN.pdf), p 119, 120.

¹³² CMA Study, para 2.40.

restricted auditors from providing specific services – suggesting that auditor-client dependence has decreased. The measures seem to have successfully helped reduce conflicts of interest and break up strong relationships between auditors and their auditees.

139. However, managerial influence remains over some audit committees. Some audit committees still value ‘cultural fit’, ‘chemistry’, and ‘personal relationships’ in the audit appointment process and rely on executive feedback to judge auditor performance.
140. The Government is consulting on proposals for addressing these residual issues¹³³. These include an operational separation of multi-disciplinary firms (firms that provide both audit and non-audit services), which is expected to limit auditors’ incentives to produce unjustifiably favourable audits to secure more lucrative non-audit work, while making challenge, scepticism, and audit quality the focus. Additionally, the proposals include measures for ensuring the effective independent function of audit committees. These aim to address issues around the appointment of auditors (for example, shifting audit committees’ focus to audit quality as opposed to cultural fit), their monitoring and oversight of audit engagements, and the scrutiny applied to audit committees by the regulator.

Auditor oversight and scrutiny

141. In spite of its own amendments to ethical and auditing standards, structures and procedures, and the introduction of its Audit Enforcement Procedure to implement the requirements of the Regulations¹³⁴, the FRC has been widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing¹³⁵, for much of the period covered by the reforms. This would have had an impact on the effectiveness of the reforms. However, in light of the findings and recommendations of the FRC Review, the FRC have already made some non-legislative changes to improve its own effectiveness in this regard. These include, *inter alia*:
 - enhancing and strengthening its supervisory and enforcement functions and commencing publication of an Annual Enforcement Review;
 - centralising and updating its complaints policies and procedures; and
 - improving the handling of confidential information and prevention of leaks.
142. As part of its wider programme of audit reform, the Government is also consulting on proposals for strengthening the regulator via the implementation of recommendations from the FRC Review. These include the establishment of a new independent regulator with strengthened and expanded powers, and strategic objectives to protect the interest of users of financial information and the public interest, by setting high standards of audit and corporate reporting and by holding

¹³³ The Big 4 are already voluntarily implementing non-legislative principles for operational separation set by the FRC ahead of the Government’s reforms. Any requirements introduced by Government via its package of reforms are expected to strengthen the arrangements for operational separation currently being made by the Big 4.

¹³⁴ <https://www.frc.org.uk/auditors/enforcement-division/audit-enforcement-procedure>

¹³⁵ FRC Review, para 2.55.

companies to account. The establishment of the new regulator is expected to address weaknesses in the operation of the FRC and constraints on its ability to regulate effectively.

Investor confidence

143. **We are unable to determine the effect on investor confidence.** Survey responses from investors had an unrepresentative sample size of 4, which is not suitable to draw any meaningful conclusions from.

Overall assessment of whether the objectives are met

144. Table 4 below shows how successful survey respondents thought the Regulations have been in achieving the policy objectives. Most respondents agreed that the Regulations had indeed helped to improve confidence in the quality of auditor reporting and increased the professional scepticism of auditors – with more mixed pictures surrounding confidence in the quality of financial information, the risk of misstatement and errors in audited accounts, and the standards of auditor independence.

Table 4: Table showing respondent views on how well the package of Regulations achieved the following results

	Improved confidence in the quality of financial information	Improved confidence in the quality of auditor reporting	Increased professional scepticism of auditors	Reduced the risk of mis-statement or errors in audited accounts	Led to higher standards of auditor independence
Strongly agree	0	2	1	2	1
Agree	16	18	21	10	18
Neither agree nor disagree	10	10	9	12	12
Disagree	10	8	7	12	7
Strongly disagree	4	3	2	5	3
Don't know	0	0	0	0	0

Prefer not to say	0	0	0	0	0
Total Responses	40	41	40	41	41

145. Our overall assessment on the objectives of the Regulations is thus as follows:

Table 5: Assessment of Performance Against Objectives

Policy Objective	Summary
Improve confidence in the value of audit	The evidence shows the Regulations have been effective in improving confidence in audit. The survey responses show greater confidence in the UK audit framework as a result of the Regulations.
Reinforce the independence and professional scepticism of the statutory auditor	The evidence shows that auditor independence has improved, in part owing to measures such as non-audit service prohibitions and the provisions on audit committees in the Regulations. This is likely to have had a positive effect on the level of professional scepticism that an auditor brings to their work, as conflicts of interest have been reduced, demonstrated by the survey responses. However, there is evidence that suggests further improvement would enhance audit quality.
Increase accountability of independent audit committees of PIEs	The evidence shows the Regulations have generally performed well. Independent audit committees are functioning better, as they are now clear in their duties, which most have been working diligently to perform, as shown by both the survey responses and CMA Study data. However, there are still concerns; both sources also show that there is significant variation in the amount of work that committees carry out, and evidence that management can still influence the results of committee work.
Improve and better co-ordinate auditor supervision by competent authorities, thereby enhancing audit oversight and quality	The evidence shows oversight and scrutiny have generally not improved, and there is still a need to go further. The FRC Review identified significant weaknesses in the FRC's effectiveness as a regulator, findings echoed by the survey responses. The Government has responded to this evidence with plans to establish a successor body – the Audit, Reporting and Governance Authority (ARGA) which will have formal duties, functions and powers to make it fully effective.

Policy Objective	Summary
Reduce the risk of misstatement or error in audited accounts, thereby making audit reports more credible for shareholders and audit committees	Survey respondents reported increased confidence in the quality of auditor reporting, and greater independence and professional scepticism arising from the Regulations.
Increase competition and choice in the PIE audit market, thereby making the market for large company audits more dynamic	Evidence from the CMA Study and annual FRC reports show that there is more switching behaviour, but that this has not resulted in increased choice. This is in part a direct result of unanticipated choice-constricting measures such as mandatory rotation and non-audit service prohibitions. Market mobility has increased but most switching occurs from Big 4 to Big 4 or non-Big 4 to non-Big 4. Big Four firms continue to dominate the market, especially in the FTSE 350. The survey findings show smaller PIEs and audit firms feel that they face higher costs that affect them disproportionately. However, the multivariate analysis suggests that audit fees have not increased for PIEs because of the Regulations (see later). However, this could be a result of fee rates not changing immediately after the Regulations, but increases were delayed until auditors changed clients.

146. Our judgement is that the Regulations represent progress towards achieving the objectives set for them, but with the following additional observations:

- It is relatively early to evaluate some measures. For example, the retendering and rotation periods are 10 and 20 years respectively and the Regulations have only been in force for 5 years so there are tranches of companies that are only now being required to retender their audit contracts.
- In part the effectiveness of the Regulations will depend on improvements to the regulator, which are being made, and with the Government's proposals on audit reform to make that progress secure.
- There have been unintended consequences, in that measures to increase audit quality have come at the expense of auditor choice either because of mandatory rotation or because the added burden of auditing a PIE has reduced the number of auditors available.
- The lack of choice appears to arise because the challenger firms are not considered to provide the same level of audit services as Big Four firms. For example, they lack international networks and experience of the most complex audits.
- For this reason, the Government is consulting on reforms to try to increase capacity and experience of non-Big Four auditors e.g. by introducing managed shared audit to provide non-Big Four auditors with opportunity to grow and to gain experience on the most complex audits. By increasing supply side

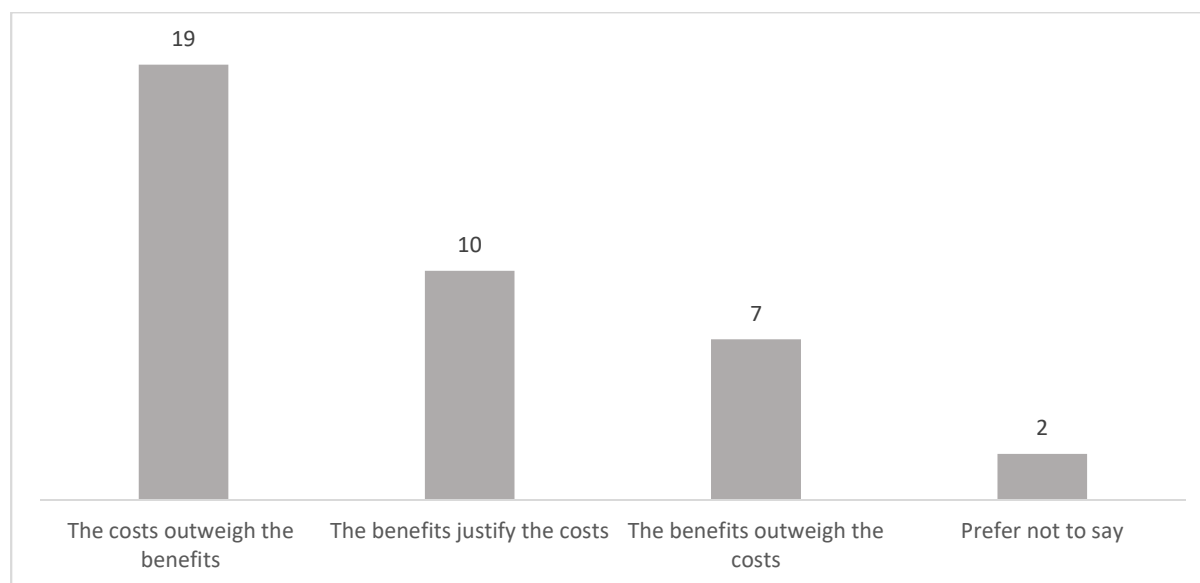
capacity to carry out the largest audits we would expect the effectiveness of these Regulations in promoting choice to increase.

Can the Objectives be Achieved with a Lower Burden on Business and Society?

Survey results

147. In our survey, the largest number of respondents suggested that the costs of the Regulations outweighed its benefits, while an almost equal number responded saying that the benefits of the Regulations either justified or outweighed its costs. This is shown in Figure 16 below.

Figure 16: Chart showing respondent views on the costs and benefits of the package of measures (N=38).



148. Many survey respondents expressed strong sentiments around costs to business, suggesting:

The Regulations are *“complex, convoluted, and unnecessary”*

Company audit committee member, PIE

“All it has done is increase cost and bureaucracy”

Company audit committee member, PIE

“Increased costs and inefficiencies”

Company audit committee member, PIE

149. Prohibiting Big Four-only clauses was also simply seen as:

“More box ticking”

Company audit committee member, PIE

150. Several respondents complained about the extra costs involved with new tender processes:

“The investment required to pitch effectively is a high barrier”

A body that has an interest in financial or non-financial reporting

“Incurred a huge amount of cost, both for auditors and for companies who have to run these processes”

Company audit committee member, PIE

it is a *“waste of a lot of time and effort”*

Company audit committee member, PIE

“The costs of tendering [are] a recipe for bankruptcy”

Company audit committee member, PIE

151. Some survey respondents also noted that this cost increase, while affecting all firms, was disproportionately affecting smaller companies, and smaller audit firms. Responses argued the Regulations:

had *“significant cost implications for smaller firms”*

Company Director, PIE

made it *“less commercially viable for smaller audit firms”*

A body that has an interest in financial or non-financial reporting

were a *“disproportionate burden on smaller businesses”*.

Company Director, PIE

152. One response even suggested:

“the market for external audit for small mutuals is failing; the current definition of PIEs is cumbersome, imprecise and should not be applied to smaller mutual insurers ... it has distorted the market to the detriment of consumer choice ... the lack of competition has resulted in an unwelcome and unjustified increase in costs. One small ... member, with only 5 employees and a very small book of insurance business, saw its existing auditor withdraw services in 2020. The options available were three or more times more expensive. In the insurers assessment this dramatically increases the prospects that they will be unable to trade in the next three years”.

Representative Organisation Personnel, PIE

153. More robust audit is expected to result in improvements in information flows within firms, and in financial reporting quality. In turn, more accurate financial information can deliver benefits by:

- *improving decision-making within companies.* Higher quality financial reporting and audit can deliver new and more comprehensive insight to management which could strengthen management decision-making directly. Additionally, improved flows of better-quality information between companies and their shareholders may improve shareholders’ ability to hold management to account, and would increase incentives for management to better align their decision-making with their shareholders’ interests.
- *decreasing the cost of capital for companies seeking to raise investment:* If investors lack confidence in companies’ corporate reporting, they may demand a higher return on investment to account for increased risks and precautionary

costs. Boosting investor confidence in financial information may therefore decrease the cost of capital for companies.

- *improving of the allocative efficiency of investment across companies:* improved financial reporting quality and audit results in more transparent information on companies' prospects. The availability of more transparent financial information can reduce both over- and under-investment in companies since it may limit market failures such as moral hazard and adverse selection in the market.
- *reducing the expected cost of corporate failures:* Large corporate failures can generate significant first-order costs. For example, Carillion's insolvency cost the UK government £148m and also large second-order market-wide impacts. Linked to the improvements in allocative efficiency of investment, if investors receive a more accurate picture of the health of companies, they may show less willingness to invest in those that are struggling or in distress, or put pressure on management of these companies to reduce risks. This might not prevent their collapse, but would limit the investment in, and growth of, these companies, and thereby limit the cost to investors and the wider public in the event of collapse.

154. Businesses themselves may benefit directly from improved internal governance and decision-making and a decrease in the cost of capital. Figure 16 shows that just under half of the respondents recognised that the benefits of the measure either outweighed or justified the costs. However, it is important to note that the intended and realised benefits of the Regulations are often borne by wider society – for example, through improvements in the allocative efficiency of investment across companies, the avoidance of Government bail outs for collapsing companies, or more controlled, less costly, business failures – while businesses internalise the costs. This means that businesses may not recognise the positive externalities that the audit reform was intended to deliver, as they do not directly accrue to them.

Impact on audit and non-audit fees

155. To deepen our understanding of the Regulations, we used econometric analysis to describe the relationship between the Regulations and audit and non-audit fees. As costs may have been absorbed by audit firms (e.g. the CMA Study¹³⁶ suggested that audit firms have mostly absorbed the costs of auditor switching), this cannot demonstrate the entire impact on fees, but can indicate the minimum impact on fees from the reforms.
156. We conducted a multivariate log-level OLS regression, which controlled for auditee characteristics including company size and performance, and industry differences, using a methodology similar to that in Willekens, Dekeyser and Simac's research paper *EU Statutory Audit Reform: Impact on Costs, Concentration and Competition* (2019)¹³⁷. We ran separate regressions for listed (based on a sample of the

¹³⁶ CMA Study, para 3.90.

¹³⁷ [https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU\(2019\)631057_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU(2019)631057_EN.pdf)

FTSE350) and unlisted companies due to differences in the data coverage available for listed and unlisted companies, and because doing so allowed us to identify the impact of bringing new (i.e. unlisted) companies into the PIE definition.

157. In this section, we focus solely on the results of our variable of interest – **AFTERSATCAR** – a dummy variable equal to one if the fiscal year end was after 17th June 2016, and zero otherwise. A detailed description of the methodology along with the full set of results and caveats can be found in Annex C.
158. The results of the model show that for *listed companies*, the Regulations resulted in no statistically significant change in average audit fees. However, they showed a significant decrease in average non-audit fees of around 47%¹³⁸. For *unlisted companies*, the results indicated a significant increase in average audit fees of around 32%, and a significant decrease in average non-audit fees of around 34% from the Regulations. The results are summarised in Table 6 below.

Table 6: Post-Regulations differences in audit and non-audit fees for listed and unlisted PIEs

AFTERSATCAR	DEPENDENT = AUDIT FEE				DEPENDENT = NON-AUDIT FEE			
	% change		t-stat	p-val	% change		t-stat	p-val
FTSE350 companies	Not statistically different from zero				-47.1%	***	-8.16	0.000
unlisted companies	+31.8%	***	5.59	0.000	-34.1%	**	-3.11	0.002

Significance codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.'

159. These findings are broadly consistent with feedback from most of the responses to our survey. Respondents pointed to large additional audit fee costs for affected entities, especially smaller unlisted companies which were brought into scope of the PIE audit regime by the Regulations¹³⁹.
160. The absence of a statistically significant effect on audit fees for listed companies suggests that most of the overall additional cost burden from the Regulations fell on unlisted companies. This is not surprising, as the Regulations placed more new requirements on unlisted companies brought in scope. For example, listed companies were already required to have their auditors produce transparency reports, and would therefore have incurred significantly lower costs than unlisted companies, for whom no such previous requirement was in place.

¹³⁸ Percentage change given by $(e^{(estimated\ co-efficient)} - 1) * 100$

¹³⁹ See section "Can the Objectives be Achieved with a Lower Burden on Business and Society – Survey results".

161. Several respondents suggested that audit fees for unlisted companies had increased significantly because of reduced choice¹⁴⁰, whereby a smaller (and cheaper) audit firms stopped offering audit services to unlisted PIEs following the Regulations. However, as shown in Annex C, the coefficient on control variable BIG4 – a dummy variable which measures whether Big 4 audit fees are higher than non-Big 4 fees – was not statistically significant from zero for unlisted companies. This suggests that the observed cost increases did not stem from switching from non-Big 4 to Big 4 auditors, but from the additional regulatory burden.
162. The dramatic reductions in non-audit fees for both listed and unlisted companies are also noteworthy, as the 70% fee cap on non-audit fees only became fully effective in 2019. This result is therefore implicitly borne mainly from the restrictions on the provision of certain non-audit services, or an anticipatory effect.
163. Generally, whilst the results of the regression indicate the scale and direction of the effect of the Regulations on audit and non-audit fees, we do not believe that the entire relationship described by the model is driven solely by the Regulations. We expect the effect to be smaller than the model suggests, since factors that could potentially affect fees over time ('time effects') have not been controlled for in the model. We were unable to accurately model time appropriately, as adding time, either as an independent regressor or as a fixed effect dummy variable for individual years, interacted with our variable of interest and invalidated the model.
164. Moreover, we urge caution in drawing parallels between our findings and those of Willekens, Dekeyser and Simac. Due to slight differences in methodology, available data for the period covered by the reforms and data sources, our results are not directly comparable to those from their analysis, which ran separate regressions for non-financial and financial PIEs. For non-financial PIEs, their results show a modest increase of 3.15% in audit fees, and a 27.53% decrease in non-audit fees. Financial PIEs saw no statistically significant change in audit fees, and a 38.37% decrease in non-audit fees. However, we are unable to draw any parallels between our findings for listed and unlisted companies and these results, since their analysis did not assess this split.

Conclusions and recommendation

165. Our conclusion is that the Regulations should be **kept**. This is based on the following observations:
- The objectives of the Regulations are still highly relevant. This is evident by the following:
 - The Government remains committed to ensuring that the audit market delivers high quality audits, as shown by its recent White Paper: *Restoring trust in audit and corporate governance*, which proposed further measures to improve audit. The package of reforms are still under consideration, however, the evidence from this review will inform the final proposals.

¹⁴⁰ For example, see para 148 (from Representative Organisation Personnel).

- The concerns raised by three independent Reviews since the Regulations which recommended further improvements to audit regulation: and
- Continued interest in audit reform from the BEIS Committee of the House of Commons.
- We do not consider that the Regulations to have any relevance to the Public Sector Equality Duty (Annex F).
- The Regulations are being complied with.
- The Regulations represent progress towards higher levels of audit quality. The reasons for this are:
 - It is relatively early to evaluate some measures. For example, the retendering and rotation periods are 10 and 20 years respectively and the Regulations have only been in force for 5 years so there are tranches of companies that are only now being required to retender their audit contracts.
 - Ultimately, the effectiveness of the Regulations is likely to be dependent on the changes made within the FRC following the FRC Review, and further proposed changes to the statutory framework of the Regulator which are included in the reform package currently being consulted on.
 - There have been unintended consequences, in those measures to increase audit quality have come at the expense of auditor choice either because of mandatory rotation or because the added burden of auditing a PIE has reduced the number of auditors available. For this reason, the Government is consulting on reforms to try to increase supply side capacity to carry out the largest audits. We would then expect the effectiveness of the Regulations in promoting choice to increase.
- Respondents to the survey, particularly those that represent smaller companies, are concerned about compliance costs which many consider to be high and not matched by the benefits they receive. Findings from our econometric analysis shows that firms brought into the PIE definition by the regulation have faced higher audit fees.
- The rationale for the expansion of the PIE regime was that the previous regime did not include all companies that potentially represented a systemic risk, particularly to the financial system¹⁴¹. Whilst just under half of the respondents to our survey recognised that the benefits of the Regulations either outweighed or justified the costs, it is likely that firms do not recognise all the benefits of the Regulations as some do not accrue to them but accrue to wider society.

¹⁴¹ The types of business brought into scope of statutory audit by the Regulations included: issuers of transferable securities admitted to trading on a regulated market, markets in financial instruments Directive investment firms, undertakings for collective investment in transferable securities, alternative investment funds and payment institutions.

Plan for future evaluation

166. Regulation 24 of the Regulations sets out the statutory review obligation for these reforms, which requires a post-implementation review to be undertaken within every five-year interval following the Regulations initially coming into force. This section of this PIR sets out the plan for further evaluation.
167. Given we were unable to see the full effects of the following measures due to gestation periods and 10-year interval periods, we recommend that the next PIR gives greater focus to the effects of the non-audit service fee cap, and mandatory rotation and retendering. This is also because the effects of other measures such as the audit committee provisions, or the restriction of Big Four-only clauses are unlikely to see any dramatically new evidence or develop any other consequences by the time of the next review. Mandatory rotation and retendering, and the non-audit service provisions, were also the two most costly measures as assessed in the original IA.
168. Further analysis should also be undertaken to see how audit and non-audit fees evolve over the next five years to see whether costs are passed through and to identify the full effects of measures such as mandatory rotation and retendering and the 70% fee cap. It should also consider how conflicts of interest may have reduced as a result of a separation of functions.
169. Moreover, a concentrated effort to analyse the effect on investor confidence is also recommended. The Regulations made it an expressed rationale and objective to improve investor confidence in the value of audit, and in the accuracy of financial reporting. Insufficient numbers of investors responded to our survey, making it impossible to draw any meaningful conclusions on this matter. As a result, the next PIR should seek to close this evidence gap, to assess the Regulations' effect upon investors and consider how investor confidence in audit and the market effect of audit failures. To do this, a future evaluation should look to boost the sample size of investors in primary data collection.
170. Future reviews should consider whether the power in Article (1)31 of the Audit which allowed the regulator or 5% of the members of the company, to remove an auditor in specific circumstances has been used. It should also consider the impact of this measure on key stakeholders.
171. With the wider audit reform programme underway, we expect that any new regulations will impact the scope of future evaluations. The outcomes of the wider audit reform programme are also likely to affect the scope and findings of the next PIR, as measures such as the changes to the framework of the FRC are likely to be affected, given the FRC is planned to be abolished and replaced by a new independent regulator. As such, the next PIR should consider these changes appropriately.

Annex A: Comparison of UK implementation of the Audit Regulation and Directive with other EU Member States

The UK was among 12 of 28 Member States which had transposed all articles into national regulation by the June 2016 deadline when the Audit Regulation came into force and the Audit Directive should have been implemented¹⁴². The other Member States may have implemented some measures, but not completed full implementation. By January 2017, a further 8 Member States had finished implementing all articles, and by March 2018, 27 of the 28 Member States had transposed all articles into their respective national legislative statutes. All EU Member States had fully transposed all articles by July 2020.

Iceland and Norway were also subject to the audit reform measures, although they were given a later deadline to transpose all measures. Iceland had completed full implementation by January 2020, while as of July 2020, Norway was yet to have done so.

Member states varied in their implementation of the Audit Regulation and Directive. In the case of the UK, some measures were already in domestic legislation. For example, the measures related to listed companies reporting to the FCA and handover files required few substantive changes to UK legislation as this was already within our law. However, this was not the case for all member states, and therefore changes would have been required. The impact of EU exit also resulted in some differences in implementation across member states, with measures such as the increase in scope of the 2006 Directive to cover entities such as MFIDs not being carried forward in the UK following the EU referendum. Other Member States would have been required to enact such legislation.

The Audit Regulation and Directive also allowed EU Member States a degree of flexibility in meeting the specific requirements within the legislation. These were referred to as Member State options and allowed for minor variances in areas such as the duration of mandatory firm rotation periods. The Government decided to implement the minimum EU baseline for these pieces of EU legislation, other than the minor extension of the Audit Regulation's scope to auditors of non-PIE LLPs to ensure consistency across the audit framework.

The Audit Directive allowed Member States to modify the definition of a PIE, which determined the number of companies subject to the Audit Regulation. The UK followed the EU's definition of a PIE, along with 11 other Member States, while 16 others adopted different PIE definitions, subjecting more companies to the Audit Regulation. Table A1 below shows the variation in Member State implementation of the PIE definition.

Table A1: EEA countries' implementation of the PIE definition (excluding Liechtenstein)

PIE definition as per EU definition	PIE definition different from EU definition
Cyprus	Austria
Denmark	Belgium
Estonia	Bulgaria

¹⁴² <https://www.accountancyeurope.eu/publications/1606-new-audit-rules-state-play/>

PIE definition as per EU definition	PIE definition different from EU definition
Finland	Croatia
Germany	Czech Republic
Greece	France
Ireland	Hungary
Luxembourg	Iceland
Netherlands	Italy
Norway	Latvia
UK	Lithuania
	Malta
	Poland
	Portugal
	Romania
	Slovakia
	Slovenia
	Spain
	Sweden
Total: 11	Total: 19

Source: Accountancy Europe (July 2020)

Article 17 of the Audit Regulation gave Member States options related to the duration of audit engagements for PIEs, with regards to extending minimum and reducing maximum engagement lengths, and flexibility to extend the total duration to 20 years in the case of a public tendering (or 24 years in the case of a joint audit). Again, the UK implemented the EU baseline for implementation – a minimum engagement length of 1 year, a maximum engagement length of 10 years, which could be renewed once, and no joint audit extension. However, there was significant variation across Member States related to these options, which combined, resulted in 17 different mandatory audit firm rotation regimes across the EU. Table A2 below outlines the implementation of Article 17 of the Audit Regulation and its options for all 28 EU Member States.

Table A2: Member State implementation of mandatory audit firm rotation

Country	Minimum initial duration of engagement	Maximum initial duration of engagement	Tender extension (following initial engagement)	Joint audit extension
Austria	1	10	No ¹⁴³	No ¹⁴⁴
Belgium	3	9	9	15
Bulgaria	1	7	No	No ¹⁴⁵
Croatia	1	10	10	10 ¹⁴⁶
Cyprus	1	10 ¹⁴⁷	10 ¹⁴⁸	No ¹⁴⁹
Czech Republic	1	10	10	14
Denmark	1	10	10	14
Estonia	2	10	10	No
Finland	1	10	10	14
France	6	10	6	14 ¹⁵⁰
Germany	1	10	10 ¹⁵¹	14
Greece	1	10 ¹⁵²	10	No
Hungary	1	10 ¹⁵³	No	No
Ireland	1	10	No	No
Italy	9	9	No	No
Latvia	1	10	10	No

¹⁴³ Up to 10 years with tender extension for engagements appointed between 2003-2014.

¹⁴⁴ Up to 14 years with joint audit extension for engagements appointed between 2003-2014.

¹⁴⁵ Mandatory joint audit for financial companies.

¹⁴⁶ Mandatory under certain conditions.

¹⁴⁷ 9 years for banks.

¹⁴⁸ Not for banks.

¹⁴⁹ Not for banks.

¹⁵⁰ Mandatory.

¹⁵¹ Not for banks.

¹⁵² 5 years for SIFIs.

¹⁵³ 8 years for banks.

Country	Minimum initial duration of engagement	Maximum initial duration of engagement	Tender extension (following initial engagement)	Joint audit extension
Lithuania	2	10	No	No
Luxembourg	1	10	10	No
Malta	1	10	10	No
Netherlands	1	10	No	No
Poland	2	5	No	No
Portugal	2	8 or 9	1-2 ¹⁵⁴	No
Romania	1	10	10	No
Slovakia	2	10	10	No
Slovenia	3	10	No	No
Spain	3	10	No	4
Sweden	1 ¹⁵⁵	10	10 ¹⁵⁶	4
UK	1	10	10	No

Source: Accountancy Europe (Nov 2018)

Articles 4 and 5 of the Audit Regulation required the capping of non-audit fees and the prohibition of certain non-audit services, respectively, while allowing Member States the flexibility to apply more stringent caps than the baseline 70%, or prohibit more non-audit services than the ones listed in Article 5. There was less variation in the implementation of these articles; every country currently mandates the 70% cap, although Portugal had implemented a 30% cap up to February 2019, and few countries opted not to derogate tax and/or valuation.

The UK again implemented the EU baseline for the reforms, opting for the suggested 70% fee cap and derogation of tax and valuation. Initially, the UK adopted the baseline level of prohibitions – however in 2019, the FRC revised their Ethical Standards¹⁵⁷ to move to a ‘white-list’ approach to non-audit services, in response to the Big Four committing to the BEIS Select

¹⁵⁴ Extendable up to 10 years.

¹⁵⁵ Max 4 years.

¹⁵⁶ Not for banks.

¹⁵⁷ <https://www.frc.org.uk/getattachment/601c8b09-2c0a-4a6c-8080-30f63e50b4a2/Revised-Ethical-Standard-2019-With-Covers.pdf>, the new regulations are set out in section 5.

Committee that they would not offer non-audit services to PIEs unless they were closely linked to the audit. This change became effective on 15th March 2020.

Table A3 below outlines the implementation of Articles 4 and 5 of the Audit Regulation and its options for all 28 EU Member States.

Table A3: EEA countries' implementation of non-audit service regulations (excluding Liechtenstein)

Country	Additional prohibitions of NAS	Derogation of tax and/or valuation	Cap
Austria	No	Tax & Valuation	70%
Belgium	No	Tax & Valuation	70%
Bulgaria	No	Tax	70%
Croatia	No	Tax & Valuation	70%
Cyprus	No	Tax & Valuation	70%
Czech Republic	No	Tax & Valuation	70%
Denmark	No	Tax & Valuation	70%
Estonia	No	Tax & Valuation	70%
Finland	No	Tax & Valuation	70%
France	No	No	70%
Germany	No	Tax & Valuation	70%
Greece	No	Tax & Valuation	70%
Hungary	No	Tax & Valuation	70%
Iceland	No	Tax & Valuation	70%
Ireland	No	Tax & Valuation	70%
Italy	No	No	70%
Latvia	No	Tax & Valuation	70%
Lithuania	No	Tax	70%
Luxembourg	No	Tax & Valuation	70%
Malta	No	Tax & Valuation	70%

Country	Additional prohibitions of NAS	Derogation of tax and/or valuation	Cap
Netherlands	Yes (whitelist)	No	70%
Norway	No	Tax	70%
Poland	Yes (whitelist)	No	70%
Portugal	No	No	70%
Romania	No	Tax & Valuation	70%
Slovakia	No	Tax & Valuation	70%
Slovenia	No	No	70%
Spain	No	Tax & Valuation	70%
Sweden	No	Tax & Valuation	70%
UK	Yes (whitelist as of 2020)	Tax & Valuation	70%

Source: Accountancy Europe (July 2020)

Accountancy Europe's *Organisation of the Public Oversight of the Audit Profession*¹⁵⁸ report also shows that the UK and 21 other EU Member States already had regulatory authorities in place, six Member States had to establish public oversight bodies following the Audit Regulation and Directive.

The Audit Regulation and Directive extended the option for Member States' designated public oversight bodies to delegate certain activities to various professional bodies – although the regulator has ultimate responsibility for the oversight of any delegated activities. These activities include: the approval and registration of statutory auditors and audit firms (licensing); the adoption of relevant standards; continuing education; quality assurance systems (but only for non-PIE audits/auditors); and the investigative and administrative disciplinary system (although for PIE audits/auditors Member States were only provided with the option to delegate tasks related to sanctions and measures, and only to a body independent from the profession).

In the UK, the FRC is responsible for all the regulatory tasks, but has devolved a number of these to Regulatory Supervisory Bodies (RSBs) under its 2016 Delegation Agreements¹⁵⁹. This agreement also formalised that delegation would be done by the FRC rather than the BEIS Secretary of State. The following activities were delegated to the professional bodies:

In relation to firms and auditors which audit PIEs:

¹⁵⁸ https://www.accountancyeurope.eu/wp-content/uploads/200609_Organisation-of-the-Public-Oversight-of-the-Audit-Profession-2020-survey-update.pdf

¹⁵⁹ <https://www.frc.org.uk/auditors/professional-oversight/oversight-of-audit/delegation-agreements>

- Licensing
- Continuing education

In relation to firms and auditors which do not audit PIEs:

- Licensing¹⁶⁰
- Continuing education
- Monitoring and quality assurance
- Enforcement (unless referred to the FRC on public interest grounds)

The UK RSBs include:

- The Association of Chartered Certified Accountants (ACCA)
- Chartered Accountants Ireland (ICAI)
- The Institute of Chartered Accountants in England and Wales (ICAEW)
- The Institute of Chartered Accounts of Scotland (ICAS).

Table A4 below outlines the implementation of measures related to the statutory regulator of the Audit Regulation and Directive across the 28 Member States, as well as EEA countries Iceland and Norway.

¹⁶⁰ The Government is currently consulting on this through the White Paper:
<https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms>

Table A4: EEA countries' implementation of public oversight bodies and delegation of powers¹⁶¹ (excluding Liechtenstein)

Country	Name of public oversight body	Newly created?	Delegation of approval and registration		Delegation of standard adoption		Delegation of continuing education		Delegation of quality assurance systems		Delegation of disciplinary systems	
			For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs
Austria	APAB	Yes	Some	Some	Some	Some	Some	None	None	Some	Some	
Belgium	CSR-CTR	Yes	Yes, under supervision	Some	Some	Yes, under supervision	None	None	None	Some	Some	
Bulgaria	CPSOSA		None	Yes, adoption through law	None	Full	Full	None	Full	None	None	
Croatia	MoF		None	Full	Full	Some	Some	None	None	None	None	
Cyprus	CyPAOB	Yes	Full	None	None	Full	Full	None	Full	None	None	
Czech Republic	PAOB		Full	Full	Ful	Full	Full	None	Full	None	Full	
Denmark	DBA		None	None	None	None	None	None	None	None	Some	
Estonia	AAOB		None	None	None	Full	Full	None	None	None	None	

¹⁶¹ National public oversight bodies still have ultimate responsibility for the oversight of delegated activities.

Country	Name of public oversight body	Newly created?	Delegation of approval and registration		Delegation of standard adoption		Delegation of continuing education		Delegation of quality assurance systems		Delegation of disciplinary systems	
			For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs
Finland	AOU	Yes	None	None	Some	Some	Some	Some	None	None	Some	Some
France	H3C		Some	Full	Some	Some	Some	Some	None	Full	None	None
Germany	APAS	Yes	Full	Full	Full	Full	Full	Full	None	Full	None	Full
Greece	HAASOB		Some	Some	None	None	Some	Some	None	Some	None	None
Hungary	KKH		Full	Full	Full	Full	Full	Full	None	Full	None	Full
Iceland	AOB		None	None	n/a ¹⁶²		None	None	None	None	None	None
Ireland	IAASA		Full	Full	None	None	Full	Full	None	Full	Some	Some
Italy	RGS and CONSOB		None	None	Some	Some	Some	Some	None	None	None	None
Latvia	CCAPOU		Full	Full	Full	Full	Full	Full	None	Full	None	Full
Lithuania	AVNT		Full	Full	Some	Some	Full	Full	None	Full	None	None

¹⁶² Icelandic audits are performed according to the International Standards on Auditing (ISAs).

Country	Name of public oversight body	Newly created?	Delegation of approval and registration		Delegation of standard adoption		Delegation of continuing education		Delegation of quality assurance systems		Delegation of disciplinary systems	
			For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs
Luxembourg	CSSF		None	None	None	None	None	None	None	None	None	None
Malta	AB and GAU		None	None	Minister of Finance by regulator recommendation	Some	Some	None	None	None	None	None
Netherlands	AFM		None	None	Full	Full	Full	None	None	Some	Some	Some
Norway	FSAN		None	None	Full	None	None	None ¹⁶³	Full	None	None	None
Poland	KNA		Full	Full	Full	Full	Full	None	None	Some	Some	Full
Portugal	GMVM		Some	Some	Full	Full	Full	None	Full	Some	Some	Some
Romania	ASPAAS	Yes	None	None	Some	None	None	None	Some	Some	Some	Some
Slovakia	UDVA		None	None	None	Full	Full	None	Full	None	None	Some
Slovenia	ANR		None	None	None	None	None	None	None	None	None	None

¹⁶³ For audit firms of PIEs listed in the US, joint inspections made by FSAN and PCAOB (the US public oversight body).

Country	Name of public oversight body	Newly created?	Delegation of approval and registration		Delegation of standard adoption		Delegation of continuing education		Delegation of quality assurance systems		Delegation of disciplinary systems	
			For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs	For PIEs	For non-PIEs
Spain	ICAC		None	None	Some	Some	None	None	None	None	None	None
Sweden	SIA and RI		None	None	Some	Some	Some	Some	None	Some	None	None
UK	FRC		Full	Full	None	None	Full	Full	None	Full	None	Full

Source: Accountancy Europe (July 2020)

Annex B: Evidence Sources

Methodology

Evidence Review

The existing evidence was first collated to understand the current landscapes and existing evidence gaps. This included a review of the original IA, and the development of a logic model to allow us to identify the key analytical questions and where the current evidence was weaker.'

An extensive literature review was also performed, which looked at: the three major policy papers (the FRC Review, the CMA Study, the Brydon Review); the EU's own post-implementation review of the audit reform programme; the BEIS Committee's Future of Audit report; various FRC reports; as well as academic literature on topics such as mandatory rotation and non-audit services. This included papers such as Chi et al. (2011), Singer and Zhang (2018), Rickett et al. (2016), and more. References to all papers can be found in the footnotes of this PIR.

Primary Research: Stakeholder Survey

The evidence review highlighted the need for primary data collection to fill evidence gaps. As a result, the team developed a stakeholder survey. This survey was administered online (with an approximate duration of 15-20 minutes), and the full set of questions can be found in Annex D.

The survey was designed by BEIS, seeking feedback on content from other relevant organisations. The survey focused only on measures covered in this PIR and took a "broad approach" to questions avoid complexity for the respondents. However, it also gave respondents the opportunity to give open responses to elaborate on their answers and provide more complex/detailed feedback.

The aims of the survey were to get a general understanding of the impact of the Regulations and whether they met the policy objectives, namely, to improve audit quality, transparency, competition and reduce conflicts of interest. It also sought to understand whether stakeholders felt the costs of the Regulations were justified, and in some cases, whether the benefits justified the costs. The survey also looked to assess whether there were any unintended consequences as a result of the regulation.

The survey took a convenience and purposive sampling approach to gain access to the relevant respondent groups that were impacted by the regulatory changes. Although, there are limitations with this sampling approach (e.g., possibly lacking representativeness), the decision was taken that this was the most suitable approach considering the time constraints and wider contextual issues e.g., pressures on businesses/companies, organisations and firms in light of the pandemic. The data collection approach of an online survey was therefore the most suitable approach considering the context and the responding organisations.

The survey was emailed to 102 contacts, some of which forwarded on the survey link to relevant respondents within the organisation. The groups surveyed included audit firms, companies, individual investors, representative organisations, and other organisations with an interest in financial reporting. We also promoted the survey through publications e.g., the FRC newsletter, to reach as many stakeholders as possible.

The survey was launched on 2nd March 2021 and closed on the 19th March 2021.

We had an achieved sample of 62 responses to the survey at the time the survey closed. A breakdown of respondents by their role and organisation can be found below.

Figure B1: Chart showing number of respondents from different types of business/companies or organisations, (N=62)

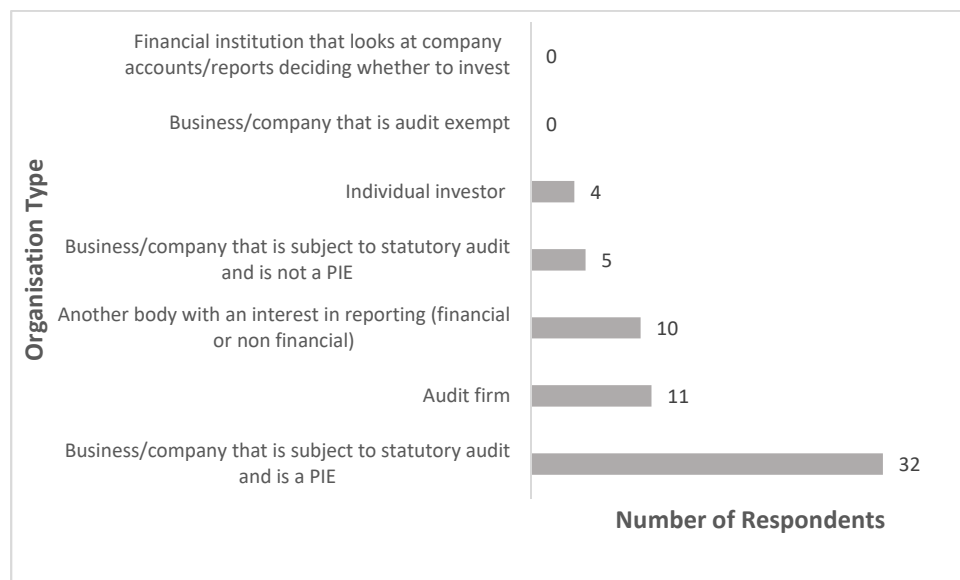


Table B1: Table showing the role types of the respondents, (N=58)

Role	Count
Company audit committee member	15
Company director or comparable in another form of business	12
Other	11
Company or other business personnel	7
Auditor - signing audit reports	5
Representative organisation personnel	4
Auditor - other	3
Non-audit services provider with an audit firm	1
Company shareholder	0
Senior manager or director at an investment institution	0
Investment analyst	0

The chart and table above show that most respondents are audit committee members or company directors (or equivalent) from PIEs, which means the responses are not representative of all stakeholders but will be skewed towards the views of companies. Therefore, the findings need to be viewed in light of this.

However, there are still other key stakeholder groups represented, and for some organisations or firms, one survey response represents the views of several individuals in the organisation (as some respondents canvassed views and submitted a group response).

Of the 11 respondents from audit firms, 8 were from Big Four audit firms and 3 were non-Big Four firms.

The base sizes may differ for each of the questions as respondents may have skipped certain questions, been routed out of the questions which were not applicable to them or may not have completed the survey.

Data Analysis

We carried out in-house primary research and analysis into the impact of the Regulations, using available data sources. These included FAME and Audit Analytics. Econometric modelling was utilised to review the change in audit fees, to examine the economic burden from compliance with the Regulations – this is expanded further in Annex C. This helped to inform judgements about whether the Regulations impacted audit fees, and business costs, to the extent originally expected.

Annex C: Cost-benefit analysis – methodology and results

Methodology

Using data taken from Audit Analytics and FAME, we used econometric modelling to estimate the impact of the Regulations' reforms on audit and non-audit fees. As costs may have been absorbed by audit firms (e.g. the CMA Study¹⁶⁴ suggested that audit firms have mostly absorbed the costs of auditor switching), this cannot demonstrate the entire impact on fees, but indicates the minimum economic impact on fees.

We focus on the **audit fees** paid by auditees to their auditor, as well as the **non-audit fees**, given that the Regulations imposed a 70% cap on the non-audit service fees that could be provided by a client's auditor.

Our data set covers the years from 2011 to 2019, due to gaps in company reporting data for 2020 and 2021. As the FRC's switch to the non-audit service 'white-list' only came into force in 2020, this will not affect our results.

We used a multivariate log-level OLS regression, using a methodology similar to the model from Willekens, Dekeyser and Simac's research paper *EU Statutory Audit Reform: Impact on Costs, Concentration and Competition* (2019)¹⁶⁵. This paper did a similar analysis of the effects of the audit reform programme, throughout the EU. Their methodology is backed up by other research papers such as Soltani and Rekik (2011)¹⁶⁶, which finds audit fees are affected by the presence of the Big 4, and company specific characteristics which include the auditee's size, complexity, and performance.

We estimated the following model:

$$\text{Dependent}_t = \alpha_0 + \alpha_1 \text{AFTERSATCAR}_t + \alpha_2 \text{ASSETS}_t + \alpha_3 \text{ROA}_t + \alpha_4 \text{LOSS}_t + \alpha_5 \text{ENDYEAR}_t + \alpha_6 \text{BIG4}_t + \alpha_7 \text{LEADER}_t + \alpha_8 \text{FIRSTYEAR}_t + \text{industry specific FE} + \varepsilon$$

With DEPENDENT:

FEE	The natural logarithm of the total audit fee paid by the auditee to their auditor.
NASFEE	The natural logarithm of the total non-audit fee paid by the auditee to their auditor.

The test and control variables are defined as follows:

AFTERSATCAR	Dummy variable equal to one if the fiscal year end was after 17 June 2016, zero otherwise. This is our variable of interest, which from its coefficient, we will be able to infer the percentage change in audit fees following the reforms, and thus the minimum cost of compliance and burden from SATCAR.
ASSETS	The natural logarithm of the auditee's total assets.
ROA	Net income divided by total assets of the auditee.

¹⁶⁴ CMA Study, para 3.90.

¹⁶⁵ [https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU\(2019\)631057_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2019/631057/IPOL_STU(2019)631057_EN.pdf)

¹⁶⁶ Soltani, B. and Rekik, C. (2011) *Factors affecting audit fees in Europe: France, Germany, and the UK*. Available at: <https://basepub.dauphine.fr/handle/123456789/8473>.

LOSS	Dummy variable equal to one if the company reports a loss (negative net income), zero otherwise.
ENDYEAR	Dummy variable equal to one if the auditee has a December 31 st fiscal year end, zero otherwise.
BIG4	Dummy variable equal to one if the auditor is one of the Big Four firms, zero otherwise.
LEADER	Dummy variable equal to one if the auditor is the largest audit firm by total fee income in the UK, as recorded in the FRC's annual <i>Key Facts and Trends in the Accountancy Profession</i> reports ¹⁶⁷ , and zero otherwise. According to these reports, PwC was the industry leader every year from 2011-9.
FIRSTYEAR	Dummy variable equal to one if the auditor is in their first year of tenure with the client, zero otherwise.
Industry-specific FE	Variable to account for any industry level fixed effects, based on SIC main codes/sectors.

We used a log-level regression to control for potential outliers and exponential growth.

In comparison to Willekens, Dekeyser and Simac's study, we were unable to run their DEBT variable due to data constraints. We do not see this as an issue as this was found to be statistically insignificant in their study, and data constraints meant they had to drop this variable for one sample also. We also excluded the JOINT variable as joint audits are uncommon in the UK.

Ideally, we would have liked to run another control variable to account for a company's complexity, such as the number of overseas subsidiaries. Unfortunately, we were unable to do so due to data constraints.

We had also hoped to run further separate regressions to determine the isolated effect on the financial and non-financial sectors, companies audited by Big 4 and those audited by challengers, etc., however the limited sample size meant that we were unable to.

We conducted separate regressions for listed companies and unlisted companies for the following reasons:

- The data sources available have several limitations. Audit Analytics has the most robust data on audit and non-audit fees, but is only available for listed companies. Therefore, for unlisted companies, we used data from the Fame database. As there were two data sources involved, we ran separate regressions to ensure that potential differences between the data sources did not affect or bias our findings.
- The Regulations affected listed and unlisted companies in different ways – unlisted companies had more new measures imposed on them by the Regulations. Therefore, separate regressions would allow us to conduct a more robust assessment of the impact of the Regulations on each affected group.

¹⁶⁷ <https://www.frc.org.uk/auditors/professional-oversight/key-facts-and-trends-in-the-accountancy-profession>

Data from Audit Analytics was given in EUR values. To convert this into GBP, we used the Bank of England's annualised average spot exchange rates¹⁶⁸.

All data was also adjusted for inflation using the GDP deflator¹⁶⁹, and converted into 2011 real prices.

The listed company sample was created by examining FTSE 350 company indexes. As we were unable to find such lists from prior to 2018, staff at BoardEx compiled a report containing the list of FTSE 350 companies which traded each year from 2011-2017. Companies were cross-checked to find if they appeared on this report for every year in the report, as well as in the FTSE 350 index in every quarter from 2018-9. Those which were found to appear in every year from 2011-2019 was used as our sample of listed companies; there were 102 companies in this sample which reported audit fee data, and 74 which reported non-audit fee data.

The unlisted company sample was created by examining a list of unlisted PIEs for 2020¹⁷⁰. Since we were unable to procure similar lists going back annually to 2011, we formed our sample by randomly selecting from this 2020 list of unlisted PIEs. This is because unlisted PIEs are generally made of unlisted banks, building societies and insurers, which are often long-standing companies not prone to significant churn.

Issues and caveats

Our sample sizes for our regressions were as follows:

On audit fees:

- 102 FTSE350 companies
- 110 unlisted companies (around a quarter of all unlisted companies)

On non-audit fees:

- 74 FTSE350 companies
- 36 unlisted companies

We recognise that our sample sizes are small, however, this was, unfortunately, unavoidable. On audit fees, we believe that this is still a fairly representative sample. On non-audit fees, however, we recognise that these sample sizes are very limited and thus are much less likely to be robust. Nevertheless, we believe the results still provide a good indication for how fees changed following the reforms.

We were hoping to use Audit Analytics data for audit and non-audit fees for both listed and unlisted PIEs, but this was not possible for unlisted PIEs. For unlisted PIEs, we used data from FAME, which uses data provided to Companies House. While FAME data is generally accurate, it is not as robust a source of audit data as Audit Analytics, which is a specialised product. Therefore, we recognise that there may be issues with the fee data for unlisted PIEs.

Our non-audit fee regressions only include companies that reported their non-audit fees every year from 2011-9. They therefore do not include firms which simply stopped purchasing non-

¹⁶⁸<https://www.bankofengland.co.uk/boeapps/database/index.asp?first=yes&SectionRequired=I&HideNums=-1&ExtraInfo=true&Travel=Nlx>

¹⁶⁹ <https://www.gov.uk/government/collections/gdp-deflators-at-market-prices-and-money-gdp>

¹⁷⁰ Based on the FRC's PIE population estimate of 1,945 UK PIEs from February 2020

audit services entirely, which we recognise could influence the results. This would suggest that there is an upward bias on the coefficients on non-audit fees, and that the real coefficient is lower than the model suggests.

Generally, we expect the effect of the Regulations to be smaller than the model suggests, since factors that could potentially affect fees over time ('time effects') have not been controlled for in the model. We were unable to accurately model time appropriately, as adding time, either as an independent regressor or as a fixed effect dummy variable for individual years, interacted with our variable of interest and invalidated the model.

Results

FTSE350 COMPANIES	DEPENDENT = AUDIT FEE				DEPENDENT = NON-AUDIT FEE			
	coefficient		t-stat	p-value	coefficient	σ	t-stat	p-value
AFTERSATCAR	-0.015		-0.336	0.737	-0.637	***	-8.157	0.000
ASSETS	0.769	***	34.877	0.000	0.658	***	18.745	0.000
ROA	0.006		1.568	0.117	0.017	**	2.917	0.004
LOSS	0.268	**	2.990	0.003	0.256		1.616	0.107
ENDYEAR	0.170	**	2.830	0.005	0.849	***	7.397	0.000
BIG4	0.089		0.544	0.587	-0.358		-0.588	0.557
LEADER	-0.070		-1.355	0.176	0.086		0.936	0.350
FIRSTYEAR	-0.089		-1.070	0.285	-0.174		-1.177	0.240
Industry fixed effects	Included				Included			
N	102				74			
Adjusted R²	0.880				0.759			

Significance codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.'

UNLISTED COMPANIES	DEPENDENT = AUDIT FEE				DEPENDENT = NON-AUDIT FEE			
	coefficient		t-stat	p-value	coefficient	σ	t-stat	p-value
AFTERSATCAR	0.276	***	5.585	0.000	-0.417	**	-3.107	0.002
ASSETS	0.444	***	37.341	0.000	0.582	***	18.625	0.000
ROA	-0.009	*	-2.111	0.035	-0.018		-0.753	0.452
LOSS	0.140	*	2.369	0.018	0.161		1.054	0.293
ENDYEAR	0.249	***	3.517	0.000	0.050		0.235	0.814
BIG4	-0.036		-0.449	0.654	0.514	*	2.263	0.024
LEADER	-0.058		-0.998	0.319	-0.373	*	-2.015	0.045
FIRSTYEAR	-0.113		-1.188	0.235	0.330		1.132	0.259
Industry fixed effects	Included				Included			
N	110				36			
Adjusted R²	0.708				0.672			

Significance codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.'

Annex D: Questionnaire - Stakeholder survey

This annex sets out the complete list of questions and answers asked to survey respondents. Not all questions were asked to respondents, as some questions were relevant to only to certain types of respondents (e.g. investors).

Q1. What type of organisation are you responding on behalf of, or do you represent?

Q2. Please select one of the options below which best describes your role in the organisation?

Q3. Is your organisation one of the "Big-4"?

Q4. Please could you provide some details about your business e.g. size, sector etc.

Q5. As a representative organisation, please could you provide some details about those your organisation represents e.g. size, sector etc.

On extending the scope of the Regulations to banks, building societies and insurers that do not issue securities on a regulated market

Q6a. How far do you agree or disagree that extending the scope of the measures affecting PIEs in the EU Regulation and the amending Directive to cover banks, building societies and insurers that do not issue securities on a regulated market...

Gave me more confidence in unlisted PIEs' audits

Created additional burdens for little benefit

Q6b. How far do you agree or disagree that extending the scope of the measures in the amending Directive affecting non-PIEs to LLPs...?

Gave me more confidence in LLPs' audits

Created additional burden for little benefit

Q7. How would you describe the benefits of this measure against the costs?

Mandatory rotation and retendering

Q8a. How far do you agree or disagree that this measure has...

Resulted in more opportunity for audit firms to compete to provide audit services for PIEs

Created more choice for PIEs and shareholders between Big 4 and non-Big 4 auditors

Created more choice for PIEs and shareholders between Big 4 auditors

Q8b. How far do you agree or disagree that this measure has...

Increased auditor scepticism by periodically bringing in a new audit firm

Improved audit quality as a result of improving competition

Resulted in more competitive audit pricing

Q9. In your own words, how would you describe the impact mandatory rotation and retendering has had on non-Big 4 audit firms?

Q10. Which statement best applies when considering the periods of repeated reappointment before retendering?

10 years is too long before retendering

10 years is not long enough for an audit firm before retendering

10 years is about right

Don't know

Prefer not to say

Q11. Which statement best applies when considering the periods of repeated reappointment before rotating?

20 years is too long before rotating the audit firm

20 years is not long enough for audit firm to hold a contract before rotation

20 years is about right to rotate audit firm

Don't know

Prefer not to say

Prohibition of Big-Four only clauses

Q12. How far do you agree or disagree that this measure has...

Increased audit firm participation beyond Big-4 and competition

Created more choice between Big-4 and non-Big 4 auditors

Increased costs for firms

Decreased costs for firms

Increased quality through more choice in the market

Q13. Has this measure enabled greater participation in the audit market?

Q14a. In your experience, has this measure had any unintended consequences?

Q14b. In your own words, please describe these unintended consequences.

Restriction on provision of non-audit services and prohibition of certain non-audit services

Q15. In your opinion, how much did this measure, if at all, reduce conflicts of interest within audit firms?

Q16. How far do you agree or disagree that...

This measure has improved stakeholder confidence in audit because perceived conflicts of interest were more clearly addressed

The restriction on non-audit services has driven up audit fees

Audit committees and additional auditor report to the committee

Q17. How far do you agree or disagree that this measure...

Improved audit quality and independence through greater scrutiny of the process by audit committees

Improved quality of financial information in the accounts and reports

Increased costs for PIEs

Q18. How far do you agree or disagree that the additional report...

Provided greater transparency on the audit process

Increased the accountability of audit firms, improving their scrutiny of accounting records and processes

Increased costs for audit firms

Q19a. Has this measure increased or decreased the amount of time spent at your firm on audit committee activities?

Q19b. Could you provide an indication of how much time (in hours) has either increased or decreased annually as a result of these measures.

Q20. How would you describe the benefits of the regulation against the costs?

Change to the regulatory framework of the FRC

Q21. How far do you agree or disagree that this measure has...

Increased confidence in the UK regulatory framework

Increased costs due to increased inspections of auditors of PIEs that previously could be delegated by FRC

Increased costs through use of new powers of obtaining 3rd party information

Improved overall audit quality

Q22. How would you say this measure, if at all, has impacted your confidence to make investment decisions based on audited accounting information?

Summary

Q23a. Thinking of all the measures that you have considered so far, as a package, to what extent have they...

Improved confidence in the quality of financial information

Improved confidence in the quality of auditor reporting

Increased professional scepticism of auditors

Reduced the risk of misstatement/error in audited accounts

Led to higher standards of auditor independence

Q23b. Thinking of all the measures that you have considered so far, as a package, to what extent do...

The benefits of enhanced, wider regulation outweigh the costs of compliance

The costs of compliance outweigh the benefits of enhanced, wider regulation

The benefits justify the costs

Don't know

Prefer not to say

Q24. Is there anything else you would like to mention?

Annex E: Summary of Expected Costs of the Regulations (taken from the IA)

Subject Matter	One-off cost £m	One-off cost £m	One-off cost £m	One-off cost £m	One-off cost £m	Ongoing cost £m	Ongoing cost £m	Ongoing cost £m	Ongoing cost £m
	Lower bound estimate	Best estimate	Higher bound estimate	Lower bound estimate	Higher bound estimate	Lower bound estimate	Best estimate	Lower bound estimate	Higher bound estimate
Conditions for Carrying out Statutory Audit									
Ethical Standards - Audit fees	13.76	26.59	39.42						
Ethical Standards - Professional Ethics				Unquantified	Unquantified	Unquantified	Unquantified	Unquantified	Unquantified
Audit Reporting - Additional Report to The Audit Committee				2.33	2.91	3.50			
Appointment of Audit Committee	3.79	4.80	5.82	11.72	16.15	21.13			
Scope of Audit Committee				6.73	6.99	7.25			
Regulatory Reporting and Information - Report to Supervisors of PIEs					Negligible				
Regulatory Reporting and Information - Retaining and Disclosing Information				2.08	2.60	3.12			
Appointment of Statutory Auditors or Audit Firms									

Subject Matter	One-off cost		One-off cost		Ongoing cost		Ongoing cost	
	£m	Lower bound estimate	£m	Higher bound estimate	£m	Lower bound estimate	£m	Higher bound estimate
Appointment Requirements - Duration of Engagement				41.66		45.02		48.38
Dismissal or Resignation of Auditor		Negligible				Negligible		
Educational Qualifications, Professional Competence and Continuing Professional Development		Negligible				Negligible		
Surveillance of Activities of the Statutory Auditors and Audit Firms Carrying Out Statutory Audit								
Competent Authorities - Designation and Delegation of Tasks within UK				0.41		0.51		0.61
Competent Authorities - Powers						Negligible		
Familiarisation and Implementation costs								
Costs to auditor and audited entities	94.55	118.62	142.63					

Subject Matter	One-off cost		One-off cost		One-off cost		Ongoing cost		Ongoing cost		Ongoing cost	
	£m	Lower bound estimate	£m	Best estimate	£m	Higher bound estimate	£m	Lower bound estimate	£m	Best estimate	£m	Higher bound estimate
Total Costs of Audit Regulation and Directive	112.10		150.02		187.87		64.92		74.18		83.99	
Total Costs from the Audit Regulation	78.87		108.28		137.65		46.07		50.53		55.00	
Total Costs from the Audit Directive	33.23		41.74		50.22		18.85		23.65		29.00	

Annex F: Public Sector Equality Duty Assessment

Scope

This document records the analysis undertaken by the Department for Business, Energy and Industrial Strategy (BEIS) to fulfil the requirements of the Public Sector Equality Duty (“the equality duty”) as set out in section 149 of the Equality Act 2010. This requires the department to pay due regard to the need to:

- i. eliminate unlawful discrimination, harassment and victimisation and other conduct prohibited by the Act.
- ii. advance equality of opportunity between people who share a protected characteristic and those who do not.
- iii. foster good relations between people who share a protected characteristic and those who do not.

The protected characteristics which should be considered are:

- age
- disability
- gender reassignment
- marriage or civil partnership¹⁷¹
- pregnancy and maternity
- race
- religion or belief
- sex
- sexual orientation.

Outline

This report is a Post Implementation Review (PIR) of the Statutory Auditors and Third Country Auditors Regulation 2016, The Statutory Auditors and Third Country Auditors Regulations 2017 and the Statutory Auditors Regulations 2017. These regulations were introduced to implement the EU Directive and Regulation (“Regulations”) as part of a package to improve audit quality and build confidence in the audit process.

Following the financial crisis of 2008, there was a widespread perception that the accounts of many financial institutions had been given unjustifiably clean bills of health which had misled investors and regulators, undermined business confidence in, and the operation of the wider financial system, and contributed to the eventual recession. This led to measures to re-establish investor confidence in the audit process and in the quality of financial information reported by companies.

¹⁷¹In relation to the protected characteristic of marriage and civil partnerships the Department is required to have due regard only to point (i).

This PIR found that there has been progress towards achieving the Regulations' objectives. The regulations were a step towards the goal of higher audit quality. The effectiveness of the regulations will depend on improvements currently being made to the regulator, through the Government's proposals on audit reform. Less progress has been achieved on increasing auditor choice (which was an unintended consequence of the regulations) as challenger firms are not considered to provide the same breadth of audit services as Big-4 firms. For this reason, the Government is consulting on reforms to try to increase capacity and experience of non-Big 4 audit firms.

The findings assessed in this Equalities Impact Assessment seek to address the findings of the review. The regulations assessed as part of the PIR and this review apply to companies, auditors or audit firms, the audit regulator, and shareholders (who are expected to passively accrue any associated benefits).

Following discussions with the relevant colleagues, we do not consider that the regulations to have any relevance to PSED. Therefore, we do not consider it necessary or proportionate to gather equality data for this assessment.

PSED Considerations

We have considered the potential and likely impacts of the regulations on the three aims of the PSED.

Our findings are provided below.

Aim 1 – Eliminate unlawful discrimination, harassment, victimisation, and any other conduct prohibited by the 2010 Act.

Does your policy or service disadvantage some people or groups more than others?

The regulations assessed here are not expected to treat any individuals or groups more favourably (or unfavourably) than others, nor is it expected to result in any differential impact on groups or individuals with protected characteristics. We also do not expect them to have impacted people with protected characteristics as a result of them possessing those characteristics, or any unintended impact on any of those groups.

Whilst affected entities (audit firms and the companies they audit) will employ individuals who have protected characteristics, the measures would have impacted on the entire firm or company and not on any specific individual or groups therein. We therefore expect the actual impact on employees to be the same regardless of their individual characteristics.

Where specific actions, arising as a result of the regulations assessed here, might have affected individuals, such as in the case of measures related to company directors, it will be on the basis of their conduct and not their individual characteristics. Where shareholders were affected, we expect the impact to be positive, and to apply to shareholders equally, without regard to their individual characteristics.

Aim 1 Assessment

Protected Characteristic	Expected Impact
Disability	None
Race	None
Age	None
Gender reassignment	None
Religion or belief	None
Pregnancy & Maternity	None
Sexual orientation	None
Sex	None
*Marriage & Civil Partnership	None

Aim 2 – Advance equality of opportunity between people who share a particular protected characteristic and people who do not share it.

Will our actions deliver a less good outcome for any groups compared to others?

Given that measures mainly affected directors, auditors, shareholders and audit firms, and the audit regulator on the basis of their conduct and performance, we do not expect any disproportionate adverse impact on any individuals or groups who hold one or more protected characteristics.

Is there evidence that particular groups are less involved in this policy area and is this linked to a protected characteristic?

We have not undertaken any formal consultation specifically to investigate whether particular groups are less involved in the policy areas covered by these Regulations, since there are no practical limitations, based on protected characteristics, to involvement in any of the activities therein. Whilst there may be some existing inequalities in this area, the measures introduced under these regulations were not expected to change any aspect of how individuals or groups with protected characteristics engage, and the individuals and groups that are already active in these policy areas are not expected to change as a result of how measures may interact with their protected characteristics. Measures to effect the changes that would address existing inequalities in this policy area are beyond the scope of the regulations assessed here.

Aim 2 Assessment

Protected Characteristic	Expected Impact
Disability	None
Race	None
Age	None
Gender reassignment	None
Religion or belief	None
Pregnancy & Maternity	None
Sexual orientation	None
Sex	None

Aim 3 – Foster good relations between people who share a particular protected characteristic and people who do not share it.

How is the policy going to be received by people who do not benefit from it?

The entire UK population is expected to benefit in some way or another from measures introduced under these regulations. The purpose of these regulations was to enhance audit quality and increase investor confidence which would have wider benefits to society through greater financial stability across the UK economy, and increased economic growth potential, improving the UK's reputation and position as a world-leading place to do business is strengthened. These wider benefits will apply to everyone in the UK, regardless of whether they have one or more protected characteristics.

Will our actions help to tackle prejudice and promote understanding between different groups – can we take positive action in respect of the three aims of PSED?

The regulations were not intended to directly encourage actions to tackle prejudice or promote understanding between different groups.

Additionally, we do not expect any of the measures in the PIR to have hindered any action to tackle prejudice or promote understanding between different groups or give rise to, or create an increased risk of, discrimination, harassment, victimisation or any other conduct prohibited by or under the Equality Act 2010.

Aim 3 Assessment

Protected Characteristic	Expected Impact
Disability	None or small
Race	None or small
Age	None or small
Gender reassignment	None or small
Religion or belief	None or small
Pregnancy & Maternity	None or small
Sexual orientation	None or small
Sex	None or small

Conclusion

We conclude that these regulations would have had no adverse or disproportionate negative impact on persons or groups with a protected characteristic, and no steps need to be taken to advance equality of opportunity and foster good relations because of, or in relation to, them.

The measures under these regulations are not expected to give rise to discrimination, harassment, victimisation, or any other conduct prohibited by or under the Equality Act 2010. Further, they did not make specific or direct provision in respect of any of the protected characteristics, and they were not expected to result in outcomes where people who share particular protected characteristics are treated differently from people who do not. They were not expected to give rise to a direct or indirect impact on individuals as a result of any protected characteristic they may have.

On this basis, we do not consider it is necessary or proportionate to seek further evidence to support this assessment, or to recommend any changes to our existing plans.

Approach to monitoring

The Department does not intend to monitor the outcomes of these proposals in relation to the PSED specifically.