FRC announces Principles for Operational Separation of audit practices

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On 6 July 2020 the Financial reporting Council (FRC) announced the road map for the Big 4 Accountancy firms to achieve operational separation for their audit practices by 30 June 2024.

There is to be no hiving off of audit practices, but the objective of the operational separation is said to be a world leading approach focussed above all on delivery of high quality audits in the public interest. The FRC list four desired outcomes:-

- Audit practice governance prioritises audit quality and protects auditors from influences from the rest of the firm that could divert their focus away from audit quality;
- The total amount of profits distributed to the partners in the audit practice does not persistently exceed the contribution to profits of the audit practice;
- The culture of the audit practice prioritises high-quality audit by encouraging ethical behaviour, openness, teamwork, challenge and professional scepticism/judgement; and
- Auditors act in the public interest and work for the benefit of shareholders of audited entities and wider society.

This announcement flows from the three Government Reviews - the Kingman Review, the Competition & Markets Authority Update Paper and the Brydon Review - all published from 2018. These Reviews stem from concern over high profile corporate collapses following the credit crunch and include more recent corporate failures such as Carillion and BHS.

There is no suggestion that the Reviews' various recommendations are being deferred to the new regulator, a proposal suggested by Kingman which is to be known as the Audit, Reporting and Governance Authority (ARGA). Instead the FRC confirm they are pressing ahead with the broad suite of reform measures on corporate reporting and audit reform arising from those Reviews.

The Big 4 have to submit implementation plans by 23 October 2023. It is evident from their public announcements that this is something the firms have been working on for a while and so should be well prepared to agree their transition with the FRC.

The details of this plan are yet to be worked out, and it remains to be seen how significant this specific proposal proves to be in terms of its impact on audit standards. Being seen to be independent is of course very important, and the public find it hard to believe that the independence of an audit partner is not impacted by the potential for his/her firm to earn large fees for non-audit services. However, in our experience, this supposed conflict which exists for a firm which provides both audit and non-audit services to their client is often impressionistic rather than real. In truth, the real conflict for every audit partner lies not in maximising non-audit fees, but rather in ensuring the audit client is happy with the service provided, ensuring the cost of that service is acceptable to the client and at the same time approaching the information provided by management with the necessary professional scepticism. This proposal does not address this.

It's also noteworthy that the FRC's current focus on the Big Four firms raises questions about what the knock-on effects might be on others, including those encouraged to be 'challenger' firms. Neither does it directly deal with the cost of audit services generally. The FRC's announcement and its commitment to reform are part of a wider dialogue about the role of audit in modern corporate life and future editions of the Accountancy Newsletter will be following developments closely.

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