

## What is Operational Separation?

### The Background to Operational Separation

Following the disorderly failures of several high-profile companies in the 2010s, the UK Government commissioned independent reviews into various aspects of the UK audit and corporate governance framework. These included:

- The 2018 Kingman Review<sup>1</sup>, a ‘root and branch’ review of the Financial Reporting Council (FRC), a regulator for the UK’s auditors, accountants and actuaries.
- A 2019 Competition and Markets Authority (CMA) market study<sup>2</sup>, which aimed to investigate competition in the UK audit sector and whether the sector was resilient enough to maintain high quality standards.
- The 2019 Brydon Review<sup>3</sup>, an independent assessment of the scope and quality of UK audit, including how audit should be developed to serve the public interest.

Many of the recommendations from these reviews were adopted by the Government in its 2022 paper, ‘Restoring Trust in Audit and Corporate Governance’<sup>4</sup>, and were intended to be introduced through legislation.

However, in January 2026, the Government announced<sup>5</sup> it was no longer proceeding with plans to introduce an audit and corporate governance Bill, leaving many of the policy proposals in limbo.

Since this announcement, CPIA has been looking at recommendations made by the three independent reviews which *have* been introduced through non-statutory means. One of the most notable developments has been the implementation, by the FRC and the largest audit firms, of the ‘Operational Separation’ of firms’ audit practices from the rest of their service lines. Feedback from firms and their Audit Non-Executive directors (ANEs) to CPIA has been that ‘Operational Separation’ has played an important role in driving change in audit firm governance and culture, and has been one of a number of measures that have contributed to improvements in UK audit quality over the last decade.

This paper outlines the concept and underlying principles of operational separation, the journey taken by firms to implement it, and the overall impact on the market since its introduction.

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<sup>1</sup> [Independent Review of the Financial Reporting Council](#), Sir John Kingman, December 2018

<sup>2</sup> [Statutory Audit Services Market Study](#), Competition & Markets Authority, April 2019

<sup>3</sup> [Assess, Assure and Inform – Improving Audit Quality & Effectiveness, Report of the Independent Review into the Quality & Effectiveness of Audit](#), Sir Donald Brydon, December 2019

<sup>4</sup> [Restoring Trust in Audit & Corporate Governance, Government Response to the Consultation on Strengthening the UK’s Audit, Corporate Reporting, and Corporate Governance Systems](#), Department for Business, Energy and Industrial Strategy, May 2022

<sup>5</sup> [Letter](#) from Blair McDougall MP, Minister for Small Businesses & Economic Transformation, to the Rt Hon Liam Byrne MP, Chair, Business & Trade Committee

## The CMA's Recommendation

The CMA's 2019 criticisms of the audit market included concerns regarding auditor independence from the entities they audited, a high concentration of audits among the Big Four (Deloitte, EY, KPMG and PwC), and audits 'being carried out by firms whose main business is not in audit.' These alternative business or service lines could, for example, include tax, legal, or strategic consultancy.

To address this last criticism, the CMA proposed requiring the Big Four to 'put in place a strong strategic and operational split between their audit and non-audit services practices, including separate governance and strategy, separate accounts and remuneration policies, and no profit-sharing between audit and non-audit.' The CMA said that this would 'ensure auditors' full focus is on conducting high quality audits, without their incentives being affected by the much greater revenue and profits from the non-audit side of the firm.'

In 2022, the Government said that it would legislate to give the proposed new audit regulator – intended to be known as the Audit, Reporting and Governance Authority (ARGA) – the power to design and deliver operational separation, and to create a reserve power that would enable it to enforce a full 'structural separation' of audit firms' audit and non-audit businesses. In the event, plans to establish ARGA have been abandoned and the Government has dropped plans to introduce reserve powers on structural separation. Operational separation has been effectively implemented by the Big Four and the FRC on a voluntary basis, without any requirement for Government intervention or legislation.

## What is Operational Separation?

Operational separation was designed to allow firms' audit practices to stand alone from other service lines, with distinct leadership, governance, and financial statements, and with prohibitions on cross-subsidisation and profit sharing. This approach differs to a full 'structural separation' in that audit and non-audit partners continue to work alongside each other under the same brand and with access to the same corporate infrastructure – the audit practice would be 'ring-fenced' within the wider firm. One of the arguments in favour of operational separation over structural separation was that it would allow audit practices to have ready access to the non-audit skills and expertise – on tax or strategy, for example – that are needed to deliver a high-quality audit, while still addressing the concerns around cross firm incentives.

Following on from the CMA's recommendations, the FRC published its principles for operational separation in July 2020<sup>6</sup>. The key aspects of these principles are set out below.

**Governance:** Firms should form an Audit Board (chaired by, and with a majority membership of, independent ANEs) responsible for providing independent oversight of the audit practice.

**Scope of the separate audit practice:** Audit practices should provide statutory audit services alongside some permitted audit-related and non-audit services to Public Interest Entities (PIEs). Partners and staff should spend the majority of their time on work in the audit practice, with revenues from audit work to make up at least 75% of the revenue of the audit practice.

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<sup>6</sup> [FRC Principles for Operational Separation of Audit Practices – Objectives, Outcomes and Regulation](#), Financial Reporting Council, July 2020

Financial: Transactions between the audit practice and the rest of the firm should be conducted and priced on an arm's length basis, and profit distribution between audit partners must reflect their overall contribution to the firm's profits – with 'no material, structural cross subsidy persisting in either direction.'

Remuneration: Policies should be designed around rewarding high quality work, with no incentives for sales passed to other parts of the firm.

Transparency: Firms should publish information about the governance of their audit practice and produce a separate profit and loss account.

### **Firms' Implementation of Operational Separation**

The Big Four submitted their implementation plans to the FRC by October 2020, with each firm completing the voluntary transition to operationally separated audit practices by late 2024<sup>7</sup>. Alongside significant new investment and adoption of new quality standards, operational separation has been a key feature of the UK's largest audit firms' drive towards improved audit quality since the mid-2010s. Notably, a small number of firms outside the Big Four have also adopted some of the principles of operational separation, particularly around governance.

In line with the principles set out by the FRC, the Big Four have restructured their businesses to separate their audit and non-audit functions, establish distinct governance frameworks, and implement operational and financial boundaries. While firms within the Big Four have adopted different approaches to operational separation (all of which embody and embrace in full the opportunity to deliver the principles as established by the FRC, tailored to their unique firm structure), there have been common challenges which firms have reported – in conversation with CPIA and others – as having needed to be resolved or considered. These challenges included:

- Firms needed to understand and interpret the correct scope of work to be included within the ring-fenced audit business and to evaluate the roles played by wide range of specialists – such as tax and valuation specialists – used regularly within the delivery of audits.
- Firms had to make a determination of an appropriate arm's length price to charge firm specialists supporting audits from outside the audit practice, and to establish appropriate pricing mechanisms for services provided across different service lines. Prior to operational separation, firms were not required to have formalised transfer pricing for using non-audit specialists on an audit<sup>8</sup>. Speaking to CPIA, firms have described this process, as well as the decision on which specialists should sit within the audit ring fence, as requiring most time and consideration when implementing operational separation – and that getting these decisions right was the key to making a successful implementation.

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<sup>7</sup> [Big Four Audit Firms Conclude Transition Period of Operational Separation](#), Financial Reporting Council Press Release, October 2024

<sup>8</sup> [In Conversation: Big Four Audit Firms Conclude Transition Period of Operational Separation](#), Financial Reporting Council Podcast, October 2024

- The definition of ‘material, structural cross-subsidy’ required careful consideration, with firms needing to assess the impact of, for example, exceptional losses in the audit practice, regulatory fines linked to whole firm – rather than audit – revenues, or exceptional gains across the wider firm.
- Some firms had expressed concern that separating the audit business from all other lines of service could potentially have isolated talent progression and career paths, hindering lateral moves and restricting the breadth of experience available to individuals.
- Identifying and recruiting the required ANEs posed a potential talent issue: with all four firms recruiting candidates for these roles simultaneously, there was concern around the availability of high-quality non-executives able to meet the necessary independence requirements<sup>9</sup>.
- Firms needed to implement new audit governance models in existing structures and with consideration to their overlay with firms’ European and Global governance<sup>10</sup>.

### **Firm & Audit Non-Executive Feedback on Operational Separation**

Operational separation has now been in full effect at the Big Four for over eighteen months. To understand its impact and to assess key lessons, CPIA has spoken to representatives of the Big Four and other firms, and sought views from the Audit Non-Executives (ANEs) who joined the audit practices’ new majority-independent boards. The key points from these discussions are outlined below.

#### Approach

- Firms have welcomed the FRC’s principles-based approach to implementing operational separation, as this has allowed them to adjust final structures and governance to their different sizes and circumstances – a ‘one-size-fits-all’ approach has been avoided.

#### Governance

- ANE feedback has been that the new governance structures of the operationally separated audit practices have created a governance framework with sole focus on audit outputs which had not existed previously. This focus has, in turn, helped drive improvements in firm culture.
- ANE oversight of audit partner remuneration and progression has been welcomed by firms.
- While firms have highlighted the value of independent challenge and oversight that ANEs have brought to audit practices, some ANEs themselves have noted their ability to challenge and influence should not be overstated: the executive leadership of the audit practices retain significant responsibility for culture and governance – and audit quality.

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<sup>9</sup> [In Conversation: Big Four Audit Firms Conclude Transition Period of Operational Separation](#), Financial Reporting Council Podcast, October 2024

<sup>10</sup> [In Conversation: Big Four Audit Firms Conclude Transition Period of Operational Separation](#), Financial Reporting Council Podcast, October 2024

## Finances

- ANEs have drawn particular attention to the greater transparency around the financial performance of audit practices as a result of operational separation; this added transparency has shown that the delivery of high quality audits is a viable business model. Indeed, ANEs have pointed out that, in some cases, audit practices are out-performing the non-audit parts of their firms.

## Audit Quality

- ANEs and firms have been clear that operational separation is one of a number of factors that have helped improve audit quality, including additional investment in quality programmes and the adoption of new Standards of Quality Management.
- The decision to implement ‘operational’ rather than a ‘structural’ separation has enabled firms to retain reasonably ready access to the non-audit specialists whose expertise is required to deliver high-quality audits. Conflict risks have also been managed through separate, stringent prohibitions for PIE audits – though it is worth noting that these prohibitions are being highlighted by firms in conversation with CPIA as causing frustration among PIEs facing higher costs and disruption when they are unable to use their auditor for assurance services which are related to their audit but fall outside the non-audit services fee cap.
- The FRC’s own evaluation of firms’ feedback has been that operational separation has supported firms in establishing specific audit behaviours, including the importance of challenge (both internally and externally), professional scepticism, and a strong commitment to the public interest<sup>11</sup>.

## Talent

- Although highlighted as a concern at the outset of firms’ implementation of operational separation, the feedback from firms has been that issues around talent progression or siloed career paths have not materialised, or have been successfully managed.
- Concerns around talent were raised again by ANEs in a late-2025 CPIA roundtable, but more recent feedback from the firms themselves is that the talent they need is still available to their audit practices. When discussing talent concerns with firm partners, operational separation has not been raised with CPIA – by contrast, AI and the impact of regulatory enforcement have been much more likely to be brought up as having an impact on the attractiveness of audit as a profession.

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<sup>11</sup> [In Conversation: Big Four Audit Firms Conclude Transition Period of Operational Separation](#), Financial Reporting Council Podcast, October 2024

### Impact Outside the Big Four

- While operational separation has only been required of the Big Four, firms outside this group have opted to apply some principles voluntarily, particularly around governance, and have described their decision to do so as driven by best practice. Some firms outside the Big Four have, for example, set up audit boards which include ANEs, with feedback on these ANEs' impact being similar to that reported by the Big Four.

### **Where Next for Operational Separation?**

CPIA's conversations with firms and ANEs have highlighted a number of questions about the future direction of operational separation and how the concept may need to adapt over time.

### Cost

- Feedback from the Big Four has been that the implementation of operational separation has had significant associated financial costs, including the establishment of new corporate structures and governance; even the costs of recruiting high-quality ANEs has been highlighted by firms.
- Given the costs involved, firms have expressed doubts over the extent to which full operational separation is possible for firms at the smaller end of the market. Any extension of the operational separation requirements to other firms may need a proportional approach by the FRC.

### Focusing on Audit Quality

- While the principles-based approach to implementing operational separation has been praised by firms (as noted above), there are elements within these principles where a more prescriptive approach is adopted – for example, that the audit practice must generate at least 75% of its revenue from statutory audit or audit-related services (with the rest coming from permitted services allowed by the Ethical Standard).
- ANEs expressed the view that this ratio must be kept under review by the FRC as business models and the nature of audit evolve – the 75% requirement is, after all, set at an arbitrary level and, per ANEs, it's important that the FRC's and firms' focus remains on the bigger picture of what operational separation is achieving. For example, considerations around culture, investment in audit quality, and partner incentive structures may be of more importance to audit's stakeholders than a commitment to a particular revenue ratio.
- ANEs felt that operational separation must always be assessed against whether it is supporting firms in delivering high-quality audits in the public interest. This includes ensuring audit practices have the capabilities to deliver high-quality audits, whether in terms of their access to investment or access to non-audit specialists.

### The Future of Assurance

- The audit profession and the world in which it operates are not static, and it's important that operational separation supports firms as they continue to innovate and seek to deliver high-quality audits. As highlighted above, ANEs have been clear that the focus of operational separation should be on whether it is helping deliver on audit quality rather than on the specifics of how this is achieved.
- Among the key challenges cited by firms in conversation with CPIA have been the growing expectations placed on auditors in relation to sustainability assurance and the rapid developments in AI – both in terms of its deployment by auditors, and in terms of how auditors audit companies using AI. Both these issues will ask questions of the existing operational separation model: how, for example, should firms treat the sustainability assurance work they may be asked to perform in relation to the 75% revenue ratio? And how will operational separation affect the investment in, and the deployment of, AI tools by audit practices?

### An International Blueprint

- The UK experience has shown that operational separation can have a positive impact on audit practice culture and audit quality. While there has been some interest from overseas regulators in the UK approach, operational separation has not been adopted widely elsewhere. There is an opportunity for the FRC and the UK profession to promote operational separation internationally and reinforce the UK's position as a leader on audit quality.

### **Has Operational Separation Been a Success?**

Operational separation was introduced to ensure the UK's largest audit firms focused on delivering high quality audits and to ensure incentives were divorced from the interests of their non-audit services. Feedback from firms and ANEs suggests that, on these terms, operational separation has been successful, playing a part in shifting cultures within audit practices and prioritising audit in a way that it had not been before. At the same time, operational separation as a policy choice – as opposed to structural separation – has allowed audit practices to maintain access to the non-audit services they need to deliver high quality audits.

However, operational separation was not introduced in isolation, and it is difficult to assess which changes in audit quality and culture are purely attributable to the policy. There are some aspects of operational separation that have a clear linkage to quality – largely through strengthening of governance and the introduction of governing boards and appointment of independent Non-Executives. The ringfencing of the audit business is not such a simple correlation, and needs ongoing careful consideration to ensure that we are not creating artificial barriers to skills transfer across a firm, so long as there is the appropriate governing oversight at the top.

Alongside operational separation, there have been changes to the FRC's approach to PIE audit firm supervision and enforcement, the adoption of the International Standard on Quality Management (ISQM) UK 1, significant investments in dedicated quality programmes such as 'in-flight' reviews, and there have been revisions to the Audit Firm Governance Code (AFGC).

As noted above, ANEs' influence should not be overstated and it is important to recognise the commitment among audit partners themselves to driving changes in quality and culture within their practices – though, of course, the emphasis on the link between remuneration and audit quality, introduced by operational separation, may also play a role here.

The combined impact of these changes can be seen, for example, in the CPIA's 2025 Audit Trust Index (ATI)<sup>12</sup>, which found confidence in the independence and objectivity of auditors – and audit quality – to be at very high levels across key stakeholder groups, including investors, finance directors and audit committee chairs. Similarly, the FRC's annual reviews of audit quality<sup>13</sup> have shown improvements in audit quality at the Big four and other Tier-1 firms over the last five years.

Indeed, the progress made on audit quality by audit firms and the FRC has underlined the value of tackling policy challenges through a number of coordinated policy responses.

It remains disappointing, therefore, that the Government has opted to not proceed with the long-awaited audit and corporate governance Bill that would have sought to tackle wider issues in the UK's corporate governance and audit landscape through a comprehensive legislative package.

Operational separation has been fully implemented for just over eighteen months – this review is by no means the final word on its impact, and it will be important to re-assess the policy again in future. It is also important that operational separation itself continues to evolve.

As ANEs and firms have noted, it is vital that a focus is maintained on delivering high-quality audits in the public interest: operational separation is a means to an end, rather than an end in itself.

As such, if the operational separation of 2024 is preventing the delivery of high-quality audits in the public interest in 2029, adjustments to the operational separation framework and requirements will need to be made.

The world around the audit profession will continue to evolve – whether developments in AI, or changes in the nature of corporate reporting, or mandatory assurance – and it is important that the frameworks that guide audit firms' operation continue to evolve too.

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<sup>12</sup> [Audit Trust Index 2025](#), Centre for Public Interest Audit, November 2025

<sup>13</sup> [Annual Review of Audit Quality 2025](#), Financial Reporting Council, July 2025